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www.businessvalue.com

1338 HARDING PLACE • SUITE 200
CHARLOTTE, NORTH CAROLINA 28204
PHONE: 704-334-4932 FAX: 704-334-5770
Contact: George B. Hawkins, ASA, CFA, President

FAIR VALUE™

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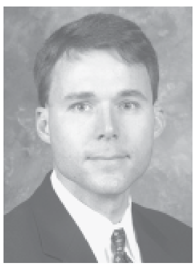
HAMBSTERS

By: Michael A. Paschall, ASA, CFA, JD
Managing Director

Introduction. Look out – here comes *Hamby* again. It's not my fault, though. I had no intention of addressing this topic again but an article in the January 2006 issue of *Family Forum* (the Family Law Section newsletter of the North Carolina Bar Association) is so riddled with factual and logical inconsistencies, I cannot let it go unanswered. The January 2006 article joins a June 2004 *Family Forum* article in defense of the concept of intrinsic value as determined by the North Carolina Court of Appeals in *Hamby v. Hamby*, 143 N.C. App. 635, 547 S.E.2d 110 (2001). Both articles are rebuttals to my original 2003 article "Namby-Pamby *Hamby*" in Banister Financial's *Fair Value* (available online at www.businessvalue.com).


Michael Paschall

Both *Family Forum* articles focus on the proposition that it is unfair to allow a contractual obligation restricting transfer to depress or eliminate the value of a closely-held company or professional practice. Both authors believe that such entities, even though restricted, have an intrinsic value to their owner that can be calculated via the capitalization of "excess" earnings under an income approach. Neither article, however, focuses on the reality of the facts of the *Hamby* case, the significant logical shortcoming upon which its creation of "value" is based, nor on the valuation free-for-all that will ensue should such Hambster "valuations" become accepted practice.

This article will first point out some of the factual errors and erroneous conclusions as concerns the restriction on transfer issue. The second focus of this article will be on the flaws in the underlying logic of the methodology used to derive the value in *Hamby*. Finally, I will caution against the significant dangers of the acceptance of Hambster "valuations" and note a North Carolina Supreme Court case that directly contradicts the Court of Appeals' holding in *Hamby*. This article is a continuation of the discussion started in my "Namby-Pamby *Hamby*" article and continued in my 2005 "Identical Twins" article, both of which are available at www.businessvalue.com and both of which should be read for a more complete understanding of the various issues involved in this particular area of business valuation.

"Similar" Facts? First, let's take a look at the issue of contractual restrictions on the transfer of an interest. Despite the insinuations of the *Family Forum* authors, I have long understood the proposition that an agreement among shareholders restricting transfer of an interest is not necessarily determinative of value. If they were, such restrictive agreements could too easily diminish or eliminate value in the estate tax and equitable distribution contexts. In fact, my business partner, George Hawkins, wrote two articles on this issue, both of which were published in *Family Forum* (May 2003 and November 2003 issues) and both of which are available online at www.businessvalue.com.

The author of the January 2006 article offers a recent North Carolina Court of Appeals decision in support of his position that such restrictions on transfer should be ignored: *Bersin v. Golonka*, No. COA04-695 (NC App. 2005), *unpublished*, *disc review denied*. The January 2006 article implies that the holding in *Bersin* is contrary to my position on *Hamby* and that the value in *Bersin* was "ironically" determined by George Hawkins and accepted without adjustment by the Court. One could interpret the comments in the January 2006 article as a suggestion that Banister Financial is inconsistent in its position on this issue, however, a more careful examination of *Bersin* than was done by the January 2006 author will show otherwise.

