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FAIR VALUE™

Reprinted from Volume XXIV, Number 1 Summer 2019

~~Business~~ People Valuations

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Introduction. In the comic strip *Calvin and Hobbes*, six-year-old Calvin invents and uses a Transmogrifier that is able to transform an individual into anything the user desires. Along with his stuffed/pet tiger Hobbes, Calvin uses his Transmogrifier with mixed success, sometimes achieving his intended outcome, other times not. Although I had always believed this to be fiction, it turns out that Transmogrifiers are real and the use of these devices is being attempted in divorce cases to turn individuals into entities in order to create value in the marital estate. This practice has resulted in an attempted significant expansion of my prior field of business valuation into the new and much broader field of people valuation. This article will first examine North Carolina case law on goodwill value in the divorce context and then will illustrate the Transmogrification process we have seen attempted by various ~~business~~ people appraisers. We conclude by observing the numerous illogical assumptions associated with this attempted practice and a potential final outcome if Transmogrification becomes accepted practice.

Michael Paschall

Goodwill Value in a Professional Practice. The North Carolina courts have clearly stated that any existing goodwill in the context of a professional practice must be valued and considered for equitable distribution purposes. In *Poore v. Poore*, 75 N.C. App. 414, 331 S.E.2d 266, *disc. review denied*, 314 N.C. 543, 335 S.E.2d 316 (1985), the husband was a dentist and was the sole owner of his own dental practice. The dental practice was an incorporated entity that was operated as a professional association.

The *Poore* Court had the following comments on the valuation of a professional practice:

> The component of a professional practice which is the most controversial and difficult to value, and yet often the most valuable, is its goodwill…Goodwill is commonly defined as the expectation of continued public patronage…It is an intangible asset which defies precise definition and valuation…It is clear, however, that goodwill exists, that it has value, and that it has limited marketability. (75 N.C. App. 414, 420)
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> We agree that goodwill is an asset that must be valued and considered in determining the value of a professional practice for purposes of equitable distribution. (75 N.C. App. 414, 420-421)
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> There is no set rule for determining the value of the goodwill of a professional practice; rather, each case must be determined in light of its own particular facts…The determination of the existence and value of goodwill is a question of fact and not of law…and should be made with the aid of expert testimony… Among the factors which may affect the value of goodwill and which therefore are relevant in valuing it are the age, health, and professional reputation of the practitioner, the nature of the practice, the length of time the practice has been in existence, its past profits,

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> its comparative professional success, and the value of its other assets. (75 N.C. App. 414, 421)
>
> Any legitimate method of valuation that measures the present value of goodwill by taking into account past results, and not the postmarital efforts of the professional spouse, is a proper method of valuing goodwill…One method that has been widely accepted in other jurisdictions is to determine the market value of the goodwill, i.e., the price that a willing buyer would pay to a willing seller for it…Another method that has been received favorably is a capitalization of excess earnings approach… Under this approach, the value of goodwill is based in part on the amount by which the earnings of the professional spouse exceed that which would have been earned by a person with similar education, experience, and skill as an employee in the same general locale…It has also been suggested that the value of goodwill be based on one year's average gross income of the practice, or a percentage thereof…and that evidence of sales of comparable practices is relevant to the determination of its value." (75 N.C. App. 414, 421-422)

The trial court in *Poore* rejected the valuations by both the husband's expert and the wife's expert, instead determining its own value by "considering available evidence including the tangible assets and net income of the business." The Court of Appeals rejected the trial court's value and required a new hearing on the value of the practice, stating that the trial court's value "does not appear to be based on a sound method of valuation nor is it supported by the evidence."

While the *Poore* Court did not bless a specific valuation methodology or determine a conclusion of value, a later case, *Hamby v. Hamby*, 143 N.C. App. 635, 547 S.E.2d 110 (2001), provided an example of how an ownership interest in a professional practice might be valued for equitable distribution purposes. In *Hamby*, the Court accepted the trial court's finding that a 100% ownership interest in a solo insurance agency could be valued based on what the *Poore* Court referred to as a capitalization of excess earnings approach:

> Under this approach, the value of goodwill is based in part on the amount by which the earnings of the professional spouse exceed that which would have been earned by a person with similar education, experience, and skill as an employee in the same general locale.

The *Hamby* Court accepted the trial court's finding that the solo insurance agent earning $105,000 per year could hire and pay somebody $47,000 per year to perform the exact same duties. This left the owner with $58,000 in "profit" at this agency that was then capitalized into a value. The validity of this methodology and its resulting value is addressed later in our explanation of the Transmogrification process.

