

Presenter:

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# **JUNE 2011 TENNESSEE JUDICIAL CONFERENCE**

## ***BERTUCA* AND BEYOND: UNDERSTANDING BUSINESS VALUATION CASE LAW**

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### I. Introduction

In divorce cases, trial judges and appellate courts are faced with a myriad of issues, including questions of entitlement to divorce, identification and distribution of marital property, parenting, child support and alimony. It is no doubt fair to say that common nature of these issues does not necessarily make their resolution any easier. Child custody decisions, relocation actions, and alimony questions are difficult no matter how often they are addressed.

The purpose of these materials is to review an issue that is less common in divorce cases, but not rare, and to help the court understand and apply strategies to make the resolution of this issue easier and more straightforward. That issue is the valuation of interests in closely held businesses. The job of a trial judge might be easier if divorcing parties only owned businesses that were traded on the New York Stock Exchange or NASDAQ, but instead divorcing parties own companies that employ only themselves, or pieces of companies that have far flung operations with hundreds of employees, or companies that own other companies, with the only common denominator being that these companies are not and have never been traded on an open stock exchange, with a free market setting the value of the party's interest. The interests in these companies are often accompanied by restrictive operating agreements, non-compete agreements, or buy-out formulas that appear to bear no relation to the value of that interest that regularly accrues to the party with the interest.

The leading cases on divorce-related business valuation in Tennessee involve security systems, travel agencies, and fast food franchises. At first glance it may appear that the only common thread in these cases is that the businesses were all based in Tennessee, but each of

them provide lessons in how to address (or how not to address) business valuations so that the results are consistent, coherent and in accord with Tennessee law.

As a final introductory note, it is important to understand that this presentation was inspired, in part, by the *Bertuca* decision of the Court of Appeals in 2008. *Bertuca* involved an appeal from the Circuit Court for Wilson County in which the value of a husband's interest in a McDonald's franchise was at issue. *Bertuca* was an unusual opinion for several reasons. First, it was unusual because the Court of Appeals issued two separate opinions, one of which replaced the other, the second of which replaced almost wholesale the valuation approach adopted by the first decision. Second, it was unusual because the Court of Appeals in some respects conducted its own valuation analysis after finding fault with the approach used by the trial court, rather than looking to the competing analysis offered by the losing party at trial. And third, *Bertuca* was a departure from prior law, because it found that marketability discounts should not be applied if there is no present intent to sell the business. It is this third issue, in particular, that is most important to address here, because this is certainly a departure from prior case law, and reliance on *Bertuca* could take Tennessee courts down a much different path than they have previously traveled.

## **II. History of Business Valuation in Tennessee Case Law**

No discussion of business valuation would be complete without a review of *Blasingame v. American Materials, Inc.*, 654 S.W.2d 659 (Tenn. 1983) and *Wallace v. Wallace*, 733 S.W.2d 102 (Tenn. App. 1987). *Blasingame* applies what is known as the "Delaware Block Method" of valuation, while *Wallace* relies on the method described in Revenue Ruling 59-60, 1959-1 C.B. 237. *Blasingame* has been cited in over scores of cases

since 1983<sup>1</sup>; *Wallace* has been cited numerous times, as well. These and other cases are discussed below.

**A. *Blasingame v. American Materials, Inc.*, 654 S.W.2d 659 (Tenn. 1983)**

*Blasingame* was a case in which valuation of an interest in a closely held business was just one of many issues addressed by the Tennessee Supreme Court. However, the four pages of analysis by Chief Justice Fones on the valuation issue, the full opinion of which was joined by all four other members of the Court, remain the primary reason for continuing to cite the case almost 30 years later. In *Blasingame*, the defendant corporation offered the plaintiff, an individual named Larry Blasingame, an oral employment contract which included an option to buy 300 shares of the corporation (a ¼ interest) for \$25,000. The corporation was organized for the purpose of producing emulsified asphalt and concrete, and Mr. Blasingame had a particular expertise in that field. After several years of employment, which passed with Mr. Blasingame still not being awarded his promised stocks, Mr. Blasingame left the company (or was fired) and brought suit against the company for fraudulent breach of contract and monetary damages.

At trial, Mr. Blasingame offered the testimony of three certified public accountants who testified that the value of 25% of the defendant corporation was \$672,500, \$657,572, and \$660,419.68, respectively. The defendant corporation offered the testimony of a CPA who calculated the value of 25% of the corporation using three different methods and came up with values of \$115,350, \$127,033 and \$165,670. The master's finding at trial averaged the highest value and the lowest value and applied a 17.5% marketability discount to arrive at a value for Mr. Blasingame's interest in the corporation of \$309,988. Both sides took exception

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<sup>1</sup> *Blasingame* is by no means the most often cited case in Tennessee domestic courts, but for the relative narrow issue that it addresses, *Blasingame* certainly is a contender.

to the master's report, and the trial court held that it was improper to average the values stated in the expert's report. Instead, the Chancellor held that the preponderance of the evidence was that the actual value of 300 shares of stock was \$600,000, to which he applied a 25% minority interest discount, deducted the option price, added a \$4,000 bonus due, and rendered judgment in favor of Mr. Blasingame in the amount of \$429,000. The Court of Appeals affirmed the trial court, and the corporation sought and received permission to appeal to the Supreme Court.

The Supreme Court first found that the oral contract was enforceable that the Statute of Frauds governing the sale of securities was not a bar to the plaintiff in this action, and that the president of the corporation could bind the corporation to an agreement to issue stock to Mr. Blasingame. It then turned to the amount of damages.

On damages, the Supreme Court first agreed with the defendant corporation that the trial court erred in using the "Earnings Value Method or Capitalization of Earnings Method" and applying that method only to the corporation's best year, and held that "any valuation of earnings that does not take into account a minimum of three years corporate earnings experience should be rejected, unless the expert opinion clearly and convincingly establishes the validity of a lesser period." 654 S.W.2d at 665. As the Supreme Court stated

"Our research convinces us that the majority of jurisdictions require at least the use of three years as an appropriate minimum period to validate the Earnings Value Method; the traditional period is five years, yet for some corporations the appropriate period might even be as many as ten years."

*Id.* (citations omitted). The Court then went on to look to cases from other jurisdictions to determine the "method or methods to be used in determining the 'fair value' of the dissenting stockholder's stock." *Id.* The Court cited a North Dakota case, which in turn cited AmJur 2d,

A.L.R. 2d, the Harvard Law Review and the Michigan Law Review for the proposition that all three primary methods for determining the fair value of dissenting shareholder's stock should be used, "assigning such weight to each method as may be appropriate considering the type of business, the objectives of the corporation, and other relevant factors." *Id.* at 666. Those methods are (1) the market value method, (2) the asset value method, and (3) the investment or earnings value method. As described in the opinion,

"The market value method establishes the value of the share on the basis of the price for which a share is selling or could be sold to a willing buyer. This method is most reliable where there is an established market for the stock. The asset value method looks to the net assets of the corporation valued as a 'going concern,' each share having a pro rata value of the net assets. The net assets value depends on the real worth of the assets as determined by physical appraisals, accurate inventories, and realistic allowances for depreciation and obsolescence. The investment value method relates to the earning capacity of the corporation and involves an attempt to predict its future income based primarily on its previous earnings record."

*Id.* The Supreme Court also found that the trial court and the Court of Appeals had "erred as a matter of law" in valuing Mr. Blasingame's stock as of the date of the trial, rather than the date Mr. Blasingame's employment with the company was terminated, which the Court found was the "date the defendant corporation took the action that gave rise to plaintiff's right to receive the fair value of his minority stock interest." *Id.* at 667. The Court remanded the case to the trial court for a determination of the fair value of Mr. Blasingame's interest in the company as of the date of his termination.

Of more than passing interest in the *Blasingame* opinion is the fact that the trial court applied a 25% minority discount to the value of Mr. Blasingame's shares; while the Supreme Court was critical of other parts of the trial court's analysis, there was no discussion of

whether, on remand, the minority discount should still be taken into account in determining the “fair value” of Mr. Blasingame’s shares. This is an important point, because *Blasingame* is not a divorce case, but rather a case in which it became necessary to value the stock of, in essence, a dissenting, minority shareholder. Many courts and commentators find it improper to include a minority discount in the valuation of a dissenting minority shareholder’s shares, and indeed, for many, the difference between “fair value” and “fair market value” is that one approach includes minority discounts and the other does not.

