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Valuing Goodwill in Divorce: Communication and Consistency are Critical

Two recent divorce decisions demonstrate how important communication among the client, counsel, and financial expert(s) can be in any given case, especially when the primary asset is a professional practice. Calculating a credible goodwill value requires the expert to have adequate disclosures, accurate data, and a complete understanding of appropriate methodologies.

Husband's expert gets a surprise at trial. In re Marriage of Theurer, 2009 WL 3823648 (Cal. App.) (Nov. 17, 2009)(unpublished) considered a well-established orthodontist with 14 people on staff, all the latest technology, and up to 150 patients per day. The practice grossed $2.6 million, earning the husband $1.3 million before tax. Notably, he averaged 921 new patients per year—more than three times the average.

At trial, the wife's expert used the excess earnings approach, estimating the husband's reasonable compensation at $500,000, a goodwill value of $2.5 million and an overall practice value of $3.0 million. Similarly, the husband's first expert used the earnings approach, but applied a lower cap rate and higher compensation ($776,000) to reach a goodwill value of approximately $990,000, plus tangible assets. He then deducted patient prepays as a liability (over $1.1 million), for a final practice value of only $126,905.

The husband's second expert was a broker; he said the excess earning approach was not normally used to value professional practice goodwill. Instead, he used two industry rules of thumb, a multiplier of net income and a multiplier of gross revenues, to reach a value between $1.3 and $1.5 million. He did not deduct patient prepays, and though new patient starts were important, he said, he had not received this information from the husband. (The court opinion does not explain why.) On learning that the husband received 866 new starts that year, the expert was "visibly shaken," saying that would make a buyer "clap his hands."

The trial court found that the husband's two experts effectively impeached each other, on the use of an appropriate methodology and patient prepays. The second expert also lost credibility when he showed such evident surprise on the stand. The court accepted the wife's expert value, reducing the cap rate to reflect the practice's "substantial" dependence on the husband's skills. This led to a goodwill value of $1.9 million, or roughly midway between the three experts' numbers—and the husband appealed.

"There is no absolute rule specifying how goodwill of a particular practice should be valued and any reliable method is acceptable if warranted by the facts," the appellate court held, stating the broad rule, applicable in most jurisdictions. Indeed, the excess earnings approach, discredited by the husband's second expert but utilized by his first (and the wife's expert), "is a method that is commonly used to determine the value of goodwill in a professional practice." In this case, the evidence amply supported the trial court's determination, especially given the lack of consistency, information, and agreement among the husband's two experts.

Good use of rebuttal expert. Compare Helfer v. Helfer, Inc., 2009 WL 3644001(W. Va.)(Sept. 9, 2009), in which the husband also retained two experts to value his solo chiropractic firm, using the first as a primary witness and the second only in rebuttal. The first used a straight excess earnings and cost approach, to value the practice at $41,000, excluding any goodwill.

In contrast, the wife's expert used the same approach to value the practice at $388,000, finding "some" practice goodwill, including the value of its location, facilities, telephone numbers, patient lists, and other data. However, he also acknowledged that clients and revenues had recently fallen and failed to assign a specific dollar amount to the practice goodwill.

Interestingly, the husband's rebuttal witness criticized the excess earnings method, because in this case, the firm's liquid assets (cash and accounts receivable)

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were already subject to marital distribution. Further, the wife's expert failed to obtain a tangible asset appraisal, relying instead on the wife's opinion that they were worth over $53,000. By comparison, the husband's expert followed IRS guidelines to calculate their depreciated value at less than $7,000.

The wife's expert also failed to consult comparative salary data or the parties' income tax returns to estimate reasonable compensation, using small business studies instead. He also noted the firm's "great location" in his goodwill calculation, but pegged its rental cost at only $10 per square foot (compared to $18 by the husband's expert), which effectively raise earnings. In fact, the practice goodwill had no value, the rebuttal expert said, and the trial court agreed, valuing the practice at $41,000.

On appeal, the wife claimed the husband's primary expert failed to calculate any value for goodwill; likewise his rebuttal expert failed to provide an independent value. Thus the trial court erred by relying on the combination of testimony to assign a zero value to goodwill.

