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FAIR VALUE™

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IDENTICAL TWINS?
(NOT IN EQUITABLE DISTRIBUTION)

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Once upon a time, there were two brothers, Jacob and Esau. Identical twins, they were best of friends and did everything together. They went to the same high school and college, each making excellent grades and each earning an undergraduate degree (with honors) in business management. Upon graduation from college, however, their paths diverged for the first time in their lives. Esau decided to go to law school while Jacob went to work for a large bank.


Michael Paschall

Following Esau's graduation from law school and Jacob's completion of the training program, each began to excel in his chosen career – Esau as a litigator and Jacob as an investment banker. Each brother also married and had children. After 25 years, each brother was earning $1 million per year and was recognized as highly competent and proficient in his respective field. Esau was a partner at a very prestigious law firm, focusing on specialized and complex business litigation for his clients. Jacob was a managing director in investment banking at one of the largest commercial banks in the country.

Alas, the demands of professional success took their toll on the brothers' personal lives. As with so many other things in their life, the brothers soon found themselves going through the unpleasantness of divorce together as well. The brothers would meet frequently to commiserate and trade observations on their respective plights. One day at lunch, the following conversation transpired:

Banker Jacob: Well, the judge finally ruled on our property settlement. I've got $1 million equity in the house and a $1 million stock portfolio. She's going to get the house and I will keep the stocks.

Lawyer Esau: Really? We just got our property settlement as well but she gets the $1 million house AND the $1 million stock portfolio.

Jacob: Well, what do you get?

Esau: I get to keep my partnership interest in my law practice.

Jacob: What is that worth?

Esau: Two million dollars.

Jacob: I didn't think you could sell your law practice.

Esau: I can't. But some business appraiser said it was worth $2 million.

Jacob: How did he figure that?

Esau: He said that an average lawyer with my experience makes $500,000 per year. I make $1 million per year, or $500,000 above the average. He capitalized my $500,000 in above-average earnings at 25%

to get to the $2 million value for my law practice.

Jacob: But if you put the average $500,000-a-year lawyer in your practice, he would never be able to duplicate what you do – he would lose your key clients.

Esau: I know.

Jacob: Or if you put a lawyer in your practice that could do what you do, he would rightly demand to be paid $1 million a year. That is what the market will bear for that job. Isn't that obvious?

Esau: I know, I know. But that's what this appraiser said it was worth and the judge bought it. I mean, he had this appraisal report that was almost a hundred pages long and had all kinds of tables and charts. Plus, the appraiser said that even if I didn't have the law practice, my law license would be worth that much.

Jacob: How does that work? I know you can't sell your law license.

Esau: Oh, this appraiser admits I can't sell any of this, but he says that my law practice and law license have an intrinsic value to me.

Jacob: In what sense?

Esau: In the sense that they allow me to earn the income that I do. This appraiser says that because I went to law school and am licensed by the bar, I earn more than if I had gone into the workforce with just my undergraduate degree in business management.

Jacob: But I have the same undergraduate degree in business management, no professional license, and earn the same income as you. There's no intrinsic value attributed to my job at the bank.

Esau: Yes, I made that point to the judge.

Jacob: And?

Esau: And my wife gets the house and the stocks.

Jacob: So even though we have the same amount of equity in our homes and stock portfolios and make the same amount of money each year, you are going to be $1 million poorer than me, just because you are a lawyer and I am a banker.

Esau: That's pretty much it.

Jacob *(leaving)*: I'll see you later.

Esau: Where are you going?

Jacob: Home. Jacob, Jr. is working on his applications to law school today. I'm going to tear them up and see if I can get him a job at the bank.

Inequitable Distribution. Welcome to the wonderful world of inequitable distribution and two-class citizenry. Although adjustments to alimony and child support may mitigate to some extent the inequity illustrated above, there still exists a significant problem in property division in divorce, at least where the valuation of professional practices or professional licenses are involved.

As a business appraiser, it is not my direct concern as to how equitable distribution law is made and upheld in any respective state. Equitable distribution does, however, become my direct concern when professional practice "valuations" such as the $2 million hypothetical shown above occur. What is basically a poorly-disguised attempt at capitalizing alimony is in reality an exercise that, purely from a valuation perspective, is logically indefensible.