**B. *Wallace v. Wallace*, 733 S.W.2d 102 (Tenn. App. 1987)**

*Wallace v. Wallace*, 733 S.W.2d 102 (Tenn. App. 1987), a divorce action, followed *Blasingame* in time, but perhaps not entirely in spirit. In *Wallace*, the Court of Appeals had, in a 1984 unreported opinion, vacated portions of the divorce decree dividing the parties’ stock in a closely held corporation, and remanded the case to the trial court. The second opinion, prompted by the husband’s second appeal, is the opinion that continues to be frequently cited in divorce actions in this state. The case involved a metal fabricating business named Gil, Inc., which the Court of Appeals described as being “on shaky financial footing during its early years of operation.” 733 S.W.2d at 104. The trial court originally awarded the wife 25% of the stock of Gil, Inc. (which was consistent with the shares she held in her name) “because it was unable to place a value on the parties’ interest in the company.” *Id.* That part of the decision that was vacated in the first appeal, because the Court of Appeals found that the wife should receive a corresponding monetary award to offset the value of the interest she had been awarded originally. By the time of the second hearing, Gil, Inc. was thriving, with 91 employees and at least \$12 million in back orders. The husband, instead of arguing that the company was nearly insolvent, testified in deposition that the company was

worth between \$4 million and \$5 million, and that he would accept \$2 million for his half interest in the company. *Id.* at 105. (The husband sought to minimize this testimony and the testimony of his business partner—who said the company was worth between \$3,000,000 and \$6,000,000—on the argument that the partners had “put their life blood” into the company. The Court of Appeals held, simply, that “Mr. Wallace is bound by his own statements.” *Id.* at 108.

As a preliminary matter, the Court of Appeals held that the trial court acted within its discretion by valuing Gil, Inc. at the time of the divorce (May 1983) rather than at the time of the parties’ separation or the date on which the trial court first heard the matter in December 1982. *Id.* at 106. (The company apparently had a run of good fortune between the first day of trial and the last day of trial, and the husband unsuccessfully sought to have the value set as of the first day.)

The husband also complained that the trial court did not follow the Delaware Rule set out in *Blasingame*, which he argued was the *only* method for valuing his interest in Gil, Inc. The Court of Appeals disagreed, holding that while the Delaware Rule must be used to determine the value of a dissenting shareholder’s shares, “[the Tennessee Supreme Court] has not decreed that the ‘Delaware Rule’ is the only acceptable way to arrive at the value of the parties’ interest in a closely held corporation in a divorce proceeding.” *Id.* at 107. The Court of Appeals held that there were a number of acceptable methods to determine the value of a corporation, including the market value method, the asset value method and the earnings value method identified by *Blasingame*, in addition to the dividend method and the liquidating value method. *Id.* at 107. The Court went on to say that it is generally improper to attempt to value a closely-held corporation using the market value, since stock in a closely-

held corporation is rarely traded. *Id.* And, while “determining the value of a closely held corporation is not an exact science,” the Court noted that Revenue Ruling 59-60, 1959-1 C.B. 237 “has been recognized as providing the most comprehensive guide to making this determination.” *Id.* This pronouncement, however, came with a substantial caveat: “Revenue Ruling 59-60 is intended to be only a guide. It was never intended to be an inflexible rule.” *Id.*

As the Court noted

Revenue Ruling 59-60 contains nine factors which should be considered when determining a closely held corporation’s value. These factors include:

- (1) the nature of the business, including its history since organization;
- (2) the economic status of the industry and the nation at the critical date of valuation;
- (3) book value;
- (4) earnings;
- (5) dividends and dividend paying capacity;
- (6) the existence or lack of good will or other intangible value;
- (7) sales of the stock and the size of the block to be valued;
- (8) the selling price of comparable securities relative to their earnings, dividends and asset values; and
- (9) the life insurance proceeds received by a corporate beneficiary on a policy covering the sole or controlling stockholder.

*Id.* at 107-108. The Court of Appeals found that the evidence in the case did not preponderate against the trial court’s determination that the value of Gil, Inc. in 1983 was \$3,000,000 and that the parties’ interest at that time was \$1,500,000. *Id.*

***C. Wright v. Quillen, 909 S.W.2d 804 (Tenn. App. 1995)***

*Wallace*, then, provided Revenue Ruling 59-60 as an acceptable basis for valuation of a divorcing party's interest in a closely-held business, but did not limit parties to the use of this ruling. The *Wallace* case was put to a test several years later in *Wright v. Quillen*, 909 S.W.2d 804 (Tenn. App. 1995) (perm. to appeal denied October 2, 1995). *Wright* involved a month-long jury trial in which one of the principal issues in dispute was the value of The Wright Travel Agency, a company formed by the wife shortly before the marriage but which experienced vigorous growth throughout the marriage. The jury found that the value of the company was \$1,750,000, which, the Court of Appeals noted, was "within the extremes in the record" ranging from \$1,000,000 to \$5,000,000.

The expert for the wife, Mr. Miller, testified to his expertise in brokering the buying and selling of travel agencies, and admitted that he had not used the Delaware Block Method recognized in *Blasingame* or Revenue Ruling 59-60 adopted by *Wallace*. Instead, he used a method he developed specifically for the travel agency business, which he called the marketing approach. As the Court of Appeals noted, "This method looks at the type of sales, the client base, the average cost of issuing a ticket, the major airlines in the area, and the firm's major clients." 909 S.W.2d at 809. Based on these factors and his knowledge of the sales price of other travel agencies, Mr. Miller valued Wright Travel at somewhere between \$1.6 and \$1.7 million. Under Mr. Miller's methodology, historical data concerning income or profitability played a small part because of the rapidly changing climate in the deregulated airline industry. As the Court of Appeals held,

“While Mr. Miller disclaimed any knowledge of Revenue Rule 59-60, some of the factors he considers important also appear in that publication; i.e., the nature of the business; the economic status of the industry; earnings; the existence or lack of good will or other intangible value; the selling price of comparable securities relative to their earnings, dividends and asset values. In this state where ‘[t]he choice of the proper method or combination of methods (to determine value) depends upon the unique circumstances of each corporation,...we think Mr. Miller’s methods form a basis ‘reliable enough to assist the jury to reach an accurate result.’”

*Id.* at 810 (citations omitted, including one cite to *Wallace*). The husband’s effort to obtain a new trial based on newly discovered evidence (an article written by Mr. Miller for Travel Weekly a few months after the trial and the sale of another travel agency in Nashville) was also rebuffed by the Court of Appeals, and the valuation of the wife’s interest, which was based on neither the Delaware Block Rule or Revenue Ruling 59-60, was permitted to stand.

**D. *Powell v. Powell*, 124 S.W.3d 100 (Tenn. App. 2003)**

Almost a decade later, the Court of Appeals heard and decided *Powell v. Powell*, 124 S.W.3d 100 (Tenn. App. 2003) (app. perm. app. denied October 27, 2003), a case which involved the value of a chain of check-cashing stores owned in part by the husband. In *Powell*, the husband and his brothers owned numerous check cashing outlets, only one of which was operating at the time of the marriage. The husband had a minority interest in most of the stores, and a 50% interest in two of them. The husband’s expert testified that the value of the business was \$385,482. The wife’s expert testified that the value of the business was about six times greater: \$2,290,000. The court accepted the valuation offered by the Wife’s expert, and the husband appealed, arguing that the valuing “does not reflect ‘fair market value’ as that term is defined in Revenue Ruling 59-60.” *Id.* at 103-104.

The Court of Appeals noted that the determination of value of a marital asset is a question of fact, not a question of law, and that the trial court's decision is to be given great weight on appeal. *Id.* at 103. The Court of Appeals also found that the trial court had not erred by not adopting the formula set forth in Revenue Ruling 59-60. *Id.* The Powell court cited the excerpts from *Wallace* which are set forth above in emphasizing that "neither Wallace, nor any other case we are aware of, mandates the use of Revenue Ruling 59-60 as the basis for determining the value of a party's interest, be it a closely held corporation or an LLC, for the purpose of marital property division." *Id.* at 104. The Court of Appeals also noted that

"It is apparent that in reaching its valuation determination, the trial court relied heavily upon the testimony of Mrs. Powell's expert, Mr. Vance, and thus found Mr. Vance's valuation to be more credible than that of Mr. Powell's expert, Mr. Noble....The record supports the trial court's use of Mrs. Powell's expert's testimony as opposed to that of Mr. Powell's."