The entire foundation of the argument made in the January 2006 article is based on the premise that "*Bersin* presented similar facts" as *Hamby*. Of course, no fact patterns are exactly the same in any two cases and the validity of this claim will depend in large part on what your definition of "similar" is. There are a number of different facts between the *Bersin* and *Hamby* cases, however, there is one particular difference that warrants careful consideration as concerns the valuation of the respective interests in these cases:

1. **Dr. Bersin could realize an immediate and guaranteed value for his interest in his medical practice.** In fact, Dr. Bersin did not even have to worry about or bother with selling his interest in his medical practice. All he (or any other doctor at the practice) had to do was say: "I quit" and he would receive cash for his interest via the combined payout mechanisms of a Stock Restriction Agreement and a Contract of Employment. Therefore, as opposed to being restrictions on transfer, the Stock Restriction Agreement and Contract of Employment in *Bersin* actually functioned as **guarantees** of value to physicians in that practice. Of course, the payout to a departing physician was subject to the practice's ability to financially honor the obligation, however, based on a financial analysis of this long-established and very successful practice, that did not appear to be an issue. Furthermore, on a fully-vested basis, the amount that would have been paid to Dr. Bersin upon his termination of employment was virtually identical to the value determined by George Hawkins and accepted without adjustment by the Court.

2. **Mr. Hamby had no market for his insurance agency.** In contrast to the guaranteed value for Dr. Bersin's interest in his medical practice, the agreement between Nationwide and Mr. Hamby clearly **eliminated** any market for Mr. Hamby's agency: "Neither you nor any other Nationwide agent may sell the portfolio of business to anyone else nor can you negotiate with any other Nationwide agent for the receipt of the portfolio. The assignment of a portfolio is made at the sole discretion of [Nationwide]. All ownership rights are vested in the policyholders – at no time are those rights vested in an agent. When you cancel your agent agreement with Nationwide, [Nationwide] will assign your policies to another Nationwide agent at its sole discretion." Mr. Hamby could not sell the sole critical assets of his insurance agency (i.e., the policies) because these policies were not owned by Mr. Hamby or his agency in the first place. Without the policies, Mr. Hamby's agency had only nominal value.

Those are the facts of *Bersin* and *Hamby*. Readers can determine for themselves whether these facts are "similar" and whether the claims of the January 2006 *Family Forum* article are therefore valid. Think of it this way: *Bersin* is the real estate equivalent of owning a house. *Hamby* is the real estate equivalent of leasing an apartment.

The "restriction on transfer" (which actually guaranteed, instead of restricted, value) in the *Bersin* case was imposed by a shareholder-derived agreement. The restriction on transfer in the *Hamby* case was a normal and legitimate commercial restriction that was a required and inseparable aspect of Mr. Hamby's ability to operate his agency. The situation in *Hamby* is similar to the situation my business partner, George Hawkins, and I have as regards our authorship of the *CCH Business Valuation Guide*. Although George and I provide all of the content and intellectual property for this book, we do not own the book or the rights to it – CCH does. Although our authorship has intrinsic value via the royalty payments we receive due to our prior and continuing efforts on the book, we have no property rights in the book and therefore nothing to sell. I have no doubt that if George and I ever tried to "sell" our authorship, CCH would terminate its contract with us immediately, leaving us with nothing. CCH's ownership of the book was a non-negotiable aspect of our contract with them. Yet George and I entered into a contract with CCH, knowingly and willingly giving up these rights in order to be the authors of this book. This was a normal and standard business provision we were willing to accept in exchange for being authors of the book. It was a contract into which we freely entered without the expectation of the creation of any transferable or marketable property.

Adjusting Compensation. For a Hambster, the issue of whether the restriction on transfer is limited or complete is ultimately unimportant. This is so because the Hambster does not let reality or the facts get in the way of arriving at some kind of "value" via the capitalization of "excess" earnings. This is the key flaw of the Hambster logic (note: this issue of salary adjustment is addressed in more detail in my "Identical Twins" article and is discussed in a far more limited manner in this article).