Two Clarifications. Before we go any further, I need to make two things perfectly clear:

1. I am NOT saying that interests in professional practices have no value or are never bought and sold on the open market. The vast majority of doctors, lawyers, and CPAs in this country started out as salaried employees who gradually earned partnership in their respective firm or practice through below-average earnings for some period ("sweat equity"), cash buy-ins, or some combination of the two. Typically, however, these cash buy-ins are nominal (many times based on either the fixed asset value of the entity or some token

amount, such as one dollar) and any sub-partner compensation level for a period of time is arguably warranted due to the below-average production that naturally comes with youth and inexperience. It is the type of "valuation" done in the hypothetical above (i.e., the extrapolation of $500,000 in "above-average" compensation into $2 million in "value") that is pure swill in the context of most professional practices.

2. Adjusting an owner's compensation to a market or average rate of compensation is a perfectly normal and acceptable business valuation practice. I have done it hundreds of times myself. Such adjustments, however, have a limited applicability depending on the nature of the company and the managerial position at issue. For example, if I am adjusting the compensation of the owner of a car dealership who also serves as the general manager of that dealership, I can find relevant compensation data for general managers in the industry and adjust this particular owner's compensation accordingly. This adjustment is done under a principal of substitution whereby I assume that this 100% owner could hire an outside general manager to execute the duties of running the car dealership, allowing the 100% owner to retire and realize only the fruits of his ownership of the business (and not the compensation he earned for managing the business).

   This exercise might go as follows: assume the 100% owner of the dealership also serves as general manager and realizes $500,000 per year in total compensation from the company (which shows zero net profit). Suppose I can find compensation data that indicates that a general manager for a dealership of a similar revenue size, models sold, geographic location, financial performance, etc., would earn $200,000 per year. I now know that my 100% owner's compensation can be separated into two components: he earns $200,000 per year for executing the duties of a general manager and $300,000 per year due to his 100% ownership of the company. Or, put another way, the 100% owner could retire, hire a new general manager at $200,000 per year, and still realize $300,000 per year from the profits of the company. In this example, the $300,000 is the amount of "excess earnings" of the 100% owner and is the amount that is properly capitalized under an income approach to derive the value of the company. Problems arise, however, when you move from this context of interchangeable managers performing at similar levels to the far more specialized and personalized nature of professional practices. This is where such compensation adjustments tend to fall off the tracks.

A *Poore* Standard. As a starting point to this analysis, let's consider the guidance given on the valuations of professional practices in North Carolina. 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 North Carolina Court of Appeals addressed the issue of the valuation of a professional practice for equitable distribution purposes. In *Poore*, the husband was a dentist and was the sole owner of his own dental practice. The Court in *Poore* offered the following guidance on the capitalization of above-average earnings method (which the Court called the "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." (75 N.C. App. 414, 421-422)

Although appearing to be helpful, this language in *Poore* leads to a logical dead-end in the professional practice context (as will be shown below). Unfortunately, the *Poore* standard has been repeatedly misinterpreted and misapplied by business appraisers for years, perhaps most recently (and infamously) in the *Hamby* case. In *Hamby v. Hamby*, 143 N.C. App. 635, 547 S.E.2d 110 (2001), the North Carolina Court of Appeals bought into the logic 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.

Compensation is Critical. Nearly all of the hullabaloo of *Hamby* has focused on the concept of intrinsic value to an owner. The argument is made that, even though the particular professional practice in *Hamby* could not be sold, it still had intrinsic value to its owner via this owner's ability to earn an "above-average" compensation. **What is lost in the myopic focus on the non-marketability issue is the illogical assumption that supports the conclusion of value in the first place: namely, the compensation adjustment to the income statement.** Nowhere have I seen or heard this issue of compensation adjustment directly addressed by *Hamby* supporters except for one sentence in the June 2004 issue of *Family Forum* (the newsletter of the Family Law Section of the North Carolina Bar Association):

