MAY/JUNE 2022

LITIGATION SUPPORT

Goodwill in divorce: Personal or enterprise?

Revealing and exorcising ghosts from the payroll record

Estate of Collins v. Tabs Motors of Valley Stream Corp.
Fixed-value provisions in buy-sell agreements need regular updates

How business valuation pros can help when M&A talks stall

Goodwill in divorce: Personal or enterprise?

The handling of goodwill in divorce cases varies depending on the jurisdiction and case facts. And a court may sometimes consider cases in other states when there's limited legal precedent in its jurisdiction.

In many states, the amount of "enterprise goodwill" in a spouse's business can significantly boost the size of the marital estate subject to division. A recent Tennessee Court of Appeals decision provides an overview of the factors used to differentiate between personal and enterprise goodwill.

Spotlight on goodwill

Most states include all or some goodwill when dividing a couple's marital assets. In Tennessee, a spouse's *personal* goodwill in a business isn't divisible, but *enterprise* goodwill can be included in the business's value — and is subject to equitable distribution between the spouses.

Tennessee courts there have found a "disturbing inequity" in forcing a professional practitioner to pay an ex-spouse a share of intangible assets at a judicially determined value that the practitioner couldn't realize through liquidating the asset. It also may be considered inequitable "double dipping" if a spouse receives the benefit of both personal goodwill and maintenance payments based on the same income stream.

Vastly different valuations

In *Cela v. Cela*, the wife opened a speech therapy practice in November 2012. The practice receives referrals from local school systems and physicians. The wife was responsible for 14.3% of the practice's income during the relevant period.

At trial, the wife's valuation expert said that she was considered a sole proprietor for tax purposes because the practice is a single-member limited liability company and all services provided by staff are billed to insurance companies through her Social Security number. The expert rejected the income approach because it considers "overall enterprise value," including personal goodwill. He described personal goodwill as the patients' propensity to return to a practice due to an individual, rather than due to elements that belong to the business as an enterprise.

Using the asset (or cost) approach, the wife's expert valued the practice at $82,000. He didn't consider the wife's income, despite her draws as a sole proprietor of more than $600,000 between January 2018 and March 2019.

The husband's expert concluded that the income approach was appropriate because the practice is a "true business," not a "classic sole proprietorship." This conclusion was based, in part, on the fact that the practice is marketed under the business name (not the practitioner's name) and

Wife disputes her share of spouse's military retirement

In *Cela v. Cela* (see main article), the husband was entitled to a military pension at retirement. On appeal, the wife challenged the trial court's calculation of her share of the pension. She contended the court erred in determining the number of months they were married while he was in service, including the application of a 48-month reduction.

The trial court applied a method used by the U.S. Department of Defense, wherein the nonmilitary spouse is awarded 50% of a fraction that has:

1. A numerator of the number of months of marriage during service, and
2. A denominator of the total months of service.

The appellate court agreed to reduce the numerator by 48 months because the spouses were separated for part of the marriage. And the wife was unwilling to travel to advance the husband's career.

But the appellate court found that the lower court had mistakenly used 119 days in the numerator of its calculation. The couple was married for 195 months during service — and 195 minus 48 equals 147, not 119. The calculation was remanded to the lower court for a correction.

services are provided by a team. This expert valued the practice at $790,000.

The trial court found that the practice has a value beyond the net asset value. It, therefore, accepted the value based on the income approach. But the court reduced it by 14.3% to account for the wife's personal goodwill, for a final value of $677,030. The wife appealed.

Validated valuation

The Tennessee Court of Appeals declined to "second guess" the lower court because its valuation was within the range presented by the two experts. It found that the lower court's decision to rely on the value derived using the income approach was supported by the expert's testimony and evidence indicating the practice operated as a "true business with enterprise goodwill."

