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For What It's Worth

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Greetings Everyone

Happy Summer! Hope you are beating the heat. In this issue of For What It's Worth, we have a mix of articles.

In the first article, "When 'Fair Value' is Not The Standard of Value in State Shareholder Disputes", we learn that marital dissolution matters aren't the only area where one needs to pay attention to the standard of value. The second article, "Idaho Considers Distinctions Between Personal and Enterprise Goodwill", shows that Idaho has a similar practice to Colorado in the treatment of goodwill. Finally, we have included an article that discusses the valuation of goodwill in Medical Practices. "Three New Cases Examine Valuation of Goodwill in Medical Practices" presents three cases where the main issue was the valuation of goodwill. The final two articles discuss the personal vs. enterprise goodwill distinction and cases in two jurisdictions that take different approaches to the issue.

I hope all of you are doing well. Please email us at lvnews@cbiz.com if you would like additional copies of our newsletter, would like to receive it by email, or would like to opt out of receiving it. And, as always, give us a call if you would like to get to know us: we'll buy lunch.

Kind regards,

Eric Six, CPA/ABV

When 'Fair Value' is Not The Standard of Value in State Shareholder Disputes

Kim v. The Grover C. Coors Trust, 2007 Colo. App. LEXIS 394 (March 8, 2007)

This Colorado Court of Appeals case is a good reminder that the standard of value should be among

the first points of discussion between analysts and attorneys in any litigation involving shareholder disputes.

Shareholder alleges unfair transaction

In 1999 to 2000, a packaging company owed \$525 million for a prior acquisition. It intended to fund the short-term debt by selling a paperboard mill—but when that deal fell through, the company needed a quick infusion of cash. It decided to sell 1 million shares of convertible preferred stock for \$100 million to a trust for which at least two of the company's directors served as trustees.

The company formed a special committee of independent directors to evaluate the transaction. The committee obtained a fairness opinion from an investment bank, indicating that the stock sale was financially fair; after several meetings, it approved the sale. A minority shareholder sued the directors, among others, for breach of fiduciary duty in approving and executing the allegedly unfair transaction.

Fairness has a broad, fact-based definition

The shareholder claimed that by "sitting on both sides of the transaction," the company's directors had manipulated it sufficiently to dilute the value and voting rights of the minority shareholders. According to local law and statute (Colorado's version of the Model Business Corporation Act (MBCA)), the directors needed to prove the fairness of the transaction. And because the Colorado statute so closely resembles the original MBCA (as in many states), the Court looked to the Act's official comments for further definition of "fair," finding that these comments gave the term a "special, flexible meaning and wide embrace."

As many state courts have also concluded, the Colorado court found that the fairness of the transaction turned on its facts and circumstances; in particular, whether there had been earmarks of an arms'-length transaction, including the company receiving "full value." The plaintiff/shareholder urged the adoption

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of Delaware's "entire fairness" test, which focuses on process and price, but the Court found no "functional difference" between that test and the approach under local law, which requires reviewing the transaction "as a whole."

Best price at best value includes discounts

Applying this standard, the Court found that the shareholder had failed to provide evidence that a better price was available. By contrast, the company presented testimony that there was no public market for the convertible preferred stock and no third-party buyer; even if there were, the purchaser wouldn't have offered better terms. Likewise, the shareholder lost the arguments that the transaction lacked sufficient disclosure, independence, good faith, or price concessions.

As to the fairness of the transaction's value, the shareholder claimed that the company's expert incorrectly applied a discount, citing a Colorado case that excluded minority discounts in "dissenters' rights actions" in all but extraordinary circumstances, because the MBCA's "fair value" provisions precluded the application of marketability or minority discounts.

"However, this case is not a dissenters' rights action," the Court said. "It involves the question of whether a transaction was fair, not the 'fair value' of dissenters' shares." It was therefore proper to discount the stock value by 15% to 20% for lack of marketability, which made the \$100 million sale price fair.

Idaho Considers Distinction Between Personal and Enterprise Goodwill

Stewart v. Stewart, 2007 Ida. LEXIS 17 (January 26, 2007)

In a case of first impression, the Idaho Supreme Court recently considered whether to distinguish enterprise goodwill (divisible marital property) from personal goodwill (non-marital, non-divisible) in a divorce proceeding. Currently, a majority of U.S. state courts have adopted this distinction. Colorado is not with the majority in making a distinction between enterprise and professional goodwill. Colorado combines the two together.

In the *Stewart* case, the husband, a dermatologist, owned a 45% share in a dermatology clinic. When the parties divorced, the trial court valued the tangible

assets of the practice at just over \$130,000, with an additional \$211,000 of "professional" goodwill, separate and above what might be ascribed to the husband's individual talents and skill. As prior law held that goodwill was an appropriate factor in determining the value of a *business*, the court deemed this component of the clinic to be marital property and divided it between the parties.

The husband appealed, arguing that goodwill was not an appropriate factor to consider in valuing a professional practice. The state Supreme Court disagreed, finding "no principled reason to treat the goodwill of a business differently when it is a professional services corporation."