*Id.* at 104-105. (In a footnote, the Court of Appeals stated that "suffice it to say that Mr. Powell's expert's qualifications paled in comparison to those of Mrs. Powell's expert.") The Court of Appeals also noted that expert testimony was not the only testimony offered as to the value of the business: the husband had placed the value of the business, which had one store, at \$595,000 as of a couple weeks before the marriage, and \$3,370,000 ten months before the divorce. The Court rejected the husband's argument that these financial statements "overstated the true value of his business," and noted that a statement which constitutes an admission against interest and can be used to establish or disprove any material fact in the case, is competent evidence against the person making the statement. *Id.* at 105. Further, the Court cited T.C.A. §39-14-120 (1997) which provided that a person may commit the crime of

issuing a false financial statement regardless of whether the statement is submitted under the penalty of perjury. *Id.* at 105, footnote 6. These financial statements, held the Court, are evidence which more strongly supported the valuation placed on the business by Mrs. Powell's expert, as opposed to that of Mr. Powell's expert. *Id.* As summarized by the Court of Appeals:

“The value of a marital asset is determined by considering all relevant evidence regarding value. If the evidence of value is conflicting, the trial judge may assign a value that is within the range of values supported by the evidence.”

*Id.* at 105-106. If no other lessons can be drawn from *Powell*, there are at least two that should be painfully obvious: (1) don't use the company's own CPA to appraise the value of the company; and (2) do not, under any circumstances, explain away earlier statements of value in financial statements as being “overstated but it doesn't matter because the statements were not under oath.”

#### **E. Valuation of Professional Practices and Other Similar Businesses**

The valuation of a professional practice (i.e., a law practice, a medical practice, or other similar business) is approached in much the same way as the valuation of any other business, with one particular exception: professional goodwill is not to be considered in such a valuation. As set forth in *Garman v. Garman*, 2011 Tenn. App. Lexis 252, Court of Appeals at Knoxville, filed May 16, 2011:

“The valuation of a marital asset is a question of fact. It is determined by considering all relevant evidence, and each party bears the burden of bringing forth competent evidence.” *Kinard v. Kinard*, 986 S.W.2d 220, 231 (Tenn. Ct. App. 1998) (citing *Wallace v. Wallace*, 733 S.W.2d 102, 107 (Tenn. Ct. App. 1987)). “If the evidence of value is conflicting, the trial judge may assign a value that is within the range of values supported by the evidence.” *Kinard*, 986 S.W.2d at 231 (citing *Ray v. Ray*, 916 S.W.2d 469, 470 (Tenn. Ct. App. 1995); *Wallace*, 733 S.W.2d at 107)). “On appeal, we presume the trial judge’s factual determinations are correct unless the evidence preponderates against them.” *Kinard*, 986 S.W.2d at 231 (citing *Jahn v. Jahn*, 932 S.W.2d 939, 941 (Tenn. Ct. App. 1996)).

In Tennessee, a professional practice may be considered a marital asset. See *Argo v. Argo*, 1985 WL 673374 (Tenn. Ct. App. April 11, 1985). The court here concluded that Dr. Garman’s partnership interest in the OCET practice was a marital asset. From our review of the record, this classification was proper because Dr. Garman’s interest in the practice was attained during the course of the marriage. Proper valuation of this marital asset, however, should include only the value of the practice’s tangible assets and not the practice’s future earnings or professional goodwill. *Nicholson v. Nicholson*, No. M2010-00042-COA-R3-CV, 2010 WL 4065605, at \*5 (Tenn. Ct. App. Oct. 15, 2010) (citing *Argo*, 1985 WL 673374, at \*4-5; *Smith v. Smith*, 709 S.W.2d 588, 592 (Tenn. Ct. App. 1985)).

*Id.* at 7-8. The Court of Appeals upheld the trial court’s determination of the value of the medical practice at \$48,000, although the practice was sold pursuant to a buy-sell agreement for approximately \$15,000. However, it was not the doctor husband who appealed from the valuation, it was the spouse wife, who asserted that the trial court got it wrong and the value of the practice was considerably higher. The Court of Appeals was highly critical of the expert for the wife, who chose the most beneficial date of the valuation for wife’s purposes (immediately before a routine round of bonus payments to the partners, which, if considered would have substantially reduced the value of the practice) and also included in his valuation

a significant mistake with respect to the value of the fixed assets of the business. In any event, the Court of Appeals chose a value between the approximately \$16,000 received by the husband in a formula buyout, and the \$68,000 the wife's expert ultimately conceded was the actual value of husband's interest in the practice. The Court of Appeals found that "the court's valuation properly disregarded the future earning capacity and professional goodwill of the practice and focused instead on its tangible assets. *Id.* The Court of Appeals also emphasized that

"It is the responsibility of the parties, not the court, to propose values to marital property. *Caldwell v. Caldwell*, No. M2007-01205-COAR3-CV, 2008 WL 4613586, at \*2 (Tenn. Ct. App. March 5, 2008) (citing *Wallace v. Wallace*, 733 S.W.2d 102, 106 (Tenn. Ct. App. 1987)). The parties are bound by the evidence they present, and the trial court, in its discretion, is free to place a value on a marital asset that is within the range of evidence submitted. *Wallace*, 733 S.W.2d at 107."

*Id.*

The "professional good will" carve-out from the value of a professional practice is long recognized in Tennessee. For example, in *Smith v. Smith*, 709 S.W.2d 588, 591-92 (Tenn.Ct.App.1985), the Court of Appeals, quoting from *Holbrook v. Holbrook*, 103 Wis.2d 327, 309 N.W.2d 343 (Wis.App.1981) stated as follows:

The concept of professional good will evanesces when one attempts to distinguish it from future earning capacity. Although a professional business's good reputation, which is essentially what its good will consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business, an actual, separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The good will or reputation of such a business accrues to the benefit of the owners only through increased salary.

. . . . There is a disturbing inequity in compelling a professional practitioner to pay a spouse a share of intangible assets at a judicially determined value that could not be realized by a sale or another method of liquidating value. 309 N.W.2d at 354-55.

*Smith*, 709 S.W.2d 588, 591-92 (Tenn.Ct.App.1985); see also *Kerce v. Kerce*, Court of Appeals at Nashville, 2003 Tenn. App. Lexis 608, filed August 29, 2003, pages 6-7. *Kerce* also cited to an unreported decision from 1996, *Alsup v. Alsup*, 1996 WL 411640 (Tenn.Ct.App.July 24, 1996) (no app. for perm. app. filed), which addressed the issue of goodwill in a context outside a professional practice: the value of a day care center operated by the Wife. The husband's expert gave the business a value of \$280,000, while the wife's expert valued the business at a little over \$58,000. The trial court accepted the wife's expert's valuation, finding that the business had little value without the wife working there. On appeal, the Court of Appeals agreed that no goodwill value should be attributed to the day care business because the goodwill rested entirely with the Wife:

“[I]t is apparent that the good will of Ms. Judy's would be valueless without wife's presence. Therefore, the good will value of Ms. Judy's depends solely upon the reputation of Judy Alsup, as is true in the cases of professional practices and sole proprietorships. The fact that Ms. Judy's is a closely held corporation is of no moment under the circumstances of the present case because, for all practical purposes, Ms. Judy's was operated as a sole proprietorship. Accordingly, we hold that the good will value of Ms. Judy's is not a marital asset subject to distribution with the marital property.”

Not everything is roses for the owner of a professional practice, however. In *Carpenter v. Carpenter*, 2008 Tenn. App. Lexis 797, Tennessee Court of Appeals December 31, 2008, the husband lawyer sought a valuation of his law practice based on the value of the hard assets of the practice. The wife looked instead to the values placed on the practice by the husband in the years leading up to the divorce trial. As summarized by the Court of Appeals,

In this case, the evidence regarding the value of Husband's law firm is conflicting. Husband valued his law firm at \$33,491. This figure was supported by Husband's own testimony and his affidavit listing the firm's assets and liabilities. He testified that these figures were corroborated by reports generated by his accounting firm, but those reports were not included in the record on appeal. Wife's valuation of Husband's law firm at \$142,695 was based in large part on the bank financial statements filed by Husband in 2003, 2004, and 2005, valuing the firm at \$175,000, \$200,000, and \$100,000, respectively. (Exh. 13, 14, 15). The \$142,695 value was derived by assuming \$200,000 in assets, minus \$57,305 in debts from Husband's three business credit cards.

