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FAIR VALUE™

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NAMBY-PAMBY *HAMBY*

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Introduction. A recent decision by the North Carolina Court of Appeals has created a new degree of subjectivity, uncertainty, and confusion in the already murky world of business valuation for equitable distribution purposes. In *Hamby v. Hamby*, 143 N.C. App. 635, 547 S.E.2d 110 (2001), the Court held that even though a particular business could not be sold to any buyer, it still had value to the owner and thus was a divisible asset of the marital estate. This article will first examine how the standard of value in *Hamby* is a significant departure from the traditional standard of fair market value. Next, this article will explore the many problems inherent with this ruling and the significant problems it creates for business appraisers, attorneys, and the parties in an equitable distribution matter. This article concludes that the *Hamby* case is a significant step backwards for business valuation and is yet another disconnect between business valuation for equitable distribution purposes and business valuation in the real world.

Michael Paschall

A Familiar Problem. *Hamby* is not a case of first impression in North Carolina as courts for years have at least indirectly subscribed to this "intrinsic value" (or value to a particular person) standard, all the while cloaking it as "fair market value." In addressing the value of an interest in an accounting practice in *Weaver v. Weaver*, 72 N.C. App. 409, 324 S.E.2d 915 (1985), the Court noted that:

> "Placing a precise or even approximately accurate value on such a partnership interest, especially when the partner whose interest is in question continues as a member of the firm, is not easy. There is no real market value for this asset. Yet, partnership interests can and have been successfully valued, with the aid of expert testimony and using various appraisal methods." (72 N.C. App. 409, 411-412).

Thus we see that even though an asset may have "no real market value," courts nonetheless have found that such assets may be "successfully valued, with the aid of expert testimony and using various appraisal methods."

This article is highly critical of the valuation report and testimony that were accepted in *Hamby*. Some of the problems with the report and testimony in *Hamby* are due to errors made by the particular business appraiser involved. However, other problems in *Hamby* are due to the continuing acceptance of this "intrinsic value" standard by North Carolina courts. In fairness to the business appraiser in *Hamby*, many of the things he does in his report and testimony are forced upon him by this "intrinsic value" standard. Therefore, a good portion of the criticism that follows is of the standard itself, and not the particular business appraiser involved. As will be effectively demonstrated by this appraiser, the "intrinsic value" standard is so subjective and nebulous that the only way a business appraiser can come up with an estimate of value is through illogical and irrational assumptions.

Facts of the Case. After seven years of marriage, the Hambys separated in 1995 and were divorced in 1996. One of the issues in *Hamby* involved the valuation of the Nationwide Insurance Agency owned and operated by Mr. Hamby. Prior to the marriage, Mr. Hamby had worked as an employee of Nationwide, however, after getting married, Mr. Hamby became an independent contractor with Nationwide, opening his own office "to sell Nationwide products as an exclusive representative."

The Husband's Expert. Mr. Hamby's business valuation expert valued the agency at $18,950, placing most of his weight on an adjusted book value method (basically the net asset value of the agency). Mr. Hamby's valuation expert reasoned that Mr. Hamby was an exclusive agent, representing only one company, and had virtually no business to sell. Mr. Hamby did not own the policies he sold. Nationwide alone had the authority to transfer those policies or do anything with them it wished at its sole discretion. A letter from Nationwide to Mr. Hamby was very clear on this point:

> "As an independent contractor agent with

> Nationwide Insurance Company, you do not own the portfolio of business written with Nationwide. 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 this portfolio. The assignment of a portfolio is made at the sole discretion of the Companies. 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, the Companies will assign your policies to another Nationwide agent at its sole discretion."

In fact, both Mr. and Mrs. Hamby agreed that the insurance agency and its policies could not be sold or transferred and the Court accepted this fact.

The Wife's Expert. In contrast, Mrs. Hamby's business valuation expert ignored the fact that the agency and its policies were not transferable to any buyer and opined that the fair market value of the agency was $110,000. The Court agreed with Mrs. Hamby's expert, stating that "even 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. The Court finds that the Rick Hamby Insurance Agency cannot be sold but that the Agency still has value." The Court ultimately accepted the valuation of Mrs. Hamby's expert, less adjustments for errors the Court found in his valuation.

Defining the Terms. Before we analyze the reasoning and potential fallout from the *Hamby* case, it is necessary to look at some industry-standard definitions. One of the key problems with the *Hamby* ruling is its expansion of the definition of fair market value into an area that is not contemplated, included, or in any way implied in its definition.

