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Divorce Roundup: Court Can't Just 'Split the Difference'

A roundup of recent divorce cases reveals key practice points on the qualification of experts, the relevance of industry evidence, the credibility of client-provided data, and more:

1. *Tax and accounting expertise may not be enough.* In ***Davidson v. Davidson*, 2011 WL 3476827 (Mich. App.)(Aug. 9, 2011)(unpub.)**, the husband hired an accountant with 30 years' experience to value his interest in a fast food franchise. The purported expert had also been trained in real estate appraisal and performed four to six informal business valuations per year for clients who wanted to know "what their business was worth." At the same time, he admitted that his expertise lay in tax matters rather than business valuation, and that he'd never been qualified as an expert in BV. Moreover, he'd taken accounting classes, but had never finished college and offered no CV. Given the "vague" presentation of credentials and qualifications, the trial court excluded the expert under the state's analogue to Rule 702 and adopted the income approach valuation offered by the wife's BV expert, and the husband appealed.

Held: the appellate court affirmed, finding that the trial court did not abuse its discretion in excluding the husband's expert, and, moreover, it did not err by discrediting testimony from the husband's franchiser, who offered only a liquidation value for the franchise interest. By contrast, the wife's BV expert considered all of the franchise's assets and based her valuation on three years of tax returns.

2. *Always verify client-provided financial information.* In ***Campbell v. Campbell*, 2011 WL 3444240 (Va. App.) (Aug. 9, 2011)(unpub.)**, the primary issues were the classification of the husband's sawmill as separate or marital property and its appreciation during the marriage. The wife's expert characterized the entire business as marital property due to the commingling of funds used to purchase and/or replace its assets and valued it at $5.37 million. The husband's expert said the business was actually worth $5.7 million, but classified roughly $2.5 million of this value as active appreciation and thus separate property. The trial court discredited the husband's expert, however, finding that he relied largely on a schedule of assets for the business provided by the husband, whose memory regarding their value was unreliable. Further, the husband's expert did not allocate the business's assets according to how and when they were acquired and with what funds. The trial court adopted the $5.37 value by the wife's expert and the husband appealed.

> **"Always verify client-provided financial information."**

Held: The appellate court affirmed, finding that the trial court did not err by discrediting the husband's expert when he relied on a list of fixed assets provided by the husband that "*estimated* the realizable value" of each asset (emphasis by the court) and failed to account for the commingling of assets with marital funds.

3. *Trial court can't just 'split the difference.'* In ***Vanzant v. Vanzant*, 2011 WL 3558151 (Fla. App. 1 Dist.)(Aug. 15, 2011)**, the husband's expert valued his liquor store business at $265,000. The wife did not offer expert testimony; however, both

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she and her mother testified that they overheard the husband say that the business was worth $600,000, based on having received a purchase offer in that amount. The trial court valued the business at $425,000 and the husband appealed.

Held: The appellate court found the trial court failed to explain how it arrived at its valuation and the record did not contain sufficient evidence supporting the valuation. "It appears that the trial court simply 'split the difference' between the values presented by the parties," the court held, and "this was error."

4. *Industry evidence can provide basis for substantial discount.* In ***In re Marriage of Erpelding*, 2011 WL 3480978 (Iowa App.)(Aug. 10, 2011)**, the parties owned and operated two hog confinement facilities. Their joint expert valued the land and facilities at approximately $1.42 million, but then the husband's industry expert testified that 1) the industry was suffering "heavy losses," with no improvement in sight; and, 2) with the industry in trouble, producers were not renewing their contracts with facilities' owners. Based on this evidence, the trial court adopted the $1.42 million appraisal but then discounted the value of one facility by 10%, because its production contract would expire in a year; and discounted the second facility by 5%, because its contract would expire in seven years. Both parties appealed, the wife claiming that the trial court undervalued the business and the husband arguing that it should have accounted for certain tax considerations such as depreciation and embedded liabilities.

Held: The appellate court affirmed. The trial court implicitly credited the industry expert's testimony regarding the state of the industry and made "reasonable reductions in value." Further, although the business's depreciation might very well affect its taxable income, it did not affect its fair market value. Secondly, the applicable state statute requires a court to consider tax consequences only when the sale of an asset is "ordered, necessary, or otherwise relatively certain," and there was no evidence in this case that the husband "even contemplated a sale" of the facilities.

5. *Error in valuating only underlying property in family LLC.* ***Elliott v. Elliott*, 2011 WL 3889181 (Mass. App. Ct.)(Sept. 6, 2011)**

The couple in this case didn't own many assets and were substantially in debt when they divorced in 2009. However, the husband did own a 25% interest in a family limited liability company (FLC), which held the parents' vacation property on Martha's Vineyard, valued at $6.4 million.

The trial court found that even after the parents passed away, the husband's ability to make any significant money from the FLC was speculative. Nevertheless, the court also found that requiring the wife to wait for any future disbursements from the FLC meant that she would effectively receive little or nothing from the husband's interest. As a result, the trial court ordered a present distribution, requiring the husband to pay the wife over $360,000 as her share of his 25% interest in the FLC, and the husband appealed.

"Use of Business Reference Guide upheld in valuing PT practice."

Held: The trial court had no evidence of "the value of the husband's minority interest in a limited liability corporation, owning and managing real estate, with very significant restrictions," the appellate court observed. This paucity of evidence left the trial court "at a significant disadvantage." As a result, the appellate court vacated the order and resubmitted the case for a hearing on the value of the husband's LLC interest.