*Id.* at 8. The trial court found that the value of the practice was the \$200,000 asserted by the wife, less the \$57,305 debt, a valuation affirmed by the Court of Appeals, which noted that "The financial statements upon which Wife relies are competent evidence of the value of Husband's law practice," citing *Powell v. Powell*, 124 S.W.3d 100, 105 (Tenn. Ct. App. 2003):

Moreover, Husband's professed profits in 2006, as well as the previous bank statements reflecting a much higher value, may indicate why the trial judge did not credit Husband's valuation of his law practice. To some extent, the trial court's decision was based on its credibility determination in favor of Wife. We will not reverse the trial court's credibility determinations absent clear and convincing evidence to the contrary. Therefore, because Wife's valuation of Husband's law firm was within the range of values supported by the evidence, we affirm the trial court adoption of Wife's proposed value for Husband's law practice. See *Brown v. Brown*, No. 36, 1990 WL 140912 (Tenn. Ct. App. Oct. 1, 1990).

*Id.* at 8.

Although not a professional practice, the "be careful what you ask for" issues wrestled with by the court in *Edenfield v. Edenfield*, 2005 Tenn. App. Lexis 689, Tennessee Court of Appeals at Knoxville, October 31, 2005, are instructive. In *Edenfield*, the husband owned a

small business with a partner that sold services to automobile dealerships. The assets of the business consisted of a checking account, two fax machines and cell phones. The wife's accountant valued the husband's interest in the business at \$345,000 using a capitalization of income method; the husband valued the business at zero. The trial court wrestled with this discrepancy and the \$50,000 debt owed by the business, and came up with an elegant solution: it awarded the entire business to the wife, together with the debt. Subsequently, the business partner quit, and the wife was left holding a business that, like the husband had argued at trial, had no value. As the Court of Appeals stated:

Like the court in *Loyd*, we are convinced that whatever the value of First Choice in the hands of the original co-owners, that value was dependent upon the efforts of and relationships established by them. Mr. Edenfield's testimony made that clear. He insisted that the business was himself and his partner. He depended on his personal relationships with car dealers to maintain the business's customer base. Mr. Edenfield's testimony at trial is instructive in this regard:

"A. . . . Our company is us. No different than anybody else in the service business. . . . I offered to give Kara this business. I will still do it today. She can have it. But she couldn't do it. You couldn't do it, You couldn't pay a dollar for it. Nobody would, because they can't do it. I am my business.

"Q. Okay. So it's basically a job?

"A. Yes."

The evidence shows that the business itself had no assets and was simply a mechanism through which its co-owners earned a living. Mr. Edenfield's description is important to the choice of the most appropriate valuation methodology, and the method used by Ms. Edenfield's expert is questionable in light of the actual facts of the company. Like the medical practice in *Hazard*, First Choice relied on the personal efforts of its principals. Because of the nature of its business, the future income of First Choice was subject to even more uncertainty.

*Id.* at 13. The Court of Appeals ultimately found that the trial court had erred in treating the business like it had any value, but it was unwilling to turn around and award the business and the entire debt to the husband, as the wife asked on appeal. Instead, the Court of Appeals awarded the business to the husband and allocated the debt equally between the parties.

Finally, the valuation of a closely-held business may, on occasion, be far simpler than it may appear at first blush. In *Inzer v. Inzer*, 2009 Tenn. App. LEXIS 498 (Tenn. App. July 28, 2009), the trial court was faced with the valuation of the husband's interest in a Sonic franchise which generated approximately \$150,000 per year in income for the husband. The wife's expert opined that the franchise interest was \$509,263; the husband's expert relied on the formula set out in the Operating Agreement to find that the value was 33,102; and the trial court found that the value was \$207,456. The Court of Appeals discussion touched on *Powell v. Powell*, *Wright v. Quillen*, *Wallace v. Wallace*, *Blasingame v. American Materials, Inc.*, and Revenue Ruling 59-60; it mentioned the four calculation methods used by the husband's expert and the methodologies employed by the wife's expert; and it noted that the trial court found the husband's value of \$33,102 "defies even common sense." 2009 Tenn. App. LEXIS 498, \*19. But in the end, the Court of Appeals found that none of this mattered, since the Wife had signed an agreement prior to the divorce "acknowledging her consent to the terms of the Operating Agreement, including but not limited to, the provisions...relating to the right of purchase of Husband's interest in the company." *Id.* at \*21. As the Court of Appeals noted

“The value established in a buy-sell agreement of a closely held corporation, not signed by the non-shareholder spouse, is not binding on the non-shareholder spouse but is considered, along with other factors, in valuing the interest of the shareholder spouse... [However], buy-sell agreements, like other contracts, entered into with mutual assent of the parties are enforceable against the parties. Wife is therefore bound by the value set by the terms of this agreement.”

*Id.* at \*20-21, citing *Harmon v. Harmon*, 2000 LEXIS 137 (Tenn. App. March 2, 2000) and *Calabro v. Calabro*, 15 S.W.3d 873, 879 (Tenn. App. 1999). The Court of Appeals in *Inzer* remanded the case to the trial court for a hearing to determine the value set in accordance with the terms of the Operating Agreement and the buy-sell paragraph in particular.

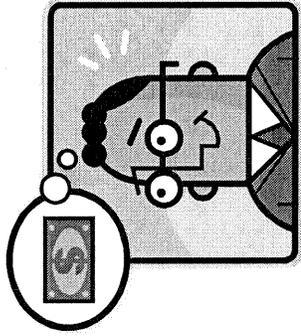
### III. Conclusions

A fair summary of the approach by Tennessee courts to the valuation of closely-held businesses is this: the method of valuation is largely up to the trial court, so long as the method makes sense in its application to the business at hand during a later review by the Court of Appeals. In reaching a conclusion, courts are free to follow the Delaware Block Approach, or Revenue Ruling 59-60, or the recommendations of experts within the industry, or to put great weight on what the individual owner has previously valued his or her business. It is not appropriate to put too much emphasis on the income stream or expected income stream of a professional practice or any business where the income stream is largely the result of the expertise and connections of the owner, particularly where those qualities can't be duplicated by another individual. A closely-held business that is more like a job is likely to have less value than a closely held business that is not simply a means of earning a paycheck. If the spouse has signed an Operating Agreement which incorporates a buy-sell formula, that formula is binding on both parties. And, finally, valuation of closely held businesses is not

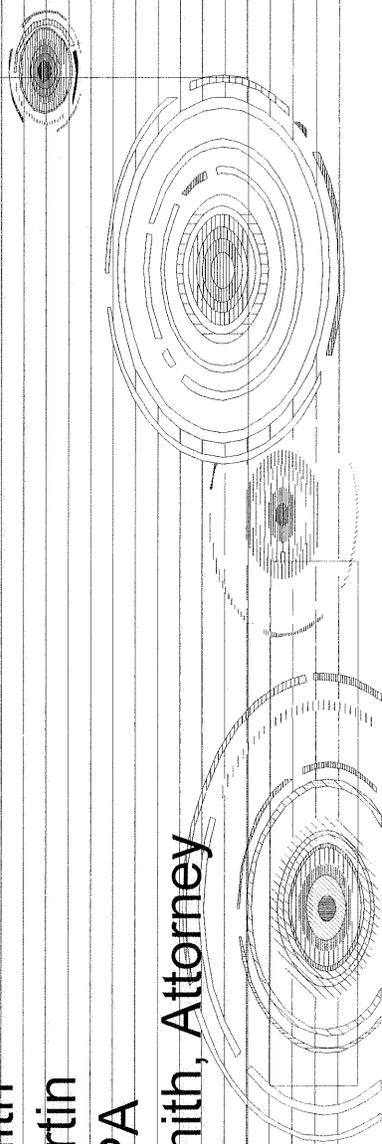
like a baseball arbitration: the court, unlike the arbitrator in a professional baseball salary dispute, does not have to select one value over the other, but may select a value within the range of values proposed by the experts at trial.

