Recent Case Law Regarding Business Valuations in Divorce Cases

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Divorce courts are required to make an equitable distribution of property. Doing so when closely-held businesses are involved, can present difficult valuation issues. It is important to keep in mind that business valuation issues are addressed differently in divorce litigation than in other civil litigation or disputes. This article will review some of the current case law in the area and identify the present state of valuations in divorce cases.

Zells and Talty Cases Still Set the Standard for Good Will Evaluation (But See Author’s Update Below)


The Zells case presented two issues. The first was whether a lawyer’s contingent fee contract was subject to an equitable division of property. The second issue was whether professional good will of a solo practitioner’s law practice was a marital asset subject to equitable division. The Illinois Supreme Court held neither contingent fee contracts nor professional good will are marital assets subject to equitable distribution.

Contingent fee contracts are not marital property because they are speculative future income. As such, contingent fees relate to support and not distribution of property. In addition, the division of attorneys’ fees is barred by ethical requirements which prohibit sharing fees.

The Zells case further holds that professional good will is merely the ability to acquire income in the future. Because this is already considered elsewhere in the IMDMA (in the division of marital property under §503 and determination of support under §504) it would be double counting to consider it as a current marital asset subject to equitable distribution. In reaching this result, the Illinois Supreme Court cited cases from other states which hold that professional good will is not a marital asset. Specifically, the Court cited Holbrook v. Holbrook, 103 Wis. 2d 327, 309 N.W.2d 341 (1981) and Powell v. Powell, 231 Kan. 456, 648 P.2d 218 (1982).

In 1995, in the case of Talty v. Talty, the Illinois Supreme Court expanded the ruling in the Zells case to hold that personal good will in a closely-held business was also excluded from marital property subject to equitable distribution. However, the Talty court distinguished enterprise good will which could be included in marital property subject to equitable distribution.

The Talty case involved a car dealership where the trial court allowed both expert appraisers to testify to good will values. Relying on the Zells case, the husband argued that this was impermissible double counting. The Supreme Court defined good will as the value of a business or practice which exceeds the combined value of its physical assets. The portion of good will which was personal to William Talty should not have been included in the marital
The Court distinguished Zells which involved a professional practice where good will was personal in nature. The opinion suggests that in a professional practice there is no need to distinguish between professional and personal good will. However, that distinction must be made in a business which consists of a combination of personal and enterprise good will.

The Supreme Court provided no direct guidance on how to distinguish between personal and enterprise good will except to say “the evidence may disclose that some portion of the good will is attributable to the dealership and will not be based on the personal efforts, but on the intangible value of the enterprise, including, for example, products it sells.” 166 Ill. 2d at 237. Thus, distinguishing personal and enterprise good will requires the appraiser to analyze the value of the business without the divorce party/owner. To the extent that the business earns money and has value without the owner, this is enterprise good will. If you represent the non-owner divorce party, I suggest that you take an early deposition of the other spouse. For a number of reasons, the divorce party/owner may have an incentive to diminish his/her importance to the business for other reasons in the divorce unrelated to the business valuation. This will be useful when analyzing enterprise versus personal good will.

There is an open question whether professional practices can have enterprise good will. Zells suggests not. However, this was a sole proprietorship of an aging attorney. In valuing, for example, a suburban dental practice of 8 or 10 dentists, it would be difficult not to conclude that enterprise value is possible. Other states allow it. (See the Yoon discussion which follows.) Illinois has no direct authority to do so. Obviously, the safest answer is to make no finding of enterprise value. However, a compromise approach would be to appraise the tangible value of the value of the business separately without any enterprise value. Then, make a separate appraisal of enterprise good will including a statement of the reason why, in this instance, enterprise good will exists. This would allow the Court to include the enterprise good will without jeopardizing the overall valuation.

Yoon Case Updates Zells and Talty in Indiana

When it comes to equitable distribution, Illinois law is essentially the same as the law of other states. For example, Indiana specifically follows Talty which was adopted by the Indiana Supreme Court in In Re: Marriage of Yoon, 711 N.E.2d 1265 (1999). However, Yoon applies that Talty distinction between enterprise good will and personal good will to a professional practice.

