

Professional Practice Valuation in a Tennessee Divorce

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The process of valuing a business is more art than science and depends on the circumstance or event causing the valuation. The fundamental concept common to most business valuations is that the value of an entity is equal to the present worth of the future benefits of ownership at a single point in time. Economic benefits to an owner ultimately must be derived from the generation of ongoing income from operations or investments, liquidation of the underlying assets or sale of the entity. Fair market value (FMV) is the value standard to be used in most cases, with a few notable exceptions, such as in some divorces or dissenting shareholder lawsuits. FMV is defined as *the amount at which the property would change hands between a willing buyer and a willing seller, neither under compulsion to buy or sell, with both parties having reasonable knowledge of relevant facts*. Believe it or not, the Internal Revenue Service created this definition in 1959 in Revenue Ruling 59-60, which, even today, is still considered a bedrock of valuation text.

In a divorce, an actual transfer of the business to a third party is not usually planned or even possible, thus does not involve a willing buyer and willing seller in an arm's length deal (i.e., no FMV). Jurisdictions, like the State of Tennessee, often impose further limitations or restrictions based on their belief that, in certain cases, the expectation of future earnings is not an asset for property division. The following article focuses on three divorce cases decided in the Tennessee Court of Appeals. These cases highlight three situations commonly argued when professionals divorce – existence of goodwill for a sole practitioner, existence of goodwill in a large practice and binding valuation formulas found in buy-sell agreements. All three cases deal with medical practices, although the same theories apply to other professions.

In a Tennessee divorce, a *sole practitioner* licensed professional, such as a physician, dentist, accountant, attorney, engineer, etc., would generally not be subject to having the practice valued at FMV. Only the value of the net assets could be considered with no allowance for an expectation of future earnings (i.e. goodwill), such as in *Hazard v. Hazard*, 833 S.W. 2d 911 (Tenn. App. 1991). Net Assets is defined as the total *non*-intangible assets (cash, accounts receivable, work in progress, inventory, equipment) less the payables and debts. Professionals with larger practices that do not depend on the sole reputation or efforts of the individual have often been likened to going concern, closely held corporations, such as in *Witt v. Witt*, 17 TAM 15-6 (M.S., Tenn. App. 1992). The valuation allowed in *Witt* more closely resembles FMV and did allow for goodwill. Another interesting twist was decided in *Harmon v. Harmon*, 25 TAM 15-22 (W.S., Tenn. App. 2000). *Harmon* established that a spouse, who is not a party to a buy-sell agreement, is not bound to the artificially low valuation method specified in the agreement.

Sole Practitioner (No Goodwill)

In *Hazard*, the Western Section of the Tennessee Court of Appeals affirmed that a sole practitioner professional practice is to be valued using the “net tangible assets with ascertainable value.” The court stated that goodwill, which is usually based on some function of future, potential income, is not to be considered based on the personal nature of a professional practice and the speculative nature of future income which may or may not materialize. Dr. Hazard was a physician in his final year of fellowship training in pulmonary medicine. He established a private practice that employed one associate physician, two nurses and two other employees. The court found the value of the practice to be based upon a total of the cash on hand, accounts receivable, equipment, fixtures, supplies and medical charts. No

provision for goodwill was allowed. The wife argued that the practice was a going concern, separate entity, and should be valued accordingly. The court determined that the practice was highly specialized and, apparently, very dependent upon the services of Dr. Hazard.

The court said:

In *Smith v. Smith*, 709 S.W. 2d 588 (Tenn. App. 1985), the...Court, in dealing with a law practice, said:

The next question is what elements of a profession are taken into account in arriving at the value of that profession for purposes of making an equitable division. The physical assets, of course, such as the furniture, buildings, library, etc., are things that have an ascertainable value and should be taken into account. The accounts receivable, properly weighted, should have a definite value. The most troublesome question involves the goodwill of the firm. Is that an asset that can be considered part of the marital property? Other states are split on the question, although a clear majority hold that the goodwill of the firm should be considered and evaluated in making a division of the marital property.

We are not persuaded, however, that this state should adopt the rule that professional goodwill is a part of the marital estate. We find the position taken by the Wisconsin Court of Appeals in *Holbrook v. Holbrook*, (Wis. App. 1981) to be persuasive. The court said:

The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity. Although a professional business's good reputation, which is essentially what its goodwill 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 goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary.

There is a disturbing inequity of 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.

The *Holbrook* opinion is one of the most often cited involving professional goodwill (or the lack thereof).

Closely Held Corporation (With Goodwill)

Exceptions do apply to the "no goodwill," net asset value divorce rule. For example, in *Witt*, the court found that Dr. Witt's outpatient diagnostic clinic had a value over and above the net asset value (i.e. it had goodwill.) The court said:

We are convinced, however, that excluding the professional goodwill, (Husband's) practice has a value over and above the net asset value. The clinic employs eight people providing CT scans and MRI examinations. (Husband) works a full day at the VA Hospital and then goes to the clinic to apply his expertise to the work performed during the day by technicians. (Husband's) professional fees are billed separately from the technical fees generated by the technicians....The trial judge found that the net asset value of the clinic amounted to \$950,000. The evidence does not preponderate against that finding....The trial judge set a value on the medical practice at \$1,300,000, i.e., \$350,000 over and above the net asset value. We think the part of the business that does not include (Husband's)

professional goodwill has a substantial value and that the trial judge's valuation of \$350,000 for that portion of the business is supported by the evidence.