The rebuttal expert reviewed both expert reports, however, and was "clearly knowledgeable" with their calculations, the appellate court held. Moreover, he clearly detailed the "serious" flaws in the wife's expert calculations and the more credibility findings by the husband's primary expert, including the lack of excess earnings. Based on this consistency among experts, the trial court was well within its discretion to conclude a zero value for goodwill.

Two Taxpayer Victories Demonstrate Winning Facts for FLPs

As textbook examples of how to form, fund, and operate a family limited partnership (FLP)—sufficient to value various assets (including publicly traded securities, real estate, and restricted holdings) at substantial discounts for federal estate tax purposes—the Murphy and Black cases make excellent reading for attorneys and financial advisors alike.

Legitimate business purpose proves critical. The Murphy Oil Corp. grew from a small family-owned business into a $2 billion international conglomerate. During the 1990s, Mr. Murphy established an FLP with $89 million in company stock plus bank and real estate holdings. Importantly, this represented only half his net worth and he never mingled his personal assets with the FLP's. Overall, the father retained a 95% limited partnership interest in the FLP, with his two sons in charge of daily operations.

For five years, the FLP traded assets, managed employees, held regular meetings, and prepared regular statements. It made only two distributions, with appropriate adjustments to the partners' capital accounts. After the father died unexpectedly in 2002, the IRS cited over $34 million in tax deficiencies and the estate sued for a refund. In Murphy v. U.S., 2009 WL 3366099 (W.D. Ark.)(Oct. 2, 2009), the federal court found the FLP was created to:

- Pool and invest the family assets according to the father's philosophy;
- Pass management responsibility onto the next generation;
- Enable the father to gift interests in the FLP while the underlying assets stayed under central management;
- Educate the father's heirs about wealth acquisition, management, and preservation; and
- Protect the family assets from creditors, divorce, and dissipation by future generations.

Moreover, the FLP was an active, ongoing entity that respected partnership formalities. Based on these strong facts, the court concluded the FLP was established for legitimate and significant non-tax purposes, sufficient to exclude the value of its underlying assets from the father's gross estate per IRC Sec. 2036(a)(1)(bona fide sale exception for adequate consideration).

To value Mr. Murphy's 95% LP interest, the court considered the parties' credentialed experts, who took the net asset values of the underlying interests before applying Rule 144 and blockage discounts as well as minority and marketability discounts. Their results diverged widely, but in each instance the court found the taxpayer's expert to be more credible, largely because he considered specific qualitative factors, including the FLP's substantial cash balance and the relative holding period, risk, distribution policy, and transfer restrictions of its assets. After adopting all the estate's discounts, the court found the fair market value of the 95% Murphy LP interest to be $74.5 million—and ordered a complete tax refund.

Another winning story. Samuel Black worked his way up from peddling newspapers on the street to senior vice president and second largest shareholder of the Erie Indemnity Co., a national insurance company. To pool, protect, and prolong his family's wealth, Mr. Black formed an FLP in 1993, retaining a 1% general partnership interest with LP interests dispersed among his son and his grandsons' trusts, with substantial restrictions. He funded the FLP with Erie stock worth $80 million, which increased to $318 million over the next seven year. The partnership distributed 92% of Erie dividends, with appropriate adjustments to the partners' accounts, and the Blacks never dipped into the assets for their own expenses.

Mr. Black died in 2001 and Mrs. Black followed soon after. The IRS assessed deficiencies totaling over $83 million on their estate tax returns. The parties resolved all the valuation issues prior to trial, leaving only the Sec. 2036(a) issue; i.e., whether the stock transfers were bona fide, for a legitimate non-tax purpose. The taxpayer claimed the following in support:

- The FLP's net asset value increased dramatically through active investment according to Mr. Black's "buy and hold" philosophy;
- The transfer restrictions successfully prevented Mr. Black's son from dissipating his assets in divorce and his grandsons from reaching their stock, even when their trusts terminated; and
- The Black family's consolidated position allowed it to maintain a seat on the Erie board.