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# JUNE 2011 TENNESSEE JUDICIAL CONFERENCE

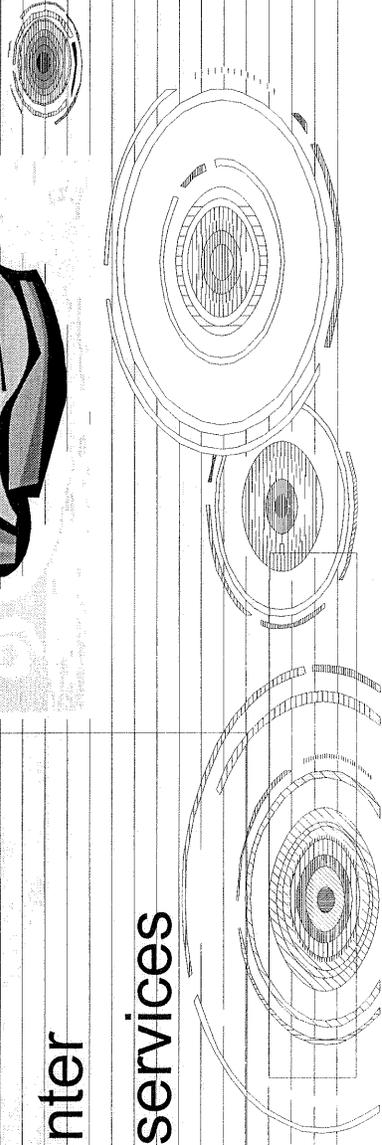
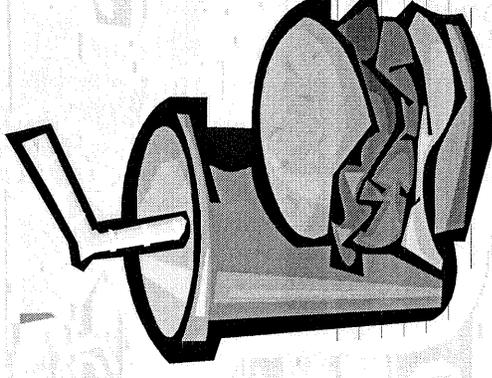


- **BERTUCA AND BEYOND: UNDERSTANDING BUSINESS VALUATION CASE LAW.**
- Judge Phil Smith
- Judge Jim Martin
- Tom Price, CPA
- Gregory D. Smith, Attorney



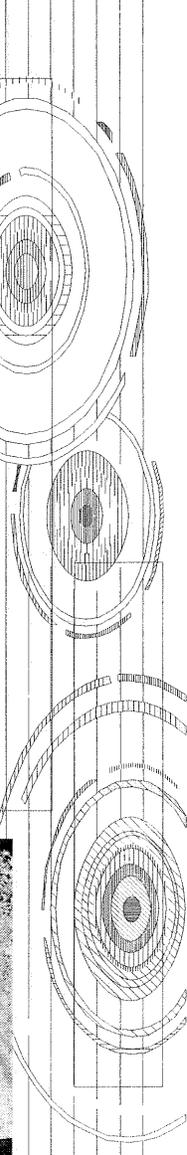
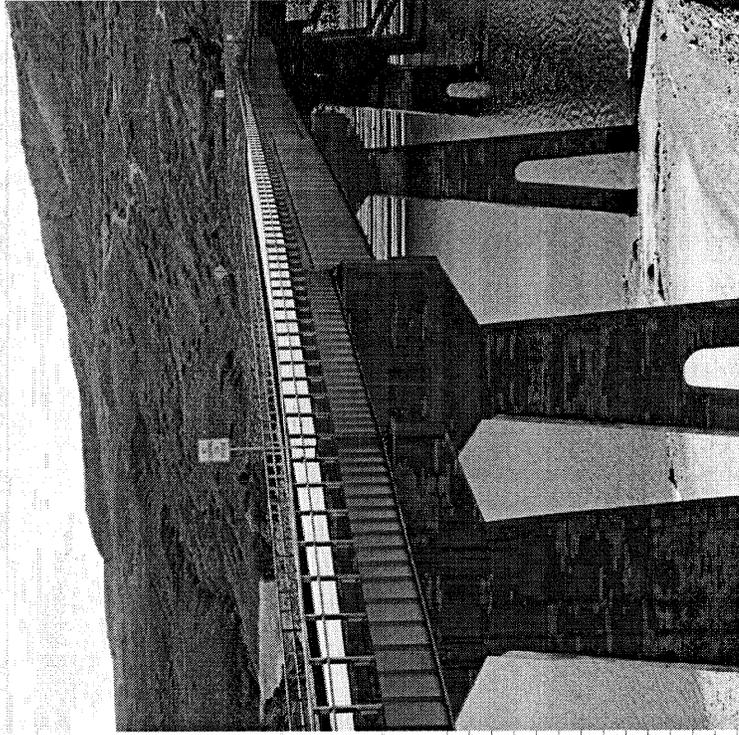
# INTRODUCTION

- Vast array of businesses at issue in Tennessee cases
- Fast food franchises
- Travel agencies
- Defense contractors
- Concrete manufacture
- Day care center
- Automobile services



# Blasingame v. American Materials

- 1983 case involving a contract dispute;
- Plaintiff was not a shareholder, but he expected to be one;
- Damages were alleged to be the value of the shares promised and then withheld.

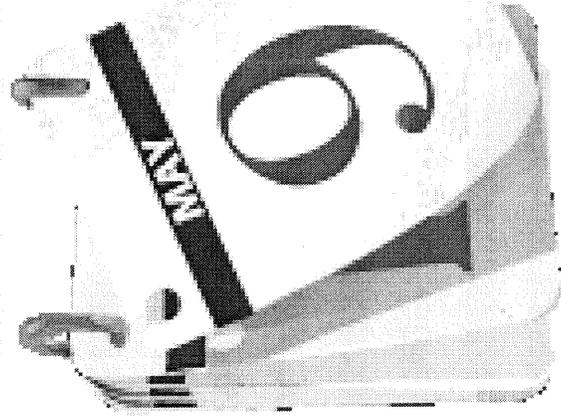


# Blasingame, Page 2

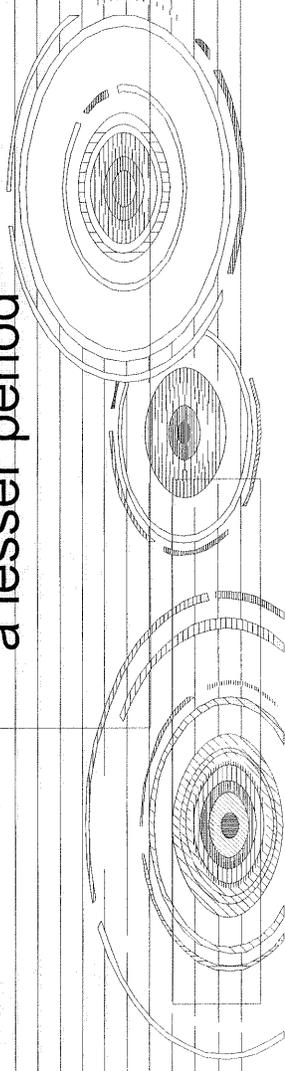
- Plaintiff's value of his alleged 25% interest in the company: over \$672,500
- Defendant's value: less than \$115,350
- Master's finding: \$309,988 (averaged high and low and applied a 17.5% marketability discount)
- Trial judge: \$429,000 (Didn't average values, found value to be \$600,000, applied minority interest discount)



# Blasingame, Page 3

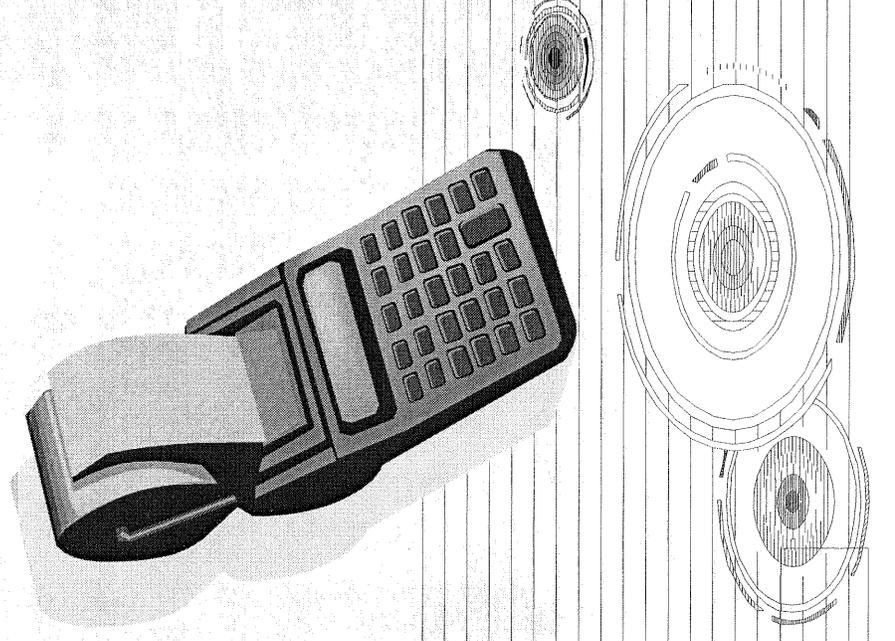


- Court of Appeals affirmed, Supreme Court reversed: “Any valuation of earnings that does not take into account a minimum of three years of earnings experience should be rejected, unless the expert opinion clearly and convincingly the validity of a lesser period”