In other words, the clinic was found to have separate goodwill that was not directly related to the Husband's professional or personal goodwill, and thus the overall value was increased accordingly to include the intangible value.

Spouse Not Bound to Buy-Sell Agreement

In *Harmon*, the wife was not bound to the valuation method (formula) mandated in the buy-sell agreement in effect in her physician-husband's medical practice. The wife was not a party to the agreement and had not signed it.

Husband owned 10 shares (1.17%) of stock in the Jackson Clinic (Clinic), a very large, multi-location medical association. He had signed an employment contract that contained a non-compete clause, which further subjected him to a buy-sell agreement. The agreement bound him to a predetermined formula for valuation of the shares if he were to attempt to sell them. The formula specified that no allowance could be made for goodwill, supplies or accounts receivable, except upon dissolution.

Prior to trial, the parties stipulated that the current net asset value of Husband's interest in the Clinic at that time was \$250,000. At trial, Wife asserted that the trial court should use the parties' stipulated net asset values. She argued that Husband's buy-sell agreements with the Clinic were designed to discourage physicians from leaving the clinic, and therefore set an artificially low price per share. She asserted that the share price set by the clinic did not reflect the actual value of Husband's interest because it did not include the accounts receivable or the inventory. Husband argued that the clinic should be valued in accordance with the buy-sell agreement because he would be bound to that price if he sold his shares. The trial court found the stipulated value of the Clinic was the value to be used if the practice liquidated. Since there was no plan to liquidate, the trial court stated that Wife was bound to the value set by Husband's buy-sell agreement.

Upon appeal, Wife first argued that appropriate value was the net asset value of \$250,000 as stipulated by the parties. She stated that this value looks to the net assets of the practice as a going concern, taking into account the value for items such as accounts receivable and supplies. Even though Wife argued that net asset value was the FMV, she did not request a provision for goodwill, which would have been closer to the true FMV. She noted that she was not a party to the buy-sell agreements, and disputes the trial court's legal conclusion that she was bound by the value set in the agreements. Husband argued that the trial court's valuation of his interest in the Clinic is correct because his interest cannot be valued at more than the price he would receive for the sale of his shares.

The *Harmon* appellate court noted that both *Smith* and *Hazard* involved professional practices in which the value as a going concern and its business reputation was inseparable from the professional reputation of the practitioners. The court stated that, in a larger professional setting that does not depend on the reputation or services of a single practitioner, such as in *Witt*, Tennessee courts have not limited the valuation to the physical assets and the accounts receivable and have included goodwill.

In *Harmon*, the court relied upon a 1992 case, *York v. York* 17 TAM 34-1 (M.S., Tenn. App. 1992) In *York*, the Court discussed at length the method for valuation of a divorcing spouse's interest in a large professional practice. In *York*, the husband owned an interest in a multi-employee, specialty medical group. The *York* Court found the husband's medical practice to be more similar to the practice in *Witt* than to a traditional solo medical practice. The trial court in *York* likened the professional association to a closely held corporation and indicated that, while future income projections would not be con-

sidered, other factors such as corporate goodwill and the price at which other physicians had purchased stock would factor into the valuation of the husband's interest.

The *Harmon* court's research revealed no Tennessee cases addressing the issue of whether Wife was bound by the value stated in the buy-sell agreement. The clear majority of courts from other jurisdictions held that the value established in the buy-sell agreement of a closely held corporation, not signed by the non-shareholder spouse, is not binding on that spouse, but is considered, along with other factors, in valuing the interest. The court found that the majority view is more consistent with the valuation approach outlined in Tennessee decisions such as in *York*. The *York* court rejected the notion of mathematical formulas for such a valuation and emphasized that valuation of a professional corporation, such as Husband's, is "a factually driven inquiry that requires the trial court to weigh and evaluate all relevant evidence regarding value."

The *Harmon* court adopted the view that buy-sell agreements *may* be considered along with any other relevant evidence on valuation, but *are not* controlling, thus reversed the trial court's holding on this issue. The cause was remanded to the trial court for valuation of Husband's interest after consideration of all relevant evidence, including, but not limited to, the parties' stipulated net asset value and the values set forth in the buy-sell agreements. The trial court was told it may consider how closely the factors for valuation in the buy-sell agreements correlate with the factors mentioned in *York* and other applicable case law. The buy-sell agreement of the Clinic specifically excluded items such as intangible assets, accounts receivable and supplies. As in *York* and *Witt*, Husband's medical practice is an incorporated medical group that does not depend solely on his professional reputation for its value as a going concern. In fact, Husband's medical group in this case dwarfs in size those considered in *York* and *Witt*. The court found that since Husband will continue to experience the benefits of being a shareholder and an employee, factors such as those deleted from the valuation in the buy-sell agreement are pertinent to the valuation of Husband's interests for purposes of the division of marital property. *The issue is not the value the shareholder spouse would receive if he sold his shares, but rather the current value to the shareholder of his interest in the corporation.*

Conclusion

The final chapter of the valuation of professional practices in Tennessee divorces has certainly not been written. The courts are continuing to grapple with the concept of professional versus practice goodwill and the point at which the line is crossed and the practice becomes diverse enough to separate itself from the professional. This article addressed three valuation issues commonly found when professionals divorce – the non-existence of goodwill for a sole practitioner in *Hazard*, the existence of goodwill for a large practice in *Witt*, and not binding a non-party spouse to artificially low-yielding valuation formulas found in a buy-sell agreement in *Harmon*. The courts are becoming more sophisticated in their understanding of business valuation as evidenced in these cases, but they continue to depart from many traditional valuation methods.