An Ownership Interest in an Entity is Required. The *Poore* Court's holding that goodwill value in the professional practice context must be valued and considered for equitable distribution purposes (as later illustrated in *Hamby*) is limited, however. In *Sonek v. Sonek*, 105 N.C. App. 247, 412 S.E.2d 917, *disc. review allowed*, 331 N.C. 287, 417 S.E.2d 255 (1992), the issue was whether a salaried employee with no ownership interest in the respective business had any personal goodwill. In *Sonek*, the husband, a physician, worked as a salaried employee at a medical practice. The husband had no ownership interest in the medical practice. The *Sonek* Court held that "a salaried employee who maintains no ownership interest in the particular place of employment does not possess goodwill." *Id.* at 250.

Uncertainty in the Middle. Reconciling and integrating the holdings in *Poore* and *Sonek* creates uncertainty in the equitable distribution context. On the one hand, under *Poore*, if you have an individual with an ownership interest in an entity, that ownership interest may have value in equitable distribution and must be analyzed to determine if any value exists. On the other hand, under *Sonek*, a non-owner employee of an entity does not have any goodwill value associated with his or her employment.

The great unanswered question lies in the middle ground between these two situations. Some examples of this middle ground may be the following:

1. An independent contractor who works for a certain entity. This individual is not an employee of the entity but also does not have any ownership interest in this entity.

2. A self-employed individual providing

services as an individual, i.e., there is no formal or informal entity involved with the provision of the services.

There may be other examples as well but the examples above are where the ~~business~~ people appraiser sees the opportunity for Transmogrification.

The Transmogrification Process. For a successful Transmogrification, ~~business~~ people appraisers need to make three gargantuan and successive leaps:

1. Reclassify the individual as an entity.

2. Reclassify the individual's compensation as the "revenues" of the fabricated "entity."

3. Use an artificially low "market compensation" figure to subtract from the reclassified "revenues" to generate a "profit" that can then be capitalized into a "value."

These three steps are examined individually in the following sections.

Step 1: Reclassify the Individual as an Entity. The first necessary step in the Transmogrification process is to turn the individual into an entity. Transmogrifiers will likely cite the following language in *Poore* as support for this step:

> It is generally agreed that in valuing a professional practice, or an interest therein, for equitable distribution, it should not make any significant difference whether the practice is conducted as a corporation or professional association, a partnership, or a sole proprietorship.

The initial step in the Transmogrification process is that every individual is, at the minimum and with no additional action required, a sole proprietor. This is because of the above language in *Poore* as well as the fact that the requirements for a sole proprietorship in North Carolina can be non-existent. In North Carolina, an individual operating as a sole proprietorship can do this in his or her own name, without filing anything with the NC Secretary of State or any other governmental body, without obtaining any additional licenses or permits, by using his or her own Social Security number (and not having to obtain a separate Employee Identification Number as a corporation or partnership must do), and by reporting any earnings from the activity on his or her personal income tax return. Based on these lack of requirements, every working individual, whether an employee, independent contractor, owner/partner, etc., could conceivably be classified as a sole proprietor.

Step 2: Reclassify an Individual's Compensation as the "Revenues" of the "Entity." After successful Transmogrification of the individual into an entity, the next necessary step for the ~~business~~ people appraiser is to reclassify that individual's compensation into "revenues." This step is necessary to (1) reinforce the earlier fiction that the individual is actually an "entity" and (2) deceive the court in the following step (see below) that an adjustment for a normalized compensation can be made (as with an actual entity).

So combining the first two steps of the Transmogrification process results in the following: Katie Smith, an elementary school teacher making $50,000 a year, is Transmogrified into Smith Primary Education Services, a sole proprietorship with annual revenues of $50,000. Bob Thompson, a commercial loan officer making $100,000 a year, is Transmogrified into Thompson Financial Services, a sole proprietorship with annual revenues of $100,000. And Wendy Hunter, attorney at law making $250,000 a year, is Transmogrified into Hunter Legal Advisory Services, a sole proprietorship with annual revenues of $250,000.

3. Adjust the Reclassified "Revenues" by a "Market Compensation" Figure. The final step needed in this alchemy is to subtract a purported "market compensation" figure from the reclassified "revenues" (which is really the individual's compensation) in order to fabricate a "profit" for this "entity" that can then be capitalized into a "value." One mandatory feature of this step is that the purported "market compensation" figure *must be lower* than the reclassified "revenues" figure (which, again, is really the individual's compensation). A lower "market compensation" figure is necessary so that some amount of "profit" for this "entity" can be fabricated and then capitalized into a value. A "market compensation" figure that is equal to or greater than the reclassified "revenues" figure defeats the Transmogrification process as no "profit" or capitalized "value" is then created.