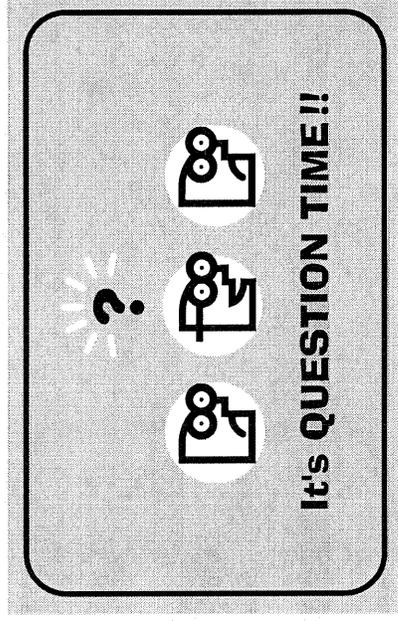


# Blasingame, Page 4

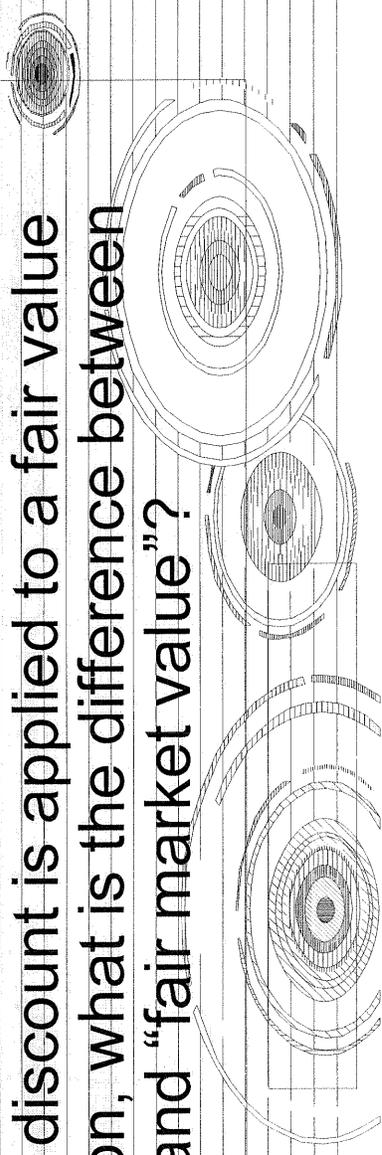
- Review of Fair Value Methods
  - Market value
    - Willing buyer
  - Asset value
    - Net assets valued as a going concern
  - Investment or earnings value
    - Past earnings used to predict future earnings



# Blasingame, Page 5



- Why apply a minority discount to a “fair value determination?”
- If a minority discount is applied to a fair value determination, what is the difference between “fair value” and “fair market value”?

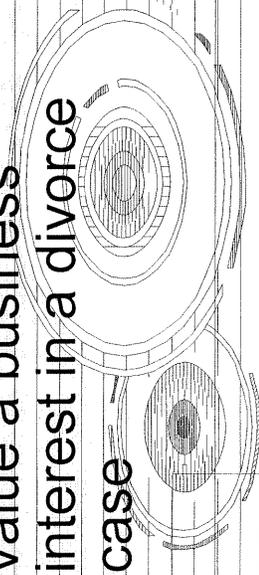
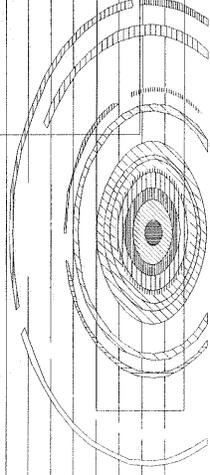
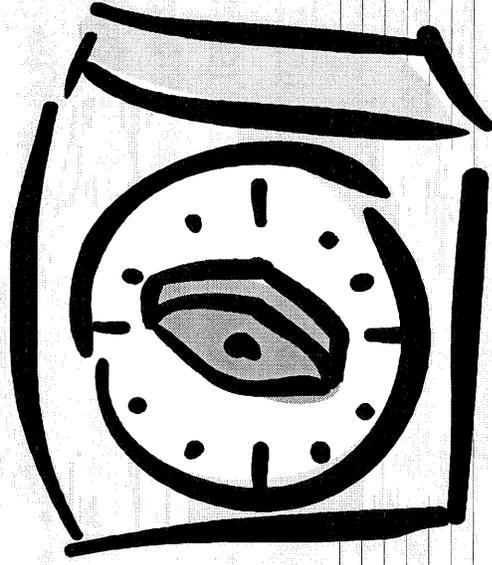


# Wallace v. Wallace

➤ 1984 and 1987: What we learned:

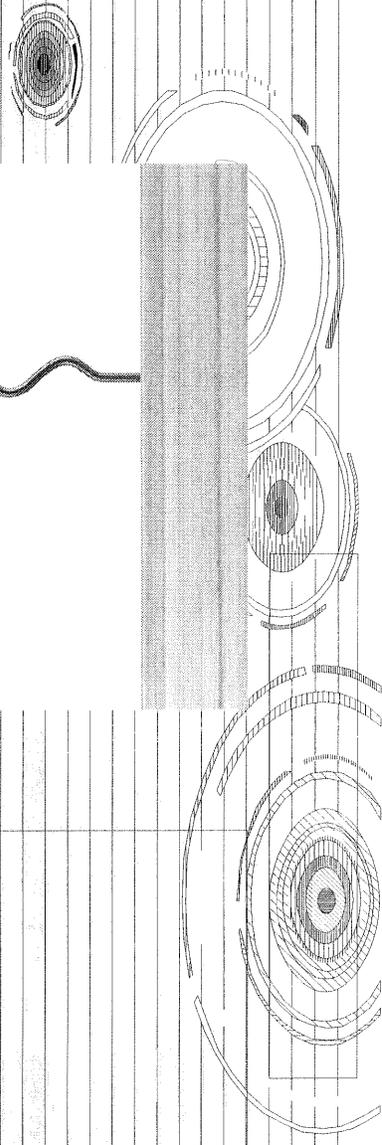
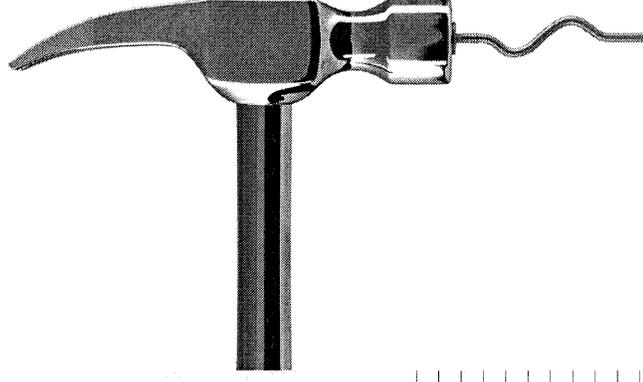
- Value, don't divide
- Value as of date of trial, not necessarily the first day of trial
- Timing is everything
- Delaware Block

Method is not the only acceptable way to value a business interest in a divorce case