Remember in *Hamby*, the North Carolina Court of Appeals accepted the proposition that a solo insurance agent earning $105,000 per year was making $58,000 above what one business appraiser opined was a market average compensation of $47,000 per year. The above-average (or "excess") compensation was then capitalized to derive the ultimate value (after discounts and other adjustments) for Mr. Hamby's insurance agency. Nearly all of the hullabaloo surrounding *Hamby* has focused on the restriction on transfer issue and the concept of intrinsic value to an owner. Virtually no defense of the salary adjustment is made by the Hambsters except for one sentence in the June 2004 article in *Family Forum*:

> "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. 14).

Or, in other words: "because the courts accepted the salary adjustment in *Hamby*, it must be right – now let's move along quickly before anyone stops to really think about this." The salary adjustment issue deserves more than this kind of ostrich analysis as it is **THE key issue** in the derivation of any value by a Hambster. Without the salary adjustment, there would have been little or no remaining income to capitalize and therefore little or no value under the capitalization method.

The real-world scenarios involving the $47,000-per-year agent replacing $105,000-per-year Mr. Hamby are discussed in more detail in my "Identical Twins" article but are summarized here as one of two possibilities:

1. The $47,000-per-year agent is unable to replicate the same degree of service, sales, and other attributes provided by $105,000-per-year Mr. Hamby. As such, the revenues and profits of the insurance agency decline accordingly until they reach an equilibrium level consistent with the services provided by the $47,000-per-year agent.

2. Alternatively, the $47,000-per-year agent finds a phone booth and turns into a $105,000-per-year agent, providing the same level of service as did Mr. Hamby. The financial results of the agency remain the same as they were with Mr. Hamby in charge. Should this happen (which is certainly possible), one other thing is certain to happen as well. The $47,000-per-year agent will demand (and should) be paid $105,000 per year.

In either case, the performance of the agency rises or falls to the level of service provided by its sole agent. Implying that the $47,000-per-year agent can keep the agency's performance at the same level as the $105,000-per-year agent defies logic, yet that is the exact assumption made in *Hamby*.

The Hambster position is to adjust compensation in the professional practice context to some industry average or median figure. This is not an accurate reading or application of *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). In *Poore*, the North Carolina Court of Appeals addressed the issue of the valuation of a sole-owner dental practice for equitable distribution purposes. The *Poore* court stated that the compensation used in comparison should be of one who has "**similar education, experience, and skill as an employee in the same general locale**." A $47,000-per-year agent has to be lacking in at least one of these areas as compared to the $105,000-per-year agent.

The Slippery Slope. Both *Family Forum* articles tell you that restrictions on transfer should have no depressing impact on value. Both *Family Forum* articles tell you that "value" can and should be created via the capitalization of "excess" compensation under an income approach. What neither *Family Forum* article tells you, however, is that *Hamby* opens the door for the creation of "value" in virtually any context:

1. **Entities that do not own their key assets.** These are the facts in *Hamby*. Mr. Hamby did not own the insurance policies and could not sell them. Without the insurance policies, Mr. Hamby's agency had virtually no value aside from the nominal value of the fixed assets of the agency. For a Hambster, the fact that the agency did not own any assets of significant value and therefore had little or no value in a sale is irrelevant. *Hamby* ignores a legitimate contractual business provision and creates an illusory value that does not exist in the real world. It is the real estate equivalent of assuming a renter owns and can sell his apartment. In contrast to the fiction of *Hamby*, the medical practice interest in *Bersin* had a non-fictional, real-world value that was actually guaranteed by the Stock Restriction Agreement and Contract of Employment.