Compensation Adjustment: The Right Way. Among its series of ridiculous assumptions, the Transmogrification process saves its most ludicrous adjustment for last. Let's first take a look at the correct way to adjust an income statement for the market compensation issue. Assume an individual owns 100% and serves as President of a furniture manufacturing company. The correct way to make a market compensation adjustment is as shown in **Table 1**:

Table 1
Correct Compensation Adjustment in the Capitalization Method

Item	Unadjusted Income Statement	Adjusted Income Statement
Revenues	$10,000,000	$10,000,000
Less: Expenses	($9,000,000)	($9,000,000)
Less: Executive Compensation	($1,000,000)	($200,000)
Equals: Net Profit	**$0**	**$800,000**
Divided by: Cap Rate	20%	20%
Equals: Value	**$0**	**$4,000,000**

Comments are as follows:

1. Both scenarios above involve a furniture company with annual revenues of $10,000,000 and annual expenses of $9,000,000. In the Unadjusted Income Statement scenario, the owner/President of the company elects to take $1,000,000 in compensation. This leaves the company with no net profit and no indicated value under a capitalization method.

2. Now suppose the owner/President wants to retire and sell the company. To do this, he needs an accurate income statement to determine an accurate value of the Company. The key question is: is the $1,000,000 compensation reasonable or is it distorted because the owner/President can set whatever compensation rate he desires? In analyzing this issue, the owner/President consults various compensation surveys to determine the market rate of compensation for a President of a furniture company with $10,000,000 in revenues. Based on various compensation surveys, the market rate of compensation for such an individual is indicated to be $200,000 per year. *Importantly, these individuals actually exist in the real world. That is, the owner/President can actually hire such an individual who can competently execute the duties of President of the company. Additionally, this individual is willing and able to competently execute these duties for the $200,000 market compensation rate.*

3. The owner hires this individual as President, retires from the company, and puts the company up for sale. After hiring a new President, the company's adjusted income statement shows $10,000,000 in revenues, $9,000,000 in expenses, and $200,000 in executive compensation (a market rate of compensation paid to the new President). Now the company reports $800,000 in annual net profit which is capitalized into a $4,000,000 value by using a 20% cap rate (an income figure divided by a capitalization rate results in a value). The owner is then able to sell the company for its $4,000,000 value.

4. The above scenario illustrates the fact that the $1,000,000 paid to the owner/President in the Unadjusted Income Statement scenario represented two separate and distinct returns to that individual. $200,000 of the $1,000,000 represented the fair market value of the managerial services provided to the company by this individual (as evidenced by the willingness of an unrelated individual to serve as President of the Company for this salary). The remaining $800,000 of the $1,000,000 represented a return on investment enjoyed by this individual as the owner of the company.

The market compensation adjustment illustrated above is a well-accepted practice in business valuation. In *Understanding Business Valuation, A Practical Guide to Valuing Small to Medium Sized Businesses, Fifth Edition*, author Gary R. Trugman, CPA/ABV, MCBA,

ASA, MVS, describes this principle as follows:

> Keep in mind that the owner of a closely held business receives two forms of compensation. First, as an employee, that individual is entitled to a return on his or her labor (salary for the job being performed). Second, as an owner, that individual receives a return on investment (dividends or capital appreciation). Be very careful not to confuse the two. The officer's compensation adjustment is intended to restate the economic income statement of the company to a basis that includes the amount of salary that would be necessary to attract others who are qualified to perform the duties required by the company.

Compensation Adjustment: The Wrong Way. In contrast to the logical and accepted compensation adjustment above, the compensation adjustment in the Transmogrification process falls flat on its face. This is due to the simple fact that the "market compensation" for the services provided by the individual are exactly equal to that individual's compensation. The ~~business~~ people appraiser who values attorney Wendy Hunter mentioned earlier will undertake the following steps:

1. Convert Wendy the individual into Hunter Legal Advisory Services, a Sole Proprietorship.

2. Convert Wendy's compensation of $250,000 per year into annual "revenues" of $250,000 for Hunter Legal Advisory Services.

