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This month's Valuation Update has several short but interesting opinions involving LLC interests in family law, law firm appraisal and U.S. Tax Court revising a previous opinion involving business valuation:

- 1 *Elliott v. Elliott*, 2011 WL 3889181 (Mass. App. Ct. - Sept. 6, 2011): In this Massachusetts's divorce case that state's court grapples with the value of an illiquid, minority LLC interest. Again showing the Court's take LLC interests credibly and that an LLC interest does not equate to a pro-rata value of the underlying property.
- 2 *Dixon v. Crawford, Mc Gilliard, Peterson & Yelish*, 2011 WL 4348058 (Wash. App. Div.1 - Sept. 19, 2011): An interesting case opinion about a law firm's goodwill on the disassociation of a former partner. We expect professional service practice's goodwill to be more and more at issue, for various reasons, in Illinois.
- 3 *Estate of Gallagher v. Commissioner*, 2011 WL 4809106 (U.S. Tax Court - Oct. 11, 2011): Tax court corrects its own calculation in a previously adjudicated case demonstrating even further involvement in the nuances of appraising equity interests.

Family LLC in Divorce: Error to Value Only Underlying Property *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. The FLC rented out the property for six weeks during the year, using the income to pay taxes and other expenses, but otherwise the parents (as general partners) had no intention to leverage or sell the property, as they wished it to remain in the family for the foreseeable future. As a result, the husband was unlikely to receive any income from his interest in the FLC, despite an assessment of the property's fair market value at \$6.4 million.

In addition to making these findings, 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 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.

No evidence of FLC value. Although the trial court record contained some evidence regarding the appraised value of the Martha's Vineyard property, there was none related to "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." In the end, the court appeared to have valued the husband's minority interest in the FLC by equaling it to one-fourth the value of the underlying real property, and then awarding the wife half this amount.

"This is troubling," the appellate court said, particularly in light of the court's other findings, supported by the evidence, that the property was likely never to be sold, mortgaged, or generate rental income for the husband. Under these circumstances, the court did not abuse its discretion in awarding the wife a share of the husband's FLC interest; however, it was "plainly wrong and excessive" for the court to base its award on an "unsupported" valuation of that interest at \$1.6 million, particularly in light of the husband's financial constraints. 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.

Lawyers try Hard to Argue Their Firm Has No Goodwill Value

Dixon v. Crawford, Mc Gilliard, Peterson & Yelish, 2011 WL 4348058 (Wash. App. Div.1 - Sept. 19, 2011)

One of the five founding partners of a well-established, 30-year-old public defense firm left in 2006, taking all of his civil defense clients with him. Two years later, a junior (non-equity) partner left the firm and sued for an accounting and purchase of his interest. At this point, the senior founding partner—concerned about potential liability—intervened in the suit. But only after the court dismissed the junior partner's claims did he assert his own for a judicial buyout.

Notably, the firm had no written partnership agreement, and the partners had always distributed 100% of the practice's profits equally among themselves. Since the late 1990s, public defense contracts had generated over half the firm's income, sufficient to pay its overhead as well as the salaries of employees who handled this work.

Law firm retains three experts. To establish the value of his one-fifth share in the firm, the dissociated partner presented an accounting expert, who used a capitalization of excess earnings approach, defining goodwill value as the "difference between the firm's earnings and the remaining partners' collective 'replacement values.'" The



expert ultimately determined the partner's 20% interest ranged between \$350,000 and \$360,000, which included both the tangible and intangible (goodwill) values.

The law firm presented three accounting experts to value the entire practice. One testified that, in his experience, law practices carried no goodwill value, but the other two experts conceded that they do. All three agreed that, to the extent there is any goodwill value, the capitalization of excess earnings is an appropriate approach. Two of the three experts (the ones who conceded goodwill value) used substantially higher "replacement values" for the remaining partners than the expert for the dissociated partner did, and they ultimately concluded that there was no goodwill value in this particular firm, leaving only the tangible assets, which all four experts agreed were worth between \$36,000 and \$48,000 for a one-fifth share.