The *International Glossary of Business Valuation Terms* is widely accepted as the definitive source of business valuation definitions. The *Glossary* has been jointly adopted by the following entities: the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), the Canadian Institute of Chartered Business Valuators (CBV), the National Association of Certified Valuation Analysts (NACVA), and The Institute of Business Appraisers (IBA). There is no one governing body of business valuation, however, these entities are widely recognized as the major governing bodies of business valuation in the United States and Canada. In its forward, the *Glossary* notes the following:

> "The performance of business valuation services requires a high degree of skill and imposes upon the valuation professional a duty to communicate the valuation process and conclusion, in a manner that is clear and not misleading. This duty is advanced through the use of terms whose meanings are clearly established and consistently applied throughout the profession. If, in the opinion of the business valuation professional, one or more of these terms needs to be used in a manner that materially departs from the enclosed definitions, it is recommended that the term be defined as used within that valuation engagement. This glossary has been developed to provide guidance to business valuation practitioners by further memorializing the body of knowledge that constitutes the competent and careful determination of value and, more particularly, the communication of how that value was determined."

It follows from the above quote that a business valuation practitioner who is a member of any one of the above five organizations has one of two choices: (1) follow the definitions, or (2) have a good reason and an adequate explanation as to why they are departing from a particular definition. Any business appraiser who is not a member of one of the above five organizations is presumably free to create or invent as many valuation definitions as he or she pleases. As relates to the *Hamby* case, the valuation report by Mrs. Hamby's business valuation expert indicates that this expert is a member of both the AICPA and NACVA, therefore, he is subject to the *Glossary* definitions and requirements as noted above.

Fair Market Value vs. Intrinsic Value. The first major problem with the *Hamby* case is that the standard of value ultimately accepted by the court is definitely not fair market value. However, in his valuation report, Mrs. Hamby's expert clearly and repeatedly cites the standard of fair market value. The first sentence in the valuation report of Mrs. Hamby's expert states the following (emphasis added):

> "We were engaged to provide our opinion of the **fair market value** of The Hamby Insurance Agency, located in Hickory, North Carolina as of August 17, 1995 for the purpose of equitable distribution considerations in a divorce proceeding."

The valuation report then proceeds directly to a definition of fair market value:

> "For the purposes of this valuation, **fair market value** is defined as '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.' (Treasury Reg. 20.2031-1(b); Revenue Ruling 59-60, 1959 1 CB 237)."

On the same page, the valuation report states:

> "Our opinion of value for The Hamby Insurance Agency is based upon a **fair market value** standard."

In numerous other places in the report, Mrs.

Hamby's expert refers to the standard of fair market value, including the final sentence of the report:

> "After application of discounts as previously described, it is our opinion that as of August 17, 1995 the **fair market value** of The Hamby Insurance Agency was $110,400 which is rounded to $110,000."

The definition of fair market value cited in the valuation report by Mrs. Hamby's expert is an accurate definition. It is very similar to the definition found in the *Glossary*:

> **Fair Market Value:** the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

As seen in both definitions above, a key component of fair market value is the ability to *transfer* property between a willing seller and a willing buyer. However, as was noted above, all parties in *Hamby* (including the Court) agreed that Mr. Hamby (the prospective willing seller) had no ability to transfer his insurance agency to any buyer. Because of his inability to transfer the agency, Mr. Hamby had no ability to realize any benefit from the sale of the agency. Even if Nationwide decided to transfer the agency to another buyer, Mr. Hamby presumably would not have realized any benefit from the sale because he did not own the policies to begin with.

Double Talk. Despite his repeated and consistent use of the fair market value standard in his report, Mrs. Hamby's valuation expert testified to an entirely different standard of value while on the witness stand. Some of the testimony of Mrs. Hamby's expert is noted below (followed by commentary on each statement):

> "And it's my understanding when we say we're valuing at fair market value we're trying to determine what if the entity that's being valued could have traded hands on date of separation, date of valuation."

This is an accurate statement. Fair market value is an estimate of what the transaction price between a willing buyer and willing seller would be as of a particular date. So far, so good, however, Mrs. Hamby's expert is about to take off on a tangent that has no relationship to fair market value:

> "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."

Mrs. Hamby's expert has just introduced a new and different standard of value from fair market value. There may be a big difference between: (1) what something is worth to a particular person and (2) what that particular person could get for that something on the open market from a willing buyer. When talking about (2) above, the standard is clearly fair market value. Talking about (1) above is something entirely different. Therefore, for purposes of this article, I am going to refer to this new standard of value in (1) above as "intrinsic value" as it is the value to a specific person and is not necessarily representative of what a willing buyer would pay a willing seller.

There are a number of problems with the standard of intrinsic value, not the least of which is: how do you measure it? Your grandmother's diamond engagement ring that you gave to your wife when you became engaged – it may have an appraised value of $5,000 but its intrinsic value to you is much greater because of its family history. How do you measure its value? Or the videotape that contains your child's first steps and first words – it is probably worth next to nothing on a fair market value basis but it is very valuable to you because it is irreplaceable. How do you measure its value?