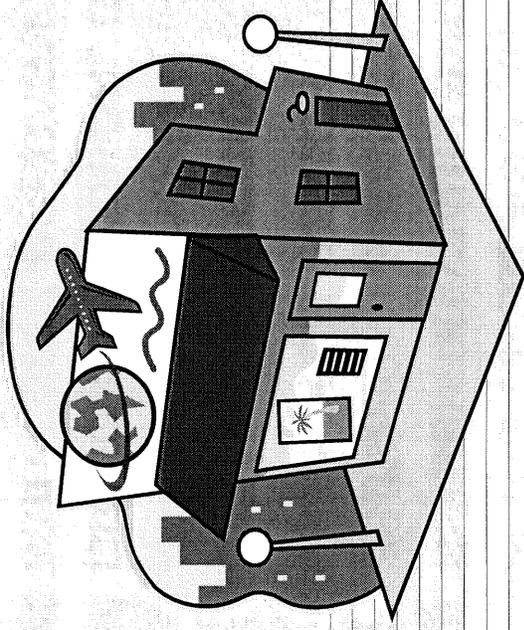


# Wallace, Page 2

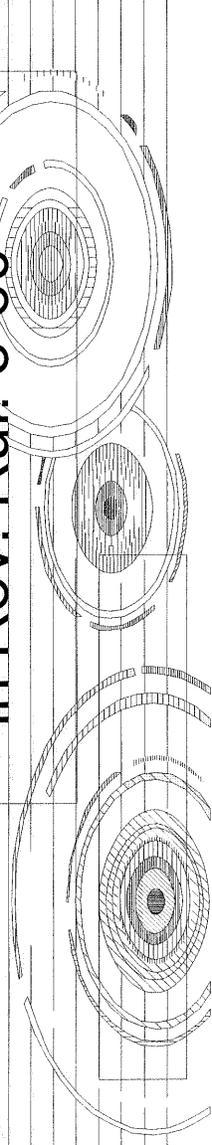
- Revenue Ruling 59-60 is a guide, not an inflexible rule
- Nine factors
- Court of Appeals upheld value of interest in business at \$1,500,000



# Wright v. Quillen

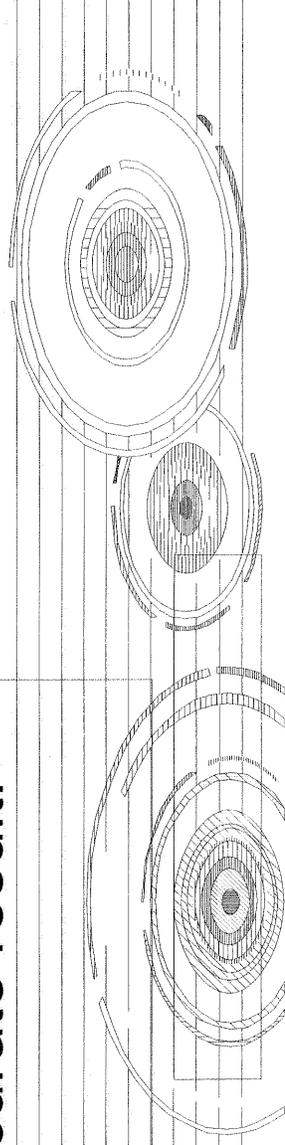
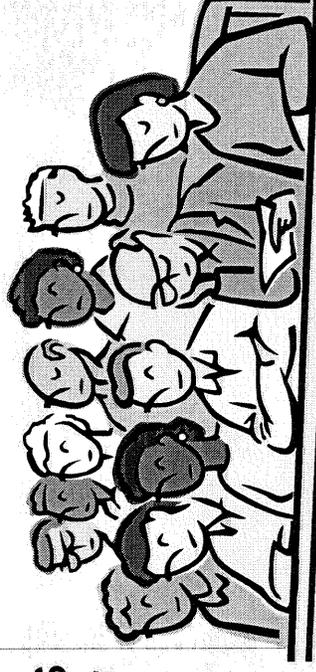


- 1995
- Valuation by expert who could not even pronounce “59-60” or “Delaware Block Method” acceptable
- Marketing approach, satisfactory, particularly where some factors are also in Rev. Rul. 5-60

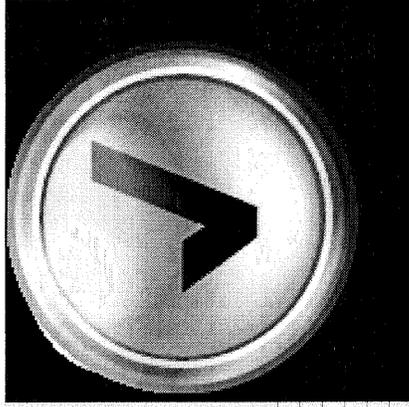


# ***Wright v. Quillen*, Page 2**

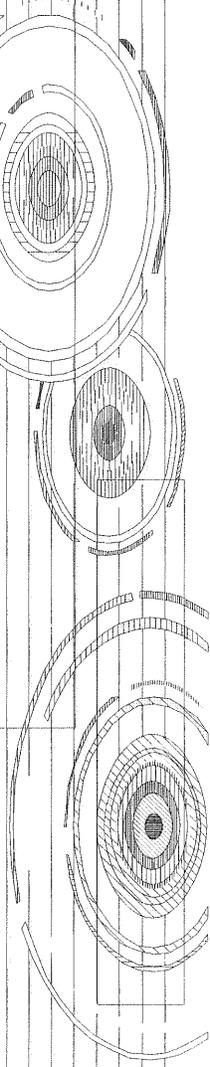
- “Choice of proper method or combination of methods to determine value depends on unique circumstances of each corporation.”
- Method of valuation should form a basis “reliable enough to assist the jury to reach an accurate result.”



# Powell v. Powell

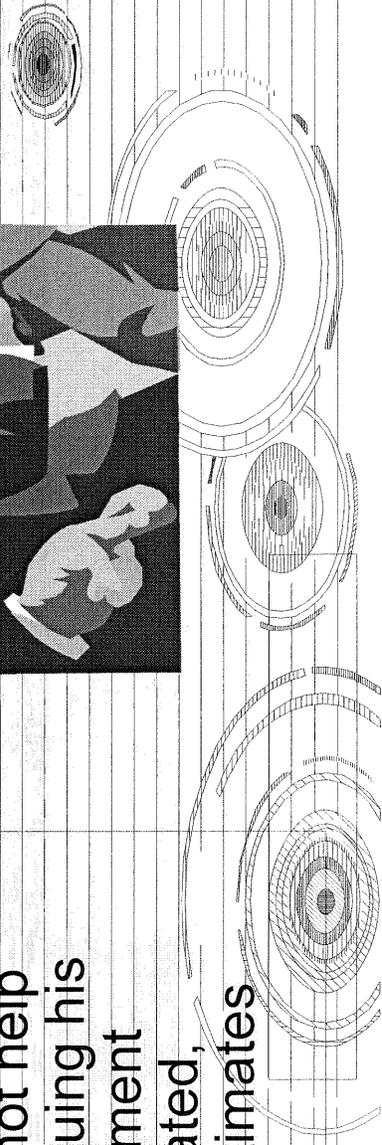


- 2003: check cashing outlets
- Husband's expert: \$385,482
- Wife's expert: \$2,290,000
- Trial court: wife's expert got it right
- Court of Appeals: Trial court got it right

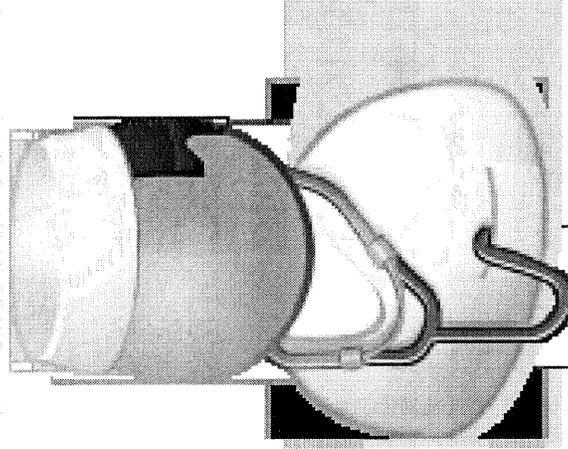


# Powell v. Powell, page 2

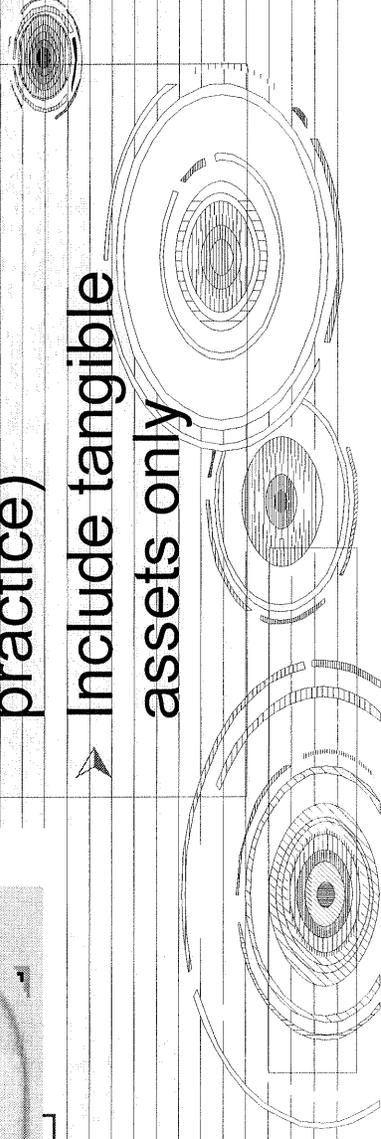
- Determination of value is a question of fact, not law
- No mandate to use Revenue Ruling 59-60 (but don't use your company CPA...)
- Husband's own valuation prior to divorce should be given weight
- Husband did not help himself by arguing his financial statement contained inflated, inaccurate estimates