3. Find a compensation survey that indicates that an average attorney of Wendy's age and experience makes $150,000 per year and then make a "market compensation" adjustment to these "revenues" as shown in **Table 2**:

Table 2
"Value" of Hunter Legal Advisory Services

"Revenues"	$250,000
Less: "Market Compensation"	($150,000)
Equals: "Net Profit"	**$100,000**
Divided by: Cap Rate	20%
Equals: "Value"	**$500,000**

Given the wide range of online and printed compensation information available, the ~~business~~ people appraiser can easily find and irrationally justify a "market compensation" rate below the fictitious "revenues" of this "entity," thereby manufacturing a "profit" that he or she can then capitalize into a "value." A crafty ~~business~~ people appraiser can even make this sound quite plausible by using various compensation surveys that demonstrate that his "compensation adjustment" is valid.

A Denial of Reality. This kind of "analysis," however, is a complete and total denial of reality. Whether she is an employee, an independent contractor, or even a Transmogrified sole proprietorship, Wendy is already compensated at a fair market rate by her law firm. Wendy is free to leave the law firm to seek employment opportunities with other law firms and the law firm is also free to fire Wendy if they are dissatisfied with her work or believe they can find a better attorney to take her place. The law firm is free to hire another individual and pay that individual at the firm's stated rate or commission with market forces keeping the rate or commission in line with other similar firms. As a profit-seeking entity, the law firm finds the balance between paying its attorneys as little as possible to minimize expenses yet as much as possible to attract and retain talented people.

The ~~business~~ people appraiser should not need any fancy or sophisticated compensation surveys to determine a "market compensation" adjustment- the market rate of compensation is right in front of his face: $250,000. As such, the actual value of Hunter Legal Advisory Services is as shown in **Table 3**:

Table 3
Actual Value of Hunter Legal Advisory Services

"Revenues"	$250,000
Less: "Market Compensation"	($250,000)
Equals: "Net Profit"	**$0**
Divided by: Cap Rate	20%
Equals: "Value"	**$0**

Compensation Adjustment: The Wrong Way- *Hamby* Style. As to the *Hamby* case noted earlier, the first two steps of the Transmogrification process were not needed as an actual entity (insurance agency) existed. The "market compensation" adjustment in *Hamby*, however,

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still suffered from the same fatal logic illustrated above. In *Hamby*, the wife's appraiser opined that an individual making $105,000 in total compensation could find an equally-qualified individual who would be willing and could actually perform the same job for only $47,000 per year. This would leave $58,000 ($105,000 less $47,000) in "net profit" to be enjoyed by the owner of the agency. In *Hamby*, this "net profit" was then capitalized into a "value" for the agency. This "analysis" resulted in the owner realizing $58,000 in net profit each year without having to lift a finger at the agency because the $47,000 per year guy was running the business.

I have yet to see any article on *Hamby* either discussing or attempting to defend the normalized compensation issue. The *Hamby* Court side-stepped the issue, noting that Mr. Hamby failed to raise this as an argument: "Neither does Mr. Hamby argue that in conducting its analysis, the trial court itself miscalculated the net value of the agency." Or, in other words, because Mr. Hamby did not raise the normalized compensation adjustment as an issue, we are not going to decide it. The appraiser in *Hamby* similarly hoped that any focus on this critical error will just go away: "The courts assumed the salary used in the valuation was appropriate and should not be an issue in the discussion of whether the courts appropriately defined value" (*Family Forum*, June 2004, p. 13).

The compensation adjustment made in *Hamby* is unfortunate as it has left us with an Court of Appeals Decision that is based on an illogical and unsupportable assumption that did not appear to be challenged at the trial court level. Furthermore, the compensation adjustment in *Hamby* clearly violated the requirement of *Poore* that the market compensation adjustment be based on the compensation earned by a person "with similar education, experience, and skill as an employee in the same general locale." It is totally unreasonable to assume that an individual would do a job that pays $105,000 in the open market for only $47,000. If you plug a $47,000 person into a $105,000 job, one of two things would happen:

1. The $47,000 person is NOT qualified or able to do the $105,000 job and the performance of the company suffers.

2. The $47,000 person IS qualified and able to do the $105,000 job and therefore demands to be paid the fair market rate of compensation of $105,000 for the job.

   Said another way, no rational individual would be willing to do $105,000 worth of work for only $47,000.