The trial court considered the experts' evidence against the age, demonstrated earning power, and professional reputation of the firm. Because the firm was "highly respected" and had "enjoyed success as a preeminent public defense firm," the court found the excess earnings method was appropriate and adopted the earnings figure used by the partner's expert but used replacement values that were in the mid-range of all the parties' experts. Ultimately the court valued the entire firm at \$1.16 million and awarded the dissociated partner \$232,142 for his share, plus nearly \$100,000 in statutory interest, and the law firm appealed.

The firm agreed that the state's partnership dissolution statute applied a going concern standard of value to the dissociated partner's share. In this case, however, the firm argued that the local Rules of Professional Conduct (RPC) for attorneys precluded goodwill in the buyout price for a law partnership. It cited a case in which the seller of a law firm agreed to encourage clients to use the buyer's services, but the court ruled that such a provision violated the RPC's prohibition against the solicitation or referral of clients for compensation.

In this case, however, the precedent did not apply, because there was no sale of the law firm and no promise to encourage clients, the appellate court held. Instead, the only issue was the practice's value as a going concern, and the law firm had failed to cite any "law, policy, or disciplinary rule" that barred a dissociated partner from receiving his share of that value that constituted goodwill. Moreover, numerous matrimonial cases recognize goodwill as an asset when valuing a law firm or any professional practice.

As to the method for valuing goodwill, the court rejected the law firm's argument that the capitalization of excess earnings approach was proper only in matrimonial cases, particularly since four out of the parties' five experts agreed that it applied in this case. "There is no suggestion in the cases that certain valuation methods apply only for purposes of marital dissolution whereas other methods apply for partnership dissociation." Similarly, there was no support for the law firm's argument that the dissolution context was "unique" due to the need to protect the non-professional spouse. "Essentially [the law firm] contends an asset with value in dissolution has no value otherwise, and has value in dissolution only where there is a non-professional spouse in need of protection," the court said. This argument defied "logic" as well as the law.



Finally, the firm tried to argue that by including the earnings from its public defense practice, the trial court had essentially “forced” the sale of the firm’s contracts and treated its clients as “commodities.” But this contention was equally unfounded, the appellate court held. Public defense contracts are no different for purposes of valuing firm goodwill than agreements to handle large litigation cases for employees, union members, or any other large class of clients.

In sum, “there is no definitive formula for ascertaining the value of goodwill,” the court held, essentially defining goodwill as “the monetary value of a reputation.” In this case, there was no partnership agreement that excluded a departing partner’s claims to goodwill, and the trial court’s method was logical and provided an “accurate reflection of the goodwill value of the firm as a whole.” It was also substantially supported by the expert evidence, the appellate court found, and affirmed the award.

TAX Court Corrects Present Value Factor in *Gallagher* ***Estate of Gallagher v. Commissioner*, 2011 WL 4809106 (U.S. Tax Court - Oct. 11, 2011)**

In another show of its increasing sophistication and emphasis on accuracy in valuation calculations—even when it comes to its own—the U.S. Tax Court issued a brief correction and update to its comprehensive decision in *Estate of Gallagher* (digested in CVS’s August 2011 newsletter). Both the original and supplemental opinions were written by Judge Halpern.

A \$3.2 million error. In its original opinion, the court determined—after a lengthy review of the competing evidence from both parties’ experts and its own carefully analyzed adjustments to a DCF approach—that the decedent’s 80% interest in a privately held publishing enterprise was worth approximately \$32.6 million. In particular, “we computed the total present value of expected cash flows for five years and added to that sum the present value of the reversion, which we assumed to be received at the end of the fifth year,” the court explained.

In computing the present value of a reversion, however, the court erred in using the present value factor “ $(1 \leftarrow 0.1)$.” To determine the present value of the reversion to be received at the end of the fifth year, the court should have used a six (not a five) for the value of the exponent in the present value factor.

Accordingly, it attached to its supplemental opinion a new appendix in which the court revised its computation of the 80% interest (representing 3,970 limited partnership units) using the corrected present value factor. Under this new analysis, the court determined a total value for the units of approximately \$35.8 million or an increase of roughly \$3.2 million over its prior calculation. The court entered its decision under Rule 155 of the Tax Court Rules of Practice and Procedure.