Specifically, the appellate court pointed out that:

- The wife handed off her patients to other employees at the practice when she took a leave of absence in 2016,
- The practice carried on successfully during this absence,
- Business continued uninterrupted during a subsequent eight-week leave of absence by the wife in 2018,
- The wife works from only one of the practice's two locations,
- The wife's therapy services account for only 14.3% of production, and
- The wife repeatedly testified that "people are making money for her."

These findings, the appellate court said, supported the trial court's conclusion that the practice is a successful enterprise, not reliant on any single therapist. The wife has established a business model that leverages others' skills and services to generate revenue.

The more you know

In *Cela*, numerous factors relating to how the wife conducted her business pointed to *enterprise* goodwill rather than *personal* goodwill — even her own expert conceded that the practice's goodwill wasn't "100% personal goodwill." Understanding these factors can help attorneys assess business valuations for divorce and other purposes. ■

Revealing and exorcising ghosts from the payroll record

A phantom employee is someone who's on a company's payroll but doesn't actually work for the business. This can be a former employee who hasn't yet been removed from the system, a friend of someone in the payroll department or someone who doesn't actually exist. However, when a ghost employee is paid, the money is always intercepted by a *real* perpetrator.

How does it work?

While it may be easier to hide payroll scams at organizations with multiple locations and offsite payroll departments, small businesses can be victims, too. All it takes is a dishonest employee who has access to the payroll system. These scams require three simple steps:

1. Put the phantom on the payroll. This can be as simple as adding a fictitious name to the payroll system or using the name of an employee who's left the company. If the criminal doesn't have access to the system, he or she might have to forge documents to create a fictitious account.

2. Create wage records. If the phantom employee is paid a regular salary, it may not be necessary to fabricate time sheets, logins and other records. Routine payments at regular intervals work to the criminal's advantage. However, the perpetrator may have to falsify records for hourly phantom employees.

3. Collect the cash. Converting paychecks or direct deposits to cash may require more subterfuge than direct cash payments. For example, an employee may set up a falsified bank account for direct deposits. Check cashing is riskier and may lead to apprehension. But once the crook pockets the cash, the fraud trail goes cold.

What are the warning signs?

Potential red flags that signal a phantom employee could be haunting the company's payroll system include:

- Missing or falsified employee files,
- Employees with overly vague (or no) job titles or descriptions,
- Multiple employees with the same mailing address or bank accounts for payroll deposits,
- Employees who don't sign up for health care or retirement benefits or who fail to take paid time off, and
- Employees who list a post office box as their mailing address.

Under normal conditions, a sudden unexplained spike in employee turnover also could forewarn of phantom employees. However, many companies have been experiencing a phenomenon known as the "Great Resignation," with employees leaving high-stress positions to achieve a better work-life balance. So, companies with high turnover should look for human resource-related causes before launching a fraud investigation.

How can you protect payroll from ghosts?

Strong internal controls — such as managerial review — are a company's first line of defense against phantom employees. Different supervisors might be assigned to approve payments to employees on a random basis, making it more difficult to hide a phantom employee. Supervisors should also be trained on how to scan payroll records for red flags, such as suspicious names and multiple employees with the same mailing address.

The payroll system also needs to be equipped with checks and balances. For instance, the head of a department should be required to verify any employees that are added or removed from the payroll system. Moreover, payroll records can be coordinated with personnel reviews. If an employee doesn't show up for a review, further investigation is warranted.

Evolving risks

Monitoring fraud risks is an ongoing process. The increasing prevalence of remote working arrangements and financial distress caused during the COVID-19 pandemic puts organizations at greater risk for payroll scams.

> Strong internal controls are a company's first line of defense against phantom employees.

When employees work remotely, people may not necessarily interact in person, providing *opportunities* to hide phantom employees. In addition, managers and payroll personnel who are struggling to make ends meet personally may be *motivated* to engage in dishonest behaviors. A forensic accounting expert can help clients assess their current risks and fortify their defenses against these scams. ■

Estate of Collins v. Tabs Motors of Valley Stream Corp.