# Garman v. Garman

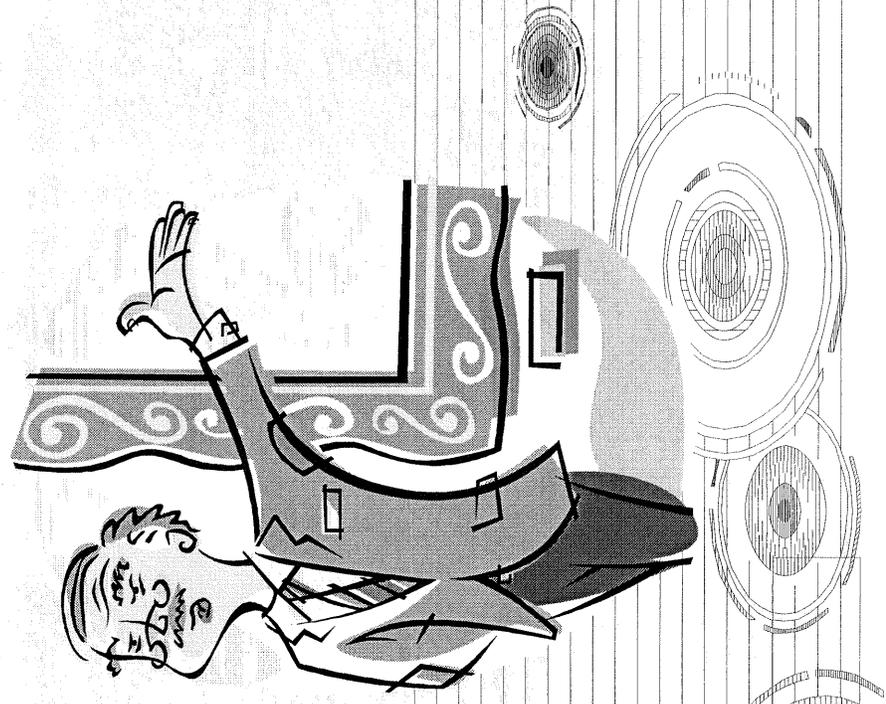


- 2011: Value of professional medical practice
- Do not include professional goodwill (see Judge Martin's comments on the value of a dental practice)
- Include tangible assets only



# Smith v. Smith

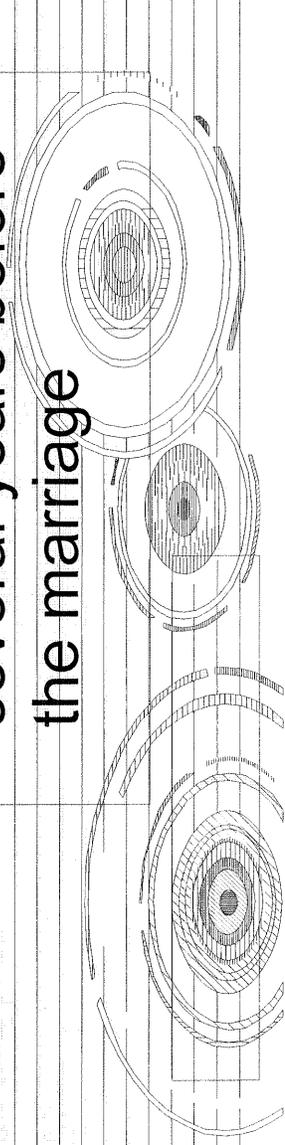
- 1985 case recognizing good will carve outs
- Good will has value, but does not bestow “an actual, separate property interest”
- “Disturbing inequity in compelling a professional to pay a spouse a share of intangible assets at a judicially determined value that could not be realized by a sale.”



# Other Important Cases

- **Alsup**: value of day care center tied to reputation of owner;
- **Carpenter**: law firm value based on value attributed by husband in bank financial statements filed in the several years before the marriage

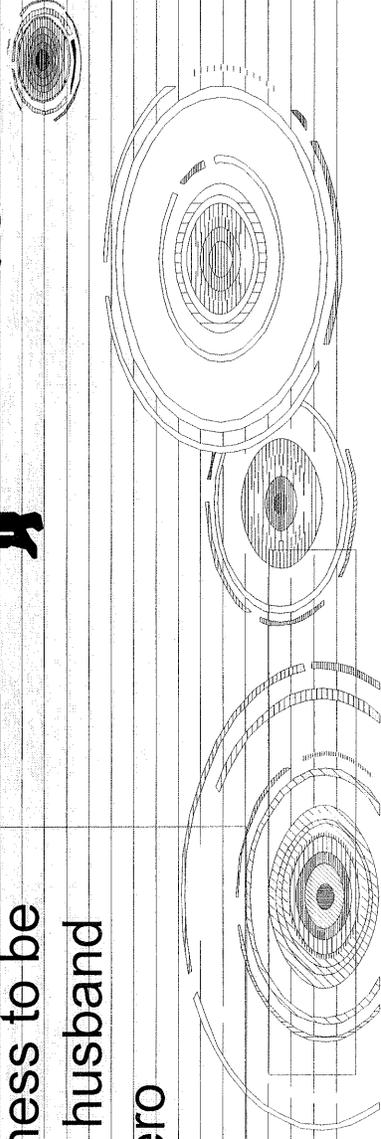
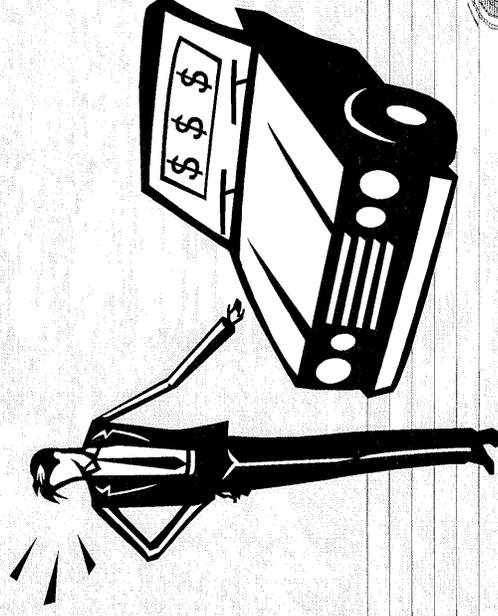
Date	Amount
10/20	\$ 738.97
10/21	528.82
10/22	590.53
10/23	524.21
10/23	267.74
10/23	308.62



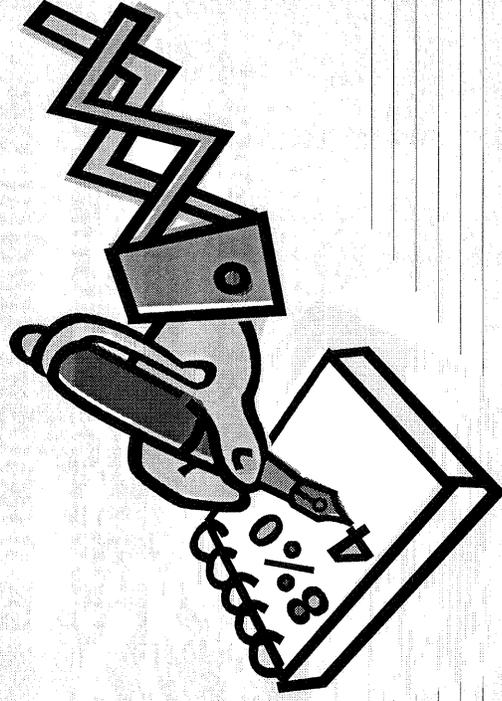
# Other Cases

## ➤ **Edenfield: 2005**

- Be careful what you ask for
- Wife really didn't want business, at least not at *that* value
- Court of Appeals apportioned debt, found business to be worth what husband claimed: zero



# Other Cases



- **Inzer:** 2009. Valuation of interest might be based on a buy-sell agreement signed by the non-shareholder spouse