2. **Commercially Legitimate Restrictions on Transfer.** In the June 2004 *Family Forum* article, the argument is made that restrictions on transfer are irrelevant because valuations are done on a hypothetical sale basis. But there are two kinds of hypotheticals aren't there? Almost twenty years ago, I made a decision at First Union National Bank to do business valuations instead of being a commercial lender. Therefore, had I not made that choice, I *hypothetically* could be a commercial lender for Wachovia today. This is the first kind of hypothetical – call it the **possible hypothetical**. The second kind of hypothetical goes something like this: *hypothetically*, if I was eight feet tall and could handle the ball like Phil Ford, I could play in the NBA. Call this the **impossible hypothetical**. *Hamby* falls into the latter category as even the June 2004 article notes that Mr. Hamby "cannot sell, and had not contemplated a sale." The danger in using the impossible hypothetical standard is that the creation of "value" is possible in any situation.

3. **Jobs.** Neither Mr. Hamby nor his agency owned the insurance policies he sold. Mr. Hamby was an agent of Nationwide. Since the author of the January 2006 article apparently has a copy of *Black's Law Dictionary* handy, I will cite from it too: An agent is "a person authorized by another (principal) to act for or in place of him; one entrusted with another's business." The key concept here is "another's business." The "business" was Nationwide's, not Mr. Hamby's. Although Mr. Hamby owned his agency, he basically functioned as an employee of the insurance company as they could take their policies from Mr. Hamby at will. **In other words, Mr. Hamby had a job.** For a Hambster looking to create value, however, this is not a problem as the fundamental building block for the Hambsters in their divination of intrinsic value is the income stream. Jobs therefore meet the two criteria of the Hambsters necessary for the manufacture of intrinsic value: (1) they are an income stream, and (2) they have intrinsic value to their holder. Therefore, any employed person who is making above what a Hambster determines to be a fair market salary is fair game for the creation of intrinsic value. All that is left for the Hambster

is to develop a cap rate and calculate the "value." To do this, however, Hambsters must ignore such pesky holdings as 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). In *Sonek*, the North Carolina Court of Appeals did not assign any capitalized value to a physician's compensation because the physician did not own any interest in his employer medical practice – he was an employee. In one fell swoop, then, *Hamby* has effectively dispatched both *Poore* and *Sonek* and created a whole new paradigm for business valuations.

4. **Highly specialized or unique services.** Imagine the Hambster stampede towards the ex-Mrs. Woods should Tiger Woods ever file for divorce. According to *Golf Digest*, Tiger earned about $87 million in 2005, including $12 million on the course and another $75 million off the course. A Hambster might adjust Tiger's prize winnings by the professional golfer who finished halfway (134th out of the 268 golfers ranked) down the 2005 PGA list. In 2005, this "Mr. Average" was Todd Hamilton with $560,000 in on-course winnings. Assuming Todd earned the same $1.65 million in off-course income in 2005 as he did in 2004, his total 2005 income would be about $2.2 million. Subtracting Average Todd's $2.2 million income from Tiger's $87 million income leaves about $85 million in excess earnings. Capitalized at 20%, this implies an intrinsic value of $425 million for Tiger's services. Sound far-fetched? It's not. In fact, our firm has already seen some Hambsters attempt "business valuations" of the intellectual capital of individuals *where no professional practice or corporate entity whatsoever was involved*. These individuals were providing services as individuals and being compensated as individuals yet the Hambsters went right ahead and adjusted the compensation by some "average" amount, capitalized the difference, and called it "value."

5. **Licenses.** Fabricating a "value" for a professional license is no sweat for a Hambster. The logic goes something like this: Because a professional license gives its holder the possibility of making a greater compensation than if no license were held, this capitalized difference must be the value of the license. Again, it doesn't matter that the license is unique to the individual and cannot be sold or transferred – all a Hambster needs is the opportunity to calculate a difference in compensation to concoct "value." Unfortunately, Hambsters have been busily engaged in these activities for years – even prior to *Hamby* – opining to multi-million dollar "values" for certain professional licenses.