In describing the good will of a medical practice, the Indiana Supreme Court said:

We hold that good will that is attributable to the business enterprise is divisible property, but to the extent that the good will is personal to the professional or to the business owner, it is a surrogate for the owner’s future earning capacity and is not divisible....In sum, to the extent a business or profession has good will (or has a value in excess of its net assets) it is a factual issue to what extent, if any, that good will is personal to the owner or employee and to what extent it is enterprise good will and therefore divisible property.

In Re: Marriage of Yoon, 711 N.E.2d at 1270.

Without direction as to how an appraiser distinguishes between enterprise and personal good will, the Indiana Supreme Court remanded the case for such a determination. The Court suggested that some of the value of a medical practice is inherent in the type of practice or nature of the patient base. The Court also held that some of the value was personal because of the husband’s long hours that made the business so successful. The Court summarized this as follows:

The goal in a dissolution, however, is not the value of the business (including the professional) for a buyer. Rather, it is to identify the portion of the value that is attributable to the business without the professional’s continued participation. To the extent that the high level of receipts are due to factors unique to Dr. Yoon, for example, unusually long hours, the enterprise value, if any, is only whatever value exists in the patient base and would be transferable to a buyer unwilling to work the same long hours.
Recent Case Law Regarding Business Valuations in Divorce Cases (Cont.)

In Re: Marriage of Yoon, 711 N.E.2d at 1272.

Indiana cases decided after Yoon established that valuations must distinguish personal and enterprise goodwill. Bertholet v. Bertholet, 725 N.E.2d 487 (March 27, 2000). The case was remanded to determine if the valuation of a bail bond business properly excluded the value attributable to husband’s personal goodwill. Frazier v. Frazier, 737 N.E.2d 1220 (November 15, 2000). The case was remanded to determine the value of husband’s personal goodwill in a family retail business, which would then be excluded from the valuation.

These cases establish that it is essential to specifically exclude personal goodwill from the valuation of a business in a divorce case.

ATTORNEYS TAKE NOTE: You must conduct a proper valuation, or raise the possibility of a malpractice claim. The case of Gilman & Statham v. Sandra Homan, 725 N.E.2d 425 (March 9, 2000, Indiana Court of Appeals, 2nd District) shows just how far an unhappy divorce litigant will take this. The plaintiff's wife alleged that the defendants committed legal malpractice when they failed to value the goodwill of her ex-husband’s medical practice. Because the husband was a staff member physician and had no ownership interest in the medical clinic, the appellate court found in favor of the defendant attorneys. The lesson here is to properly manage client's expectations by letting them know why you have not conducted a business valuation, and why it is not appropriate to do so.

Author's Update: Supreme Court Has Now Revisited The Goodwill Evaluation Issue in Schneider Case

The Illinois Supreme Court has now revisited the issue of goodwill evaluation in the case of In Re: Marriage of Schneider, which was decided by the Second District Court of Appeals on October 24, 2003. On January 21, 2005, the Supreme Court reversed the Second District and reaffirmed its holdings in Zells and Talty.

In Schneider, the former husband had a dental practice. The trial court found that no enterprise goodwill was proven and held that personal goodwill should not be included in determining the fair market value of the dental practice. The Appellate Court reversed because the ex-wife had waived maintenance. Therefore, the Court held that personal goodwill had not been a factor in determining maintenance and it was therefore appropriate to include it in evaluating the dental practice.

The Supreme Court reversed on the basis that personal goodwill was already reflected in a number of the circumstances considered by a judge in making an equitable division and therefore, should not be duplicated in evaluation analysis even when no maintenance was awarded. The Court held as follows:

In this case, as in Talty, the personal goodwill in Earl’s dental practice was considered by the Circuit Court in assessing the criteria in Section 503(d) and in deciding to award Jodi a disproportionate share of the marital assets. Any further consideration of that goodwill in valuing Earl’s dental practice would amount to an impermissible double counting. Accordingly, we find that the Appellate Court erred in holding that personal goodwill should have been included in the valuation of Earl’s dental practice.

Further, the Court declined to adopt the approach set forth in Grunsten (see below) where the First District required the Court to consider the price paid for a corporation four years earlier and compare it to the increase of gross revenues. The Supreme Court did not follow Grunsten because it involved a closely-held corporation and not a professional corporation and therefore, did not address the issue of personal goodwill.