Fixed-value provisions in buy-sell agreements need regular updates

Buy-sell agreements are a critical tool for closely held businesses, and their valuation provisions play a significant role in how the agreements will play out when triggered. Unfortunately, some members of a family business recently learned a hard lesson: While a fixed-value provision has the benefit of simplicity, failure to update it over time can prove costly.

Siblings sue

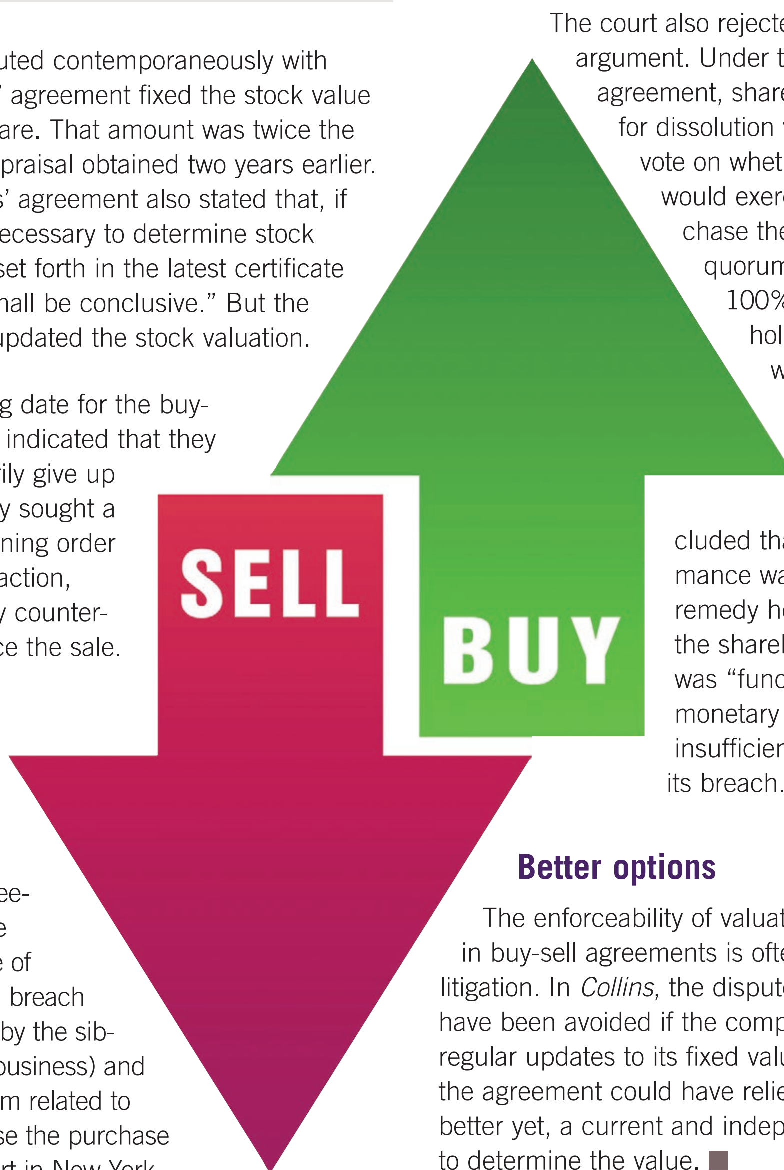
In December 2013, four siblings who owned an automotive business signed a shareholders' agreement. The siblings operated the company with little disagreement for several years. But, in 2019, one sibling and the estate of another filed to dissolve the company, thereby triggering the buy-sell provision

of the shareholders' agreement. The remaining shareholders voted to exercise the corporation's option to buy the shares of the shareholders seeking dissolution at a meeting that wasn't attended by those shareholders.

> A schedule executed contemporaneously with the shareholders' agreement fixed the stock value at $5,250 per share.

A schedule executed contemporaneously with the shareholders' agreement fixed the stock value at $5,250 per share. That amount was twice the value from an appraisal obtained two years earlier. The shareholders' agreement also stated that, if it ever became necessary to determine stock value, the value set forth in the latest certificate of stock value "shall be conclusive." But the company never updated the stock valuation.