The taxpayer also cited Estate of Schutt v. Comm'r (T.C. Memo 2005), in which the Tax Court validated an FLP for its "unique circumstances"—primarily its pooling of assets according to the founder's investment philosophy, to preserve them against claims from creditors, divorcing spouses, and irresponsible heirs. The IRS tried to distinguish Schutt by claiming that Black's concerns for his Erie holdings was either "ill-founded" or insignificant. The court was persuaded by the precedent, however, and the similar "unique" facts of this case. Moreover, the FLP respected partnership formalities, including appropriate adjustments for contributions and distributions. Accordingly, the court held that the fair market value of Mr. Black's FLP interest, rather than the fair market value of the underlying Erie stock, was includable in his gross estate.

How Patent Infringement Cost Microsoft $290 Million

i4i Ltd. Partnership v. Microsoft Corp., 2009 WL 4911950 (C. A. Fed.(Tex))(Dec. 22, 2009)

In the first phase of this closely watched patent infringement case, the federal district court confirmed a jury verdict of over $290 million in reasonable royalty and enhanced damages against Microsoft. (See i4i Ltd. Partnership v. Microsoft Corp., 2009 WL 2449024 (E.D. Tex.)(Aug. 2009.) Microsoft appealed—and moving with remarkable alacrity, the Federal Circuit Court of Appeals rendered its decision within four months.

Damages based on single benchmark. Microsoft first argued that the district court erred by denying its Daubert motion against the plaintiff's primary expert, claiming his method for calculating damages was unreliable for essentially three reasons.

- Incorrect benchmark. The plaintiff's patent concerned custom-editing computer software. In constructing a hypothetical licensing negotiation between the parties, the expert used a $499 competitive product, which contained features beyond an XML editor. His resulting reasonable royalty estimate of $98 was "exorbitant," Microsoft said, when some Word products sold for $97. A better benchmark would have been the difference between what Microsoft charged for Word products without the XML editor—or $50.
- Rule of thumb. To calculate the royalty rate, the expert also used the "25% rule," an unfounded assumption that patent inventors will keep 25% of profits from infringing sales.
- Speculative survey. To estimate infringing sales, the expert relied on a random telephone survey of 998 U.S. businesses, only 19 of which reported any infringing use. This was too small and too speculative a basis on which to conclude that 1.9% (19/988) of all copies of Word sold to all businesses between 2003 and 2008 were infringing.

In response, the plaintiff's expert said his benchmark was the cheapest of three commercial competitors, which Microsoft used before developing its own custom editor. His royalty rate was supported by Microsoft's business strategy, which was to maximize product sales and not the price of every specific feature. Lastly, the telephone survey "dramatically underestimated" infringing use by targeting only businesses, not consumers.

The Federal Circuit Court conceded that the plaintiff's expert could have used better data, but the existence of alternative facts did not render the expert's choice unreliable under Daubert. The expert relied on internal Microsoft documents, public information about competitive products, and an "acceptable" survey." These facts had a sufficient nexus to the relevant market, the parties, and the alleged infringement, the court held. "At their heart," Microsoft's objections went

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to the expert's conclusions, not his methodology. The jury had ample opportunity to weigh the competing evidence and decide a reasonable royalty rate.

Outcome depended on a single pleading? In a last effort, Microsoft urged the court to follow its recent decision in Lucent Technologies v. Gateway, 2009 WL 2902044 (C.A.Fed.), which overturned a $358 million jury award for gross excessiveness. "We cannot, however, because the procedural posture of this case differs from Lucent," the court explained. In Lucent, the defendant filed a judgment as a matter of law (JMOL) prior to the jury verdict, challenging the sufficiency of the damages evidence. In this case, Microsoft filed a JMOL regarding several issues—"but for whatever reason," it chose not to contest damages and instead, filed a motion for a new trial.

The decision made all the difference. The court could not conduct the "more searching" review of the jury award under the JMOL standard, but was constrained by the narrower standard motions for reconsideration, which turn on a "clear showing of excessiveness" (court's emphasis). Although the damages award was high, it was supported by sufficient evidence, and the court denied Microsoft's request for a new trial.

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