6. *'One size fits all' rejected for valuing stock options.* In ***Farmer v. Farmer*, 2011 WL 3929114 (Wash.)(Sept. 8, 2011)**, the Washington Supreme Court considered a wife's measure of "damages" after her husband fraudulently exercised her share of stock options awarded in divorce. During the parties' 2006 divorce, the couple agreed to divide the non-transferable stock options equally, with the husband retaining possession but the wife having the right to choose when to exercise her share. However, approximately one month after filing the agreement with the court (but before entry of a decree), the husband unilaterally cashed in all the options, netting nearly $450,000 after taxes. The wife immediately moved the court to re-open the decree and submitted an affidavit from a CPA, whose analysis of the husband's company stock over the prior 10 years revealed an annual

rate of return of just over 20%. By assuming this constant rate of return and that the wife would hold each of her options until the very last day before expiration, the expert calculated her losses at just over $617,000, which the court awarded her.

Held: The court of appeals confirmed the trial court decision, and upon the husband's appeal to the state Supreme Court rejected the husband's "proposal for a single, categorical rule for measuring the value of stock options when the stock price increases after conversion," the six-member majority wrote. The divorce precedent did not mandate such a "one size fits all" rule.

7. *Use of Business Reference Guide upheld in valuing PT practice.* ***In re Marriage of Bauer*, 2011 WL 4337093 (Cal. App. 4 Dist.)(Sept. 16, 2011)(unpub.)**

In this divorce, the parties first retained a joint forensic expert, who valued the husband's physical therapy (PT) practice between $450,000 and $547,000. He also attached to his report a copy of the *Business Reference Guide: The Essential Guide to Pricing a Business*, which states that, as a rule of thumb, a multiplier of .60 to 1.00 of annual collected fees may be an appropriate multiplier to determine the value of a physical therapy practice. The joint expert believed that a lower multiplier of .42 applied to the husband's practice, which equated to approximately 5 months of practice income. The wife's expert, meanwhile, said the firm merited a multiple of 1.0 because of its historic growth rates, good location, and well-established business. Further, a multiple of 1.0 would still be in the "mid-range" for this particular business. After hearing all the evidence, the trial court accepted the *BRG's* general rule of thumb method, explaining that, in this case, the practice was in a good location, was well-known in the medical community with a broad referral base, and had an established core of experienced employees, but it adopted the 1.0 multiple used by the wife's expert. It also looked at the firm's gross profits for the prior four years, ranging from $885,000 to $1.08 million, and used the average to value the firm at $1.05 million. On appeal, the husband challenged the trial court's reliance on the BRG on four grounds: 1) lack of foundation for the author's expertise; 2) lack of evidence that the joint expert included the guide's method in his appraisal or that the court understood it; 3) lack of support that the BRG method was "reasonable"; and, 4) the guide did not take into account the same negative factors that the joint expert cited in support for a lower multiplier.

Held: The appellate court rejected all these reasons. The trial court used a "legitimate method of evaluation," it held. The *Business Reference Guide* was part of the report submitted by the joint expert, an "undisputed expert" whose testimony provided foundation for the guide's method.

US and international valuation standards continue to merge

Business valuation standards have been more "harmonized" internationally than the standards in other professions—law for instance. And, the effort to push for complete harmonization got a big push recently from the international group responsible for professional standards.

Recently, this Private Sector Taskforce of Regulated Professions and Industries released its final report to G-20 deputies. The report responds to the G-20's request for the International Valuation Standards Council (IVSC), the member of the taskforce that reviews business valuation methods, to analyze the gaps in regulatory convergence.

To close the gaps across financial professions and industries, the taskforce's report recommends that the G-20:

- Maintain its momentum and ambition for global regulatory reform and convergence;
- Discourage unilateral national regulatory reforms that are inconsistent with international standards; and
- Support the development, adoption, and implementation of one set of globally accepted high-quality international standards for each of financial reporting, auditing, valuations, and actuarial services.

This convergence trend will make it easier for businesses with cross-border compliance and other valuation needs. "The IVSC fully supports

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the analysis and recommendations of the Private Sector Taskforce," said Michel Prada, chair of the IVSC board of trustees, in a press release. Significantly, the same release also announced that the IVSC had just signed a memorandum of understanding with the International Private Equity Valuations (IPEV) board. As part of their proposed cooperation, the two bodies plan to prepare and publish technical guidance and methodology for international PE and also venture capital valuations.

Courts appoint their own experts to deal with valuation

It's not unusual for a federal court to appoint a technical expert as an independent advisor pursuant to Rule 706 of the Federal Rules of Evidence. But now, in two high-pressure and high-profile legal settings, judges have taken the unusual step of appointing a 706 expert to testify specifically on valuation—in one case, to calculate damages directly for the jury.

Last month, in the closely watched Oracle v. Google litigation, when Judge William Alsup couldn't convince the parties to select (and pay for) an independent expert, he went ahead and appointed an economics professor to calculate damages—plus a lawyer to represent him. "Far from complicating the jury's decision on damages," the judge wrote, in defending his decision, "the testimony of a 706 expert would assist the jury by providing a neutral explanation and viewpoint," particularly when—as in this case—"both sides have taken such extreme and unreasonable positions regarding damages." Patent litigators are concerned, however, that the case will turn into a "one witness trial," as one recent blog reports. Plus—if the jury is aware of the appointment, the 706 expert's testimony could carry a "powerful stamp of court approval and objectivity."

Objectivity may be precisely the goal of appointing a 706 expert—and time will tell whether Alsup's move was an aberration (and an attempt to force settlement) or an expanding trend. In federal bankruptcy cases, for instance, the judges are increasingly troubled by the "gangs of bankruptcy debt buyers" whose "abusive tactics" threaten to embroil the cases in valuation disputes and potentially erode the Chapter 11 process, says a bankruptcy blog. At least one bankruptcy judge "has taken some unprecedented and unique actions to combat the problem of valuation wars," and one of these weapons, "appointing valuation experts to cases, can be used across the nation."

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