But "where a professional business is an independent entity...goodwill is calculable and divisible in divorce just as goodwill in any other business." Because the dermatology practice was just such an entity, the trial court was capable of distinguishing its "identity" from the husband's, and to the extent the practice had goodwill value beyond the husband's individual attributes, "that goodwill is community property."

As with professional attributes, the concurrence went on to say, personal attributes—including knowledge, background, and talent—are not in themselves community property. But personal attributes can enhance the value of a business, including a professional practice, thus *creating* value that is community property.

Three New Cases Examine Valuation of Goodwill in Medical Practices

Keane v. Lowcountry Pediatrics, 2007 S.C. App. LEXIS 6 (January 29, 2007); Bunkers v. Bunkers, 2007 Ohio App. LEXIS 523 (February 9, 2007); Nowzaradan v. Nowzaradan, 2007 Tex. App. LEXIS 1021 (February 8, 2007)

Goodwill valuation continues to cause legal headaches, as three recent cases dissect the issue, all in the context of medical practices. The first considers applying the rule regarding valuing goodwill in marital dissolutions to partnership dissolutions. The second questions the distinction between enterprise and personal goodwill in divorce. The last confirms that when both valuation experts follow state law regarding goodwill valuation, they help create a solid court record, resistant to appeal.

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Should goodwill be included in partnership dissolutions?

In *Keane*, a group of five South Carolina physicians couldn't agree how to split up their professional association. At a shareholders meeting, the three senior physicians voted to exclude an individual physician's goodwill from any appraisal, while, predictably, the two junior physicians voted to include goodwill.

Having won the vote, the senior shareholders offered to buy out the juniors based on an appraisal valuing their stockholder equity at \$69,000, excluding goodwill. But unable to resolve their differences, the senior doctors finally changed the locks on the practice, changed its name, and distributed the tangible assets to the juniors, including their pro rata share of accounts receivable and rents.

The junior physicians sued for judicial dissolution, obtaining an expert appraisal of the partnership at \$1.3 million, including tangible and fixed assets of approximately \$443,000 and individual physician goodwill of \$918,000. The trial court adopted this valuation, awarding the junior doctors their interests in the intangibles without further distribution, as they'd already received their share of the tangibles.

The senior physicians appealed, arguing that the trial court should have excluded goodwill. In a case of first impression, the South Carolina appeals court agreed, applying the standard in divorce and also conversion cases. Individual goodwill "attached solely to the professional, not to the association," and is not transferable or divisible. The trial testimony by the junior physicians' expert supported this decision, as he included the physicians' reputations in his goodwill value. If the senior doctors were to depart, "a large portion of the intangible value would go away," he conceded, and "that value would be hard to arrive at" because it was more speculative than scientific.

Partners in a professional association could still include personal goodwill in buy-sell or other contracts, the Court noted, but as these shareholders evidenced no such agreement, the junior physicians received no further award.

Ohio considers joining the majority view

The majority of U.S. jurisdictions now distinguish enterprise from personal goodwill in divorce actions. Family law practitioners can expect more cases to challenge the standard in the minority states, as the *Bunkers* case attests.

The husband owned a solo orthodontic practice, valued by his expert using the capitalization of earnings approach, using the past five years of earnings. (The opinion doesn't state the ultimate conclusion of value.) The wife's expert posited a fair market value standard and used only the most recent year's earnings to reach a value of over \$2 million. The trial court adopted the wife's valuation standard but used the husband's five-year capitalization of earnings, adjusting the husband's income downward and applying a 10% "marketability discount" (which really reflected transactions costs upon sale). The court also applied a 42.41% pre-tax rate of return to the weighted average and concluded that the practice had a fair market value of just over \$1 million.

The husband appealed, claiming that the value impermissibly included personal goodwill and urged the court to adopt the majority rule. But the Ohio Court of Appeals declined, relying on "thorough" precedent determining that all goodwill of a solo practitioner was subject to equitable division in divorce. The court rejected the argument that "goodwill is synonymous with future earnings" (where the court also awards spousal support); or that by valuing it, a court is improperly valuing a medical degree.

Texas stays true

The *Nowzaradan* case reads more like an episode of *Dallas*, involving a doctor-husband who filed a bad faith bankruptcy on the fourth day of his divorce trial. He obstructed the judicial process by withholding financial documents and failing to comply with court orders, creating havoc as well as heartburn. But just like a TV drama, at trial the bad guy lost: The court awarded the wife 70% of the marital estate, while the doctor received 30%—little more than the value of his surgery clinic.

On appeal, the husband contended that the valuation erroneously included professional goodwill. Although his expert had valued the clinic at \$240,000 and the wife's expert at \$1.2 million (income approach) and \$550,000 (asset approach), the wide divergence was due more to the husband's many failures to comply with discovery. Both experts applied accepted methodologies and the appropriate state standard, distinguishing the clinic's commercial goodwill from any personal goodwill. Both experts had also assigned a specific value to personal goodwill and excluded it from their ultimate conclusions. The trial court reconciled the opinions by valuing the practice at \$850,000. The appeals court affirmed both the decision and the good work by the appraisers in what appeared to be a very difficult case.

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