> "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 issue of salary adjustment deserves more scrutiny than this. **The salary adjustment done in *Hamby* was the key issue as regarded the determination of value. 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.**

With all due respect to the judiciary, just because a court accepts a particular adjustment does not mean that adjustment is either logical or correct. The skillful presentation of apparently reasonable (but ultimately illogical) assumptions coupled with impressive-looking (but often seriously flawed) compensation surveys can result in conclusions of "value" that make no sense whatsoever. Consider the huge gaps in reason that plague this issue:

1. The compensation adjustment calculation and "logic" accepted by the *Hamby* court are in direct opposition to the Court's holding in *Poore*. As seen above, the *Poore* court stated that the compensation used in comparison should be of one who has a similar education, experience, skill, and is in the same general locale. Now think about this for a minute. If this comparable person has the same education, experience, skill and is in the same general locale, shouldn't that person earn close to (if not exactly) the original salary to which the adjustment is being made? If Mr. Hamby was making $105,000 per year, doesn't it follow that he has some additional education, experience and/or skill than the $47,000-a-year agent? In fact, wouldn't you have to assume that Mr. Hamby likely has *significant* additional education, experience and/or skill than the $47,000-a-year agent since Mr. Hamby is making more than twice as much?

2. As clearly and intuitively seen by Jacob in the initial dialogue, if a $500,000-a-year "average" lawyer were to attempt to replicate the specialized legal services provided by Esau, many of Esau's clients would leave, revenues would decline, and much of the supposed "value" of Esau's practice would collapse, if not vanish entirely. The reason Esau earns $1 million per year is that the market values his services at that rate. An average, $500,000-a-year lawyer cannot provide the same level of legal service provided by Esau. Likewise, in *Hamby*, it was irrational for the business appraiser and Court to assume that a $47,000-a-year

insurance agent could provide the same services and achieve the same results as a $105,000-a-year insurance agent. If you make the proper compensation adjustment in *Hamby* (i.e., a $105,000-a-year insurance agent should be replaced by another $105,000-a-year insurance agent), the rug is pulled out from underneath this methodology and the value completely collapses as there are no "excess earnings" to capitalize. Unfortunately in *Hamby*, nobody argued this common sense position so it was left unchallenged and now is case law in North Carolina.

3. Conversely, if an attorney were found that could duplicate the specialized legal services provided by Esau, wouldn't that lawyer rightfully demand to be paid $1 million per year? Isn't that what the market will bear? If Esau's law firm wouldn't pay this lawyer $1 million per year, couldn't this lawyer get that from another firm? And in *Hamby*, if the $47,000-a-year insurance agent were doing the work of a $105,000-a-year insurance agent, shouldn't the $47,000-a-year agent be paid $105,000? How long would you stay in your $47,000-per-year job if you knew that the company down the street would pay you $105,000 per year for doing the *exact same thing*?

The *Hamby* position is to adjust compensation to some industry average or median figure. This is not an accurate reading or application of *Poore*. *Poore* does not say "average" or "median" – it says similar education, experience, skill and locale. **The two are not the same**.

Slam Dunk? The logical shortcomings illustrated above have a widespread application to a virtually limitless range of professional services – even the NBA. For example, Shaquille O'Neal plays center for the Miami Heat and earned $27.7 million this year. Zydrunas Illgauskas plays center for the Cleveland Cavaliers and earned $14.6 million this year, or about 53% of Mr. O'Neal's salary. This is a similar compensation discrepancy as seen in the lawyer Esau ($1 million vs. $500,000) and *Hamby* insurance agent ($105,000 vs. $47,000) illustrations above. So why is there this discrepancy in compensation for Mr. O'Neal and Mr. Illgauskas? Let's look at a comparison between the two:

Comparison [1]
Shaquille O'Neal vs. Zydrunas Illgauskas

Item	Shaquille O'Neal	Zydrunas Illgauskas
Salary	$27,700,000	$14,600,000
NBA Team	Miami	Cleveland
Age	33	30
Position Played	center	center
Career Points per Game	26.7	14.8
Career Rebounds per Game	12.0	7.7
NBA Titles	3	0
NBA All-Star Games	11	2

[1] Based on information at www.hoopshype.com and www.espn.com.