But the husband here did not win everything. The Supreme Court rejected his contention that valuing his accounts receivable amounted to an impermissible double accounting. Because accounts receivable have not yet been collected and are assets that have therefore been earned with a known value, they are distinguishable from future earnings or income generating ability. Therefore, the Supreme Court held that the trial court should consider the accounts receivable in valuing the husband’s dental practice. This portion of the Appellate Court ruling was affirmed. The cause was remanded to the trial court to assess its division of property in light of the court opinion on valuation. This opinion clarifies Illinois law by essentially affirming the salient points of Zells and Talty.
Other Recent Illinois Valuation Cases

There are three additional cases worth mentioning here:

- **In Re: Marriage of Blackstone**, 288 Ill. App. 3d 905, 681 N.E.2d 72, 224 Ill. Dec. 90 (1st Dist. 1997), the trial court must have credible evidence of value or it will be reversed. The husband had a company which provided food service to numerous food courts. The husband’s appraiser testified that because of operating losses and the fact that food service contracts were not automatically renewable, the business had zero value. The wife presented no expert testimony and simply asked the court to award her one-half of the business. The trial court rejected both suggestions and found the value of the business to be $300,000 which represented its initial capitalization. The appellate court felt compelled to reverse and remand to determine a proper value.

- **In Re: Marriage of McHenry**, 292 Ill. App. 3d 634, 686 N.E.2d 670, 226 Ill. Dec. 887 (1st Dist. 1997), even though the trial court must have proper evidence to determine values, it does not need to make a specific finding of value. Here, there were two businesses, an answering service and welding business. The trial court made no finding at all about value, but divided the property and awarded one business to each of the parties. The Appellate Court specifically found that the statute does not require the trial court to place a specific value on each marital asset, but simply to make an equitable division of the property set aside to each spouse.

- **In Re: Marriage of Steinberg**, 299 Ill. App. 3d 603, 701 N.E.2d 254, 233 Ill. Dec. 611 (1st Dist. 1998), the Court ruled that accounts receivable are a separate asset (even of a professional corporation) and are subject to division. In this case, the professional practice was non-marital, but its accounts receivable were marital, subject to reimbursement. Because the marital estate had already been adequately compensated for these accounts receivable, there was no order of reimbursement here. However, the court did find that accounts receivable are separate assets. Thus, in valuing a professional corporation, the accounts receivable should be included in the value of the tangible assets.

**Clayden Applies Value From Buy/Sell Agreement But Leaves Open Questions**

When it comes to the issue of buy/sell agreements, there is one new case worth noting. **In Re: Marriage of Clayden**, 306 Ill. App. 3d 895, 715 N.E.2d 1201, 240 Ill. Dec. 144 (4th Dist. 1999), the Court applied the value from a buy/sell agreement, but left a number of open questions.

In this case, the husband had shares in a dental practice which were subject to a buy/sell agreement. The buy/sell provided that he would receive $1,000 per share on termination and $3,400 per share on his death or retirement. The accountant from the dental practice testified that the buy/sell values were amended annually and that the $1,000 per share price was based upon hard assets, while the $3,400 per share price included good will. Based on **Zells**, the trial court found the $1,000 value and was affirmed by the Appellate Court. Therefore, the husband’s lower valuation was affirmed. This appears to support the value based on the buy/sell agreement and the concept that a professional practice can have no enterprise good will. However, the Appellate Court specifically leaves these issues open:

> had the respondent been retired at the time of the hearing or had the (wife’s) expert offered alternative fair market value of the stock, without consideration of the good will aspect-something unrelated to the buy/sell agreement for example, the court could have adopted a higher price.

The trial court did not require that the buy/sell agreement mandated value. This was true even though this particular buy/sell agreement had been adjusted annually. In many cases, we see buy/sell agreements where the number is set arbitrarily and is set low in order to incent the existing owners to stay with the company.

It should also be noted that the court rejected Dr. Clayden’s argument that $3,400 per share price upon retirement was in the future and therefore too speculative. The court distinguished the **Zells’** contingent fees contracts (which were not marital property subject to
equitable distribution) because Dr. Clayden was to receive an established amount and was only two years away from retirement. Although Dr. Clayden won the valuation issues, there are open questions remaining.