Laid up Drunk. Not having been there, it is impossible for us to know the mindset of the attorneys and appraisers as they argued this case at trial more than 20 years ago. There is, however, a very interesting argument made by the winning attorney as to the successful (but illogical) compensation adjustment made by his appraiser. Remember, the compensation adjustment in *Hamby* is based on the premise that an individual making $105,000 in total compensation could find an equally-qualified individual who would be willing to perform the same job for only $47,000 per year. This would leave $58,000 ($105,000 less $47,000) in "net profit" to be enjoyed by the owner of the agency. This owner would not have to be involved at all with the agency as the $47,000 guy he hired would do it all. Yet consider this colorful illustration by the winning attorney in his closing argument that the business has value:

> If Rick Hamby was somebody who laid up in bed and stayed drunk all the time, this business would not have value.

While this comment is undoubtedly true, *it directly contradicts his appraiser's theory as to the value of the agency*. Remember, his appraiser said that Mr. Hamby (who makes $105,000 per year) can hire a $47,000-per-year individual who will exactly replicate his duties at the agency, leaving Mr. Hamby with a $58,000 annual profit for which he does not have to do anything. Because Mr. Hamby realizes this $58,000 annual profit as an owner (and not due to any efforts at the agency - these are done fully by the $47,000 guy), *it doesn't matter what Mr. Hamby does with his time*. As an owner who has hired an individual to run the agency, Mr. Hamby is free to play golf, take vacations or, yes, ***even lay up in bed and stay drunk all the time***- his $58,000 annual profit stays the same regardless of what he does. To recap then, the *Hamby* decision: (1) was based on an illogical and unsupportable compensation adjustment, (2) violated *Poore*, and (3) was decided despite the winning attorney arguing against his own position.

The Slippery Slope. If the courts allow ~~business~~ people appraisers to fire up their Transmogrifiers, there is no limit to their use. Any individual in any job can be reclassified as a business, an estimated "market rate" of compensation subtracted from the "revenues" (i.e.,

the actual compensation), and the difference capitalized into a "value" for that "business." If this is the goal of equitable distribution in North Carolina, it would be much easier for the legislature to simply establish a "standard compensation deduction" for every working individual with any actual compensation above the standard then capitalized into a value (perhaps at a standardized capitalization rate). This would allow for uniform and predictable application to every working individual in every situation. For example, a $50,000 standard compensation adjustment would be applied as shown in **Table 4**:

Table 4
The "Standard Compensation Deduction" in Practice

	School Teacher	Loan Officer	Attorney
Annual Compensation	$50,000	$100,000	$250,000
Less: "Standard Compensation Deduction"	($50,000)	($50,000)	($50,000)
Equals: "Excess Compensation"	**$0**	**$50,000**	**$200,000**
Divided by: Capitalization Rate	20%	20%	20%
Equals: Final "Value"	**$0**	**$250,000**	**$1,000,000**

The above scenario could be the ultimate result of the use of Transmogrifiers and the bottom of the slippery slope created by *Hamby*. The market compensation adjustment for the furniture company illustrated earlier is on solid valuation ground, is reinforced by real-world application, and is safely away from the edge of the slippery slope. The direction given in *Poore* that the market compensation adjustment must be based on the compensation earned by a person "with similar education, experience, and skill as an employee in the same general locale" is an effective fence that keeps the appraiser from the slippery slope.

Hamby, however, represents a significant tumble down the slippery slope of market compensation adjustment. While *Hamby* at least involved an entity, the market compensation adjustment made in *Hamby* fails the requirement of *Poore*, not to mention the common sense test. The Transmogrification efforts we have seen and described above (i.e., reclassifying an individual as an "entity," reclassifying compensation as "revenues," and subtracting a lower "market compensation" adjustment from the "revenues" to fabricate a "profit" that is then capitalized into a "value") is a further decline down this slope and is only a short distance from the bottom. The bottom of the slope is a flat-out violation of the prohibition of goodwill value for an employee as held in *Sonek*. That is: it doesn't matter what form you take in your profession (employee, independent contractor, etc.) as every single working individual can be reclassified as a sole proprietorship. In this post-*Sonek* world, all of us, every single working individual, in every conceivable context, is walking around with a price tag on his or her head. ♦

Summary of the three necessary steps to perform a people valuation:

1. Reclassify the individual as an entity. At its most expansive definition, every working individual in every context (even an employee) can be considered to be a sole proprietorship.

2. Reclassify the individual's compensation as the "revenues" of the fabricated "entity." This step is necessary for the calculation in step 3 below, as well as to bolster the illusion created in step 1.

3. Use an artificially low "market compensation" figure to subtract from the reclassified "revenues." This will result in a fabricated "profit" for this "entity" that can then be capitalized into a "value."