Precedent. In addition to the many logical shortcomings described above, Hambsters have yet another hurdle to overcome in the support of their position on intrinsic value: the exact opposite precedent from a higher court. In 1985, the North Carolina Supreme Court decided *In the Matter of: The Appeals of Southern Railway Company and Norfolk Southern Railway Company from the valuation of their property by the North Carolina Property Tax Commission for 1980*, 313 N.C. 177, 328 S.E.2d 235 (1985). In *Southern Railway*, the Supreme Court held that the determination of value exclusively from the owner's (i.e., seller's) perspective is in violation of the fair market value standard and such a value is achieved only by the use of improper valuation methods.

[Note: *Southern Railway* is a "fair market value" case. Equitable distribution law in North Carolina requires the more ambiguous standard of "net value," however, in a large number of ED cases (including *Hamby* and *Bersin*), the willing buyer and willing seller standard required under "fair market value" is at least discussed and contemplated, if not always applied correctly.]

Under state law, railroads are public service companies subject to ad valorem taxation. The North Carolina Department of Revenue initially appraises these companies and then allocates the appraised value among local taxing units. In *Southern Railway*, the two railroad companies challenged the appraised values of their respective systems. The state's valuation expert appraised Southern Railway at $1.025 billion and Norfolk Southern at $59.5 million. Valuation experts for the railroads estimated lower values of $690.2 million for Southern Railway and $46.2 million for Norfolk Southern.

The Supreme Court gave the following direction on the standard of value in *Southern Railway*:

> "[I]n appraising a railroad for ad valorem tax purposes, the appraisers seek to determine the fair market value of the railroad's system properties, i.e., that amount which a willing and financially able buyer would pay and a willing seller would accept, neither being under any compulsion to buy or sell." 313 N.C. at 185, 328 S.E.2d at 240-241.

This definition of fair market value (also referred to as "market value" in *Southern Railway*) is virtually identical to the fair market value standard used in the valuation report accepted in *Hamby*:

> "The price at which property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

In supporting his higher values in *Southern Railway*, the state's valuation expert repeatedly testified that he disregarded the willing buyer requirement of the fair market value standard and focused only on the willing seller aspect of that standard. Excerpts of his testimony included the following:

> "I find the true value of the railroad system property by determining the value to the owner of the property. I explained that *I do not consider value to a willing buyer* because railroad sales are few and those few sales are abnormal and don't represent fair market. (Emphasis added.)" 313 N.C. at 188, 328 S.E.2d at 242.

> "My appraisal of fair market value is determined based on my opinion of the appraisal of the fair market value of the railroad to the present owner and in light of the fact that everyone seems to agree there is no willing buyer or seller, and that satisfies the criteria." 313 N.C. at 188, 328 S.E.2d at 242.

> "I confine my approach to the value of this property to its owner." 313 N.C. at 188, 328 S.E.2d at 243.

> "[I]n light of the fact that it's not going to be sold, I think that the value of the present owner represents a reasonable market value." 313 N.C. at 188, 328 S.E.2d at 243.

In other words, the state's expert appraised the railroad property on an intrinsic value basis – that is, the value to the seller only. Does this sound familiar? It should. Here are some excerpts from the testimony of the valuation expert in *Hamby*:

> "We don't have to know there's a buyer. It's a hypothetical situation…[W]e know on date of separation that the sale wasn't imminent nor was it necessary. So my purpose in valuing, and I think the appropriate purpose in valuing the agency at date of separation is what is it worth to Mr. Hamby as a going concern." 143 N.C. App. at 639, 547 S.E. 2d at 113.

> "My approach to valuing…was just to determine does Mr. Hamby have, by creating this entity of an insurance agency, has he created something of

> value to himself." 143 N.C. App. at 639, 547 S.E. 2d at 113.