**Appellate Court Reverses Trial Court in Grunsten for Failure to Consider Value From Prior Transactions (See Author's Update Below.)**

*In Re: Marriage of Grunsten, 304 Ill. App. 3d 12, 709 N.E.2d 597, 237 Ill. Dec. 342 (1st Dist. 1999)*, is significant because the Appellate Court reversed the trial court for failure to consider prior value from a prior transaction.

The business here was a mail order catalogue business. The wife’s appraiser used an excess earnings method. The husband’s appraiser used a capitalization of earnings methods. The trial court found both appraisers were wrong. The trial court found that the husband’s appraiser used the proper method but adjusted the risk factor applied by the appraiser and determined a fair market value of $550,000.

The Appellate Court rejected the trial court’s analysis because it ignored an almost identical transaction in the same stock only four years earlier. At that time, the husband had purchased his deceased partner’s stock from his widow. The widow had been paid $245,000 in cash, had received a college tuition payment for her daughter and had been paid an unearned salary. The court totaled the amount paid to the widow (including the scholarship and salary) for the value of a one-half ownership in the business four years ago. However, the court did not have profitability figures to compare the company at the time of the widow’s purchase and the present. Instead, the court used gross revenues of the company which grew in four years by approximately 50%. The court conservatively discounted this and increased the value of the company by 25%. Thus, the total of $650,000 paid to the widow became a value of $816,000 at trial.

This is an extremely active Appellate Court. Ordinarily, even if the Appellate Court reverses the trial court, the case is remanded for further proceedings by the trial court. Here, the Appellate Court essentially usurps the authority of the trial court and not only determines the method of valuation, but then applies the method and determines the value.

The Court can also be criticized from a valuation point of view. While it is certainly correct that identical transactions in the company’s stock are significant, the adjustments made by the court to bring the value current are probably just wrong. Rather than sending the case back down to the trial court where a comparison of the company’s value (four years ago and now) could be made with a complete record, the Appellate Court used a multiple based on revenue alone. Undoubtedly this oversimplifies the issue of value.

The *Grunsten* case is noteworthy for a number of reasons. Most important is that the *Grunsten* case establishes that you must have values which relate to prior transactions. If there are arm’s length transactions within a relevant time period for similar blocks of stock, this must be an essential element of your valuation. The *Grunsten* court does not address how the appraiser should adjust for dissimilar prior transactions. For example, what if the sale was 20 years ago? What if the sale was for less than 50% of the asset? What if the sale was something less than an arm’s length transaction? What if the company had gone through structural or ownership changes since the last transaction?

Obviously, all of these issues should be considered and if the transaction was not arm’s length, then it is probably of little value. However, be safe. With whatever methodology you choose, analyze all prior transactions in the same stock.

**Author's Update:** On January 21, 2005, the Supreme Court reversed the Second District’s holding in *In Re: Marriage of Schneider.* A more complete discussion of this is set forth above. However, one of the arguments raised by the wife in *Schneider* was that the trial Court failed to consider a prior transaction in the share of the husband’s dental practice and therefore ran afoul of *In Re: Marriage of Grunsten.* The Supreme Court declined to follow the *Grunsten* case. While not overruling the case, it held that *Grunsten* involved a closely-held corporation, it was inapplicable to dental practice which involved professional goodwill. The Supreme Court held therefore, that *Grunsten* was inapplicable to an analysis of personal goodwill in a professional practice. The Supreme Court did not
Grunsten in any other manner and therefore it is safe to say that the Grunsten decision must be considered in any valuation and all prior transactions in the same stock must be analyzed.

**Molitor Emphasizes the Importance of Properly Evaluating Good Will**

When it comes to the importance of properly evaluating good will, an interesting 1999 case drives this point home - *In Re: Marriage of Molitor* (1st Dist. 1999-unpublished). The case was decided under Supreme Court Rule 23, which means that there is no published opinion and therefore technically there is no precedential value.

In this case, the business was a computer consulting business. The Appellate Court opinion contains a detailed discussion of the appraisal methods used by each party’s appraiser. The wife’s appraiser valued the company at $235,000 using three different earnings-based methods analyzing all of the factors set forth in Revenue Ruling 59-60. The husband’s appraiser said that Revenue Ruling 59-60 did not apply because it was only relevant for estate valuations where the Internal Revenue Service wanted a higher valuation. Husband’s expert found there was no enterprise good will. Therefore, he valued the interest at $21,000. He found the value to be tangible assets plus receivables adjusted for bad debt minus negative cash balances. The trial court “split the baby” and found the value to be $70,000. The First District Court of Appeals reversed and required the valuation to exclude personal good will from the valuation, but to include enterprise good will in the valuation.