After reviewing the above table, ask yourself these questions: if you were trying to derive some goodwill "value" for Mr. O'Neal, would it make sense to adjust his compensation by the salary earned by Mr. Illgauskas (assuming Mr. Illgauskas is an "average" NBA center)? Issues of education, experience, and locale aside, do Mr. O'Neal and Mr. Illgauskas appear to have the same degree of skill as required under *Poore*? If the owner of the Miami Heat traded Mr. O'Neal for Mr. Illgauskas, would he really have $13.1 million more in net income each year (based on the salary savings realized in the trade of $27.7 million less $14.6 million)? Or is it more likely that the Heat's overall record, playoff possibilities, attendance, merchandise sales, concessions, profits, etc., would suffer due to the loss of such a dominant player as Mr. O'Neal – potentially putting the Heat in a *worse* position than if they had kept Mr. O'Neal?

It is clear that under the *Poore* standard, Mr. Illgauskas does not have the same degree of skill as does Mr. O'Neal. As a result, it is meaningless to adjust Mr. O'Neal's compensation to that of Mr. Illgauskas in order to derive $13.1 million of "excess earnings" that could then be capitalized into some goodwill "value" for Mr. O'Neal. Yet it is this kind of illogical adjustment that is done repeatedly in the professional practice context in equitable distribution and is accepted as "business valuation." This is exactly what the business appraiser did and the Court accepted in *Hamby*.

Bank On It? Or bring it back to the business world. Ken Lewis is the Chairman, CEO, and President of Bank of America. According to that company's public filings, Mr. Lewis earned total compensation of $19.75 million in 2004. According to the Bank of America website, Mr. Lewis holds a bachelor's degree in finance from Georgia State University and no graduate degrees or professional licenses. In two key ways, then, Mr. Lewis is identically situated as Mr. Hamby: (1) just as Mr. Hamby couldn't sell his insurance practice, neither can Mr. Lewis sell his job as Chairman, CEO, and President of Bank of America, and (2) despite each man's inability to sell his practice or job, that respective practice or job has an intrinsic value to each man.

Under the *Hamby* logic, to value each man's practice or job, it is necessary to calculate that amount of compensation that exceeds some "average" measure of compensation. Here again is where this analysis goes haywire. As noted above, Mr. Hamby's compensation was illogically adjusted by a much lower rate of compensation that in no way reflected the combination of education, experience, and skill of Mr. Hamby. Now what do we do for Mr. Lewis? Do we adjust his actual compensation by the "average" compensation of an "average" holder of an undergraduate finance degree from Georgia State (say $75,000)? Or do we adjust Mr. Lewis' compensation by some industry peer – say that of his cross-town equivalent, Wachovia CEO Ken Thompson? Based on Wachovia's public filings, Mr. Thompson made $18.1 million in total compensation in 2004, reasonably close to Mr. Lewis' compensation. But wait a minute – there are complicating factors here:

1. Mr. Lewis heads a much larger and much more profitable organization. Bank of America has $1.1 trillion in total assets, $14.1 billion in 2004 net income, and 175,000 total employees. Wachovia has $500 billion in total assets, $5.2 billion in 2004 net income, and 96,000 total employees. Shouldn't Mr. Lewis get some premium for running a company that is twice as large as Mr. Thompson's company? How do you adjust for this?

2. Mr. Thompson holds a graduate degree (a Wake Forest MBA) whereas Mr. Lewis holds no graduate degree. Shouldn't this graduate degree enable Mr. Thompson to earn more than the average undergraduate who does not hold a graduate degree? After all, this is the basic argument that is made with a law license. And because Mr. Thompson holds a graduate degree and Mr. Lewis does not, shouldn't Mr. Thompson earn more than Mr. Lewis? How does this issue factor into the salary adjustment?