Therefore, in both *Southern Railway* and *Hamby*, we have: (1) the same standard of fair market value, (2) the same fact pattern that the entity in question is rarely, never, or cannot be sold, and (3) valuation experts who state that their valuation perspective is exclusively from that of the owner/hypothetical seller with no regard given to the position or perspective of the willing buyer. The major difference between *Southern Railway* and *Hamby* comes in the holdings of the respective courts. The North Carolina Court of Appeals in *Hamby* accepted the intrinsic value argument (i.e., value to the seller alone), holding:

> "[E]ven though Mr. Hamby cannot sell it, the agency still has value as to Mr. Hamby above and beyond a salary or the net worth of the agency's fixed assets which could be sold." 143 N.C. App. at 640, 547 S.E. 2d at 113.

In contrast to the lower court holding, the North Carolina Supreme Court in *Southern Railway* held that the intrinsic value standard is inconsistent and incompatible with the standard of fair market value:

> "The testimony of the Department's expert, Mr. Underhill, is seriously flawed because of his repeated insistence that he did not attempt to appraise the railroads from the standpoint of their value to a hypothetical purchaser. His methods were designed to arrive at the value of the Railroads simply from the standpoint of the seller-owner." 313 N.C. at 187, 328 S.E.2d at 242.

> "Mr. Underhill's appraisals of the Railroads from the perspective of the present owner to the exclusion of the willing buyer were in clear violation of the statutory 'market value' standard." 313 N.C. at 188, 328 S.E.2d at 243.

> "Both Railroads' witnesses approached their appraisals from the standpoint of the willing and able buyer and the willing seller as the Act requires. Mr. Underhill's failure to follow the statutory standard by approaching his appraisals solely from the seller-owner's standpoint so detracts from the usefulness of his methods that, on the whole record test, we must conclude it was error for the Commission to adopt them and to fail to adopt the methods urged by the Railroads' experts." 313 N.C. at 188, 328 S.E.2d at 243.

The Supreme Court held further that in order to derive this intrinsic value, this expert had to employ valuation methods that "resulted in substantially higher valuations than those which would have been reached had proper methods been followed." 313 N.C. at 181, 328 S.E.2d at 239. In other words, the misuse of the standard and consideration of value solely from the seller's perspective resulted in artificial and unrealistic values.

The Supreme Court's interpretation and application of the fair market value standard in *Southern Railway* is consistent with the standard's interpretation and application in normal business valuation practice. It is a more stable, more predictable, and less subjective standard that better serves the parties involved. In contrast, the Court of Appeals in *Hamby* creates an entirely new and subjective meaning of fair market value whose interpretation is so elastic that nearly everything can and will fit under it.

Conclusion. *Hamby* ultimately boils down to a legal issue: should alimony be capitalized? For that really is what *Hamby* does. If the legislature wants to capitalize alimony based on some capitalization of "excess compensation" (however arbitrarily that may be measured), then so be it. But let the legislature do this – not business appraisers. Don't cloak capitalized alimony under the guise of "business valuation" as it detracts from the logical, reasonable, and supportable opinions of value that many practitioners in my field are trying to derive. Calculations such as in *Hamby* are just that – calculations. They are not business valuations – they are "people valuations."

HAMBSTERS (continued)

If my primary goal as a business appraiser was to maximize profit, I would fully support *Hamby* as the case creates valuation manufacturing opportunities in virtually every situation. I oppose the *Hamby* logic, however, as it is inherently subjective, does not reflect reality, and creates an unpredictable universe for the parties involved. Business appraisers are supposed to assist the court, not confuse it. True business valuations usually involve multiple methods based on real-world facts that can be used as reality checks for the final opinion of value. With *Hamby*, there is none of that – it's just pick a salary, pick a cap rate, and you have your "value."

Do not succumb to the false logic of what the Hambsters call "business valuations." That bright and shiny exercise wheel might create the illusion of exciting travel and exotic destinations but the fact of the matter remains – once you stop running and take a look around, you will realize you haven't gone anywhere. ♦

Michael A. Paschall is co-author of the *CCH Business Valuation Guide* and a Managing Director of Banister Financial, Inc., a business valuation firm in Charlotte, North Carolina. He can be reached at mpaschall@businessvalue.com or 704-334-4932.

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