The court rejected the multiple of earnings valuation since that is what is typically used for publicly held companies. The court accepted the capitalization of earnings method used by the wife’s appraiser, but held that it must specifically exclude any future earnings dependent on the husband. In other words, the court held that the business value must specifically exclude personal good will. The court also found that the husband’s valuation was in error because it excluded all good will from the value and was based solely on tangible assets.

The court noted that some of the income was generated by personnel other than the husband including minority (30%) stockholders, employees and independent contractors. The trial court remanded to determine the value attributable to these other personnel (enterprise good will).

The Appellate Court also remanded to update the value of the tangible assets of the company. Husband’s expert had testified to tangible assets as of December 31, 1996 when the date of trial was June, 1997. The court remanded to determine the value of the tangible assets of the company as of the date of trial.

Although not legal precedent, the lessons from *Molitor* are to:

1. Use the date of trial for valuing assets,
2. Use asset-based values adding enterprise good will if it is appropriate, and
3. Make certain enterprise good will is not based upon any income or value attributable to the divorcing party.

**Illinois Courts Have a Much Lower Threshold for Expert Testimony Than the Federal Courts: Why This Affects the Valuation Process**

In 1996 Illinois amended the rules on witnesses. Technically, we no longer have expert witnesses and instead we have opinion witnesses identified pursuant to Supreme Court Rule 213(g). In divorce cases, opinion testimony is allowed on a wide variety of subjects without much background or expertise. As a result, the threshold for business appraisal testimony is now much easier to meet.
This wasn’t always true. On a personal level, I have been successful in several trial courts excluding appraisers who lacked sufficient valuation experience. Simply having an accounting or financial background was not enough to be allowed to provide expert valuation testimony. As one judge pejoratively put it, "just because you can count the beans-doesn't mean you know what they’re worth."

The federal courts have a completely different and much higher standard which was established by the case of *Daubert v. Merrill Dow Pharmaceuticals, Inc.* 509 U.S. 579, 113 S. Ct. 2786 (1993). The *Daubert* court applied four factors to determine the reliability of a particular expert’s scientific theory or technique:

1. Testing - can the theory or technique be tested?
2. Peer reviews - has the theory been subject to peer review or publication, which aids in determining flaws in the method?
3. Error rates - are there standards to control the use of the technique?
4. Acceptability - is the technique generally accepted in the relevant technical community?

These are threshold questions which must be answered favorably before the expert is permitted to testify.

There have been a number of trial courts which have applied these factors to valuation and economic analysis testimony. In *Target Market Publishing, Inc. v. Ado, Inc.*, 136 F.3d 1139 (1999), the 7th Circuit applied the *Daubert* factors to exclude the financial valuation testimony of a business appraiser from Deloitte & Touch. In concluding that the trial court had properly applied the *Daubert* standard to exclude the testimony of the business appraiser, the 7th Circuit made an interesting and derogatory analogy:

If, for instance, an expert who was well qualified as an astronomer offered to testify based on lengthy and careful observation that the sun revolves around the earth, a court would not be obliged to submit the testimony to the jury. The Supreme Court recently upheld a district court’s decision to exclude expert testimony on the ground that it did not rise above subjective belief or unsupported speculation. This Court, moreover, has not hesitated in the past to uphold a district court’s decision to exclude expert testimony on similar grounds.

136 F.3d at 1143.

The Court in the *Target Market Publishing* case was undoubtedly influenced by the fact that there was no established business and the witness was testifying at least in part based on anticipated future profits. However, there is no question that the *Daubert* threshold requirements will be applied much more strictly than any such standard applied in the state courts (especially when a jury is involved).

Remember that it is important to properly treat good will or your appraisal will be subject to challenge at trial and reversal on appeal. If you are evaluating a professional practice the value should be updated tangible assets. If there is enterprise good will involved, you may include a value for that -- but make certain it does not include any income or value attributable to the divorcing party/owner.

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