So what salary measure do you use for Mr. Lewis? The Georgia State undergrad's? Ken Thompson's? Something else? Assuming a 25% capitalization rate, two possibilities for the hypothetical "value" of Mr. Lewis' job are as follows:

Hypothetical Capitalized Alimony Calculations

Average Salary Measure:	Georgia State Undergraduate	Wachovia CEO Ken Thompson
Ken Lewis 2004 Compensation	$19,750,000	$19,750,000
Less: Salary Adjustment	($75,000)	($18,100,000)
Equals: "Excess Earnings"	$19,675,000	$1,650,000
Divided by: Capitalization Rate	25%	25%
Equals: "Value" in ED	**$78,700,000**	**$6,600,000**

As seen above, based on the salary measure chosen, the "intrinsic value" of Mr. Lewis' job can vary by $72 million. So which figure is correct? **Neither one.** The above calculations are not business valuations in any sense of the word – they are purely mathematical attempts to capitalize "excess" salary. Unfortunately, this is the exact same rationale and calculation that was used in *Hamby* and passed off as a "business valuation" – just because there was a professional practice involved. Like it or not, *Hamby* is a giant step towards the capitalization of "excess compensation" (however arbitrarily measured) as a marital asset in ED. In fact, our firm has already seen "business valuations" of the intellectual capital of individuals where no professional practice or corporate entity whatsoever was involved. Where does all of this end?

Baby, I'm a Rich Man. Professional license "valuation" is a kissing cousin of professional practice valuation and is equally, if not more, nebulous and illogical. The "valuation voodoo" aspects of professional license valuation have been addressed in previous issues of Banister Financial's *Fair Value* (see articles under the Professional License Valuation subheading under the Valuation Articles tab at www.businessvalue.com). My favorite professional license valuation story comes from the epicenter of such "valuation" practice: New York. In a 1999 case (*Murtha v. Murtha*), the issue of the value of a Chartered Financial Analyst (CFA) designation was at the core of a divorce case. The wife argued that her husband's CFA designation enabled him to earn a higher salary than if he did not hold such a designation, therefore, the husband's CFA designation had a value to the marital estate that must be divided. Based on a capitalization of the assumed increased earnings due to the CFA designation, the wife's business appraiser opined that the husband's CFA designation had a value of over $3.3 million.

I earned my Chartered Financial Analyst (CFA) designation in 1991. My designation was earned over a three-year examination period and required significant amounts of evening and weekend study. I have a large diploma on my office wall to remind me of this accomplishment. You therefore can imagine my delight when I discovered that my net worth is $3.3 million higher than I previously thought. My CFA designation is unquestionably the most valuable asset I own, dwarfing by far the combined value of all my other assets, including my house. And if any of you out there want to buy my CFA designation for $3.3 million, please contact me immediately and I will hand-deliver my diploma to your home or office by 5 pm today (note: all sales are final).

Wishful thinking aside, the most valuable aspect of the *Murtha* case is its illustration of the significant potential for abuse in the professional practice and/or license valuation context. Fortunately, the *Murtha* court did not buy this advocate's position, however, there is no guarantee that every court will see through this faulty logic. Do not let what appears to be a logical and well-reasoned calculation fool you. Look behind the curtain and I believe that frequently you will find such "logic" to be irrational and unsupportable.

Conclusion. Again, it is not my position to make or influence policy on equitable distribution law. If the legislature wants to capitalize alimony based on some capitalization of "excess compensation" (however arbitrarily that may be measured), then so be it. Just don't cloak such nonsense 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 the ones above and in *Hamby* are just that – calculations. They are not business valuations. If anything, they are "people valuations."

Oh, and one more thing. For those of you lawyers who might be getting divorced in the near future, you may want to consider an immediate job change to a salaried staff legal position at some corporation, a governmental job, judgeship, etc. You may still have to fight the license valuation aspect of your profession, but at least there won't be any professional practice interest to value. Even if your new salary is lower than what you are currently making in private practice, you still may save yourself a bundle in the long run by making the switch. After all, you don't want to wind up like poor (or *Poore*) Esau. Of course, if the courts keep moving down the *Hamby* path, it won't matter anyway because eventually, professional practice or not, we'll all just have our jobs capitalized in ED. ♦

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