Before the closing date for the buyout, the plaintiffs indicated that they wouldn't voluntarily give up their shares. They sought a temporary restraining order against the transaction, and the company counterclaimed to enforce the sale.



Court takes a side

The plaintiffs argued that the shareholders' agreement shouldn't be enforced because of unconscionability, breach of fiduciary duty (by the sibling who ran the business) and issues with quorum related to the vote to exercise the purchase option. A trial court in New York disagreed on all counts. It found the shareholders' agreement was neither procedurally nor substantively unconscionable. The parties had had 18 months to consult an attorney before signing it in 2013. The agreement didn't unreasonably favor one or more siblings, and the stock price was fair.

As to the breach of fiduciary duty claim, the court noted that the allegations of looting, waste and withheld distributions had already been considered and dismissed by another court in a different lawsuit. Regardless, the court ruled that a breach wouldn't invalidate the buy-sell provision.

The court also rejected the quorum argument. Under the shareholders' agreement, shareholders petitioning for dissolution weren't entitled to vote on whether the corporation would exercise its option to purchase their shares. The 75% quorum was met because 100% of the two shareholders entitled to vote were present at the meeting where the vote occurred.

The court concluded that specific performance was an appropriate remedy here. It found that the shareholders' agreement was "fundamentally fair" and monetary damages would be insufficient to compensate for its breach.

Better options

The enforceability of valuation provisions in buy-sell agreements is often a target in litigation. In *Collins*, the dispute could potentially have been avoided if the company had obtained regular updates to its fixed value. Alternatively, the agreement could have relied on a formula or, better yet, a current and independent appraisal to determine the value. ■

How business valuation pros can help when M&A talks stall

In private company mergers and acquisitions (M&As), the appropriate standard of value is generally *strategic* value, not fair market value. In other words, the value perceptions of a *specific* buyer and seller are more relevant than the price the hypothetical universe of all buyers and sellers would agree to. Strategic value includes possible synergies that may be available to that particular buyer, resulting in additional value. For this reason, some people mistakenly believe it's unnecessary to hire business valuation professionals to help negotiate deals. This can be a big mistake.

While a full-blown written valuation report may be overkill in a private transaction, certain types of analyses can help the parties work through their differences and eventually agree on a price. Here are four examples.

1. Adjusting the balance sheet. Often, balance sheets prepared for accounting purposes are incomplete for M&A purposes. They may be missing valuable internally generated intangible assets (such as brands and patents) and costly liabilities (such as pending lawsuits and environmental claims). A valuator can help identify these items and assign values to them. This analysis can also be helpful in post-acquisition accounting for the transaction.

2. Evaluating comparables. Valuation pros have access to proprietary databases of recent deals in the target company's industry within a reasonable time frame. Pricing multiples (such as price-to-earnings or price-to-cash flow) based on comparable transactions can provide insight into what others are currently paying in the marketplace. A valuator can assess the details of comparable transactions, help the parties compare and contrast those details to their situation, and adjust pricing multiples accordingly.

3. Discounting future cash flows. This method is commonly used to value a business in a sale. As objective third parties, valuators can help 1) project the target's cash flows based on historical and expected results and 2) estimate a discount rate based on the risk of the deal vs. other investment alternatives. Small differences in projected cash flows and the discount rate can have a major impact on these analyses — and some buyers may not want to pay sellers for synergies they bring to the table (such as sales expertise or cost savings).

4. Structuring the deal. Sometimes, all that's needed to bridge the gap between the asking price and the offer is to modify the deal's terms. Issues to consider include installment payments, asset vs. stock sales, employment contracts with the seller, and earnouts (where a portion of the sales price is paid only if certain financial benchmarks are subsequently met). Valuation professionals can help the parties evaluate the tax and financial consequences of various deal structures. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2022