The discussion of whether intrinsic value or fair market value should be the appropriate standard of value is addressed later in this article. The point made now goes only to the fact that the standard of fair market value used in the valuation report by Mrs. Hamby's expert and the intrinsic value standard of value put forth by the same expert on the witness stand are entirely different. The most dangerous part about this situation is the subtle shift by this expert from his report to his testimony on the witness stand. By using a fair market value standard in his report and then modifying that standard to intrinsic value on the witness stand, there is a significant danger that courts and practitioners will (as in *Hamby*) believe that the definition of fair market value includes the intrinsic value to a particular owner. Go back and read the definition of fair market value. All I see there is talk about a transfer – I don't see anything about personal or intrinsic value to a specific owner.

> "And I don't think in valuing a closely held business as of a date of separation in a divorce situation that I have to assume that Mr. Hamby has to sell his business."

While it is true that you don't have to assume that there is a forced sale scenario, the standard of fair market value (which is cited numerous times in this expert's report) states that fair market value is the value at which property "changes hands" between a willing buyer and willing seller. Therefore, while the standard of fair market value does not contain the requirement that Mr. Hamby "has" to sell his business, the standard of fair market value does require that Mr. Hamby "can" sell his business. As discussed earlier in this article, all parties agreed and it was clear that Mr. Hamby could not sell his agency.

> "And I know we've heard testimony that, which isn't necessarily relevant to me, that the business can't be assigned…But that's not important to me on date of separation because he wasn't trying to sell it on that day. What's it worth to him?"

Here, Mrs. Hamby's expert states that the fact that the agency could not be assigned is irrelevant to him. This solidifies this expert's standard of intrinsic value as expressed on the witness stand ("What's it worth to him?") and further distances him from the fair market value standard that is first defined then cited repeatedly in his report.

Problems and Inconsistencies. Nowhere else in this expert's valuation report is any standard of value other than fair market value cited. However, the new standard of intrinsic value testified to on the witness stand creates a number of problems and inconsistencies in this expert's report:

1. Under the income approach, the report develops a capitalization rate that attempts to quantify the risk to a potential buyer of the agency. This is all good and proper under the fair market value standard, but under the standard of intrinsic value, shouldn't this expert try to quantify the risk to Mr. Hamby alone? After all, there is no potential buyer under the standard of intrinsic value.

2. This expert's report also makes such comments as: "expenses will be analyzed from the perspective of the hypothetical buyer." The report also makes adjustments for expenses "which would be appropriate for a potential buyer." Again, under the standard of fair market value, that is the proper perspective and analysis, however, under the standard of intrinsic value put forth by this expert on the witness stand, who cares about the perspective of a hypothetical buyer or potential buyer who doesn't exist? Shouldn't the perspective be Mr. Hamby's alone?

3. The report also utilizes a market approach that examines actual transactions of other insurance agencies. Therefore, throughout the report, methodologies are utilized that contemplate a *transaction* of the agency. However, when taking the witness stand, Mrs. Hamby's expert states that the impossibility of such a transaction for this particular agency is irrelevant to his determination of the value.

No Marketability Analysis Needed. There is yet another highly illogical aspect of the valuation report of Mrs. Hamby's expert given this expert's switch to the intrinsic value standard in his testimony. This aspect has to do with the fact that Mrs. Hamby's expert applies a discount for lack of marketability despite the fact that no marketability analysis should be needed under the valuation standard of intrinsic value. The *Glossary* noted earlier in this article defines the following two terms:

> **Marketability:** the ability to quickly convert property to cash at minimal cost.
>
> **Discount for Lack of Marketability:** an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.

In *Hamby*, all the parties (and the Court) agreed that the insurance agency could not be sold by Mr. Hamby to anyone. Therefore, under the above definition of marketability, the "ability to convert [the insurance agency] to cash at minimal cost" did not exist. As discussed above, Mr. Hamby was completely and entirely unable to convert his agency to cash at any cost. As a result, the "relative absence of marketability" (as defined under discount for lack of marketability) was complete. In other words, under the standard of fair market value, the discount for lack of marketability is 100%, resulting in a value of zero (although there presumably was a minor amount of hard assets such as furniture and equipment that Mr. Hamby could have sold).

The standard of intrinsic value under *Hamby*, however, states that the potential sale of an entity is irrelevant. Under the standard of intrinsic value, the only thing that matters is the value of the entity to its particular owner. As a result, under the standard of intrinsic value, the marketability of an entity is irrelevant and no marketability analysis is needed. Therefore, no discount for lack of marketability should be taken. However, the valuation report by Mrs. Hamby's expert includes both a marketability analysis as well as the application of a discount for lack of marketability. The valuation report states the following:

> "The concept of marketability deals with the liquidity of an ownership interest; that is how quickly and easily it can be converted to cash of [sic] the owner chooses to sell."

The report then applies a 35% discount for lack of marketability to derive the final estimate of value. Where is the logic in this? All parties have already agreed that the owner could not transfer the agency to anyone at any price at any time. Under a fair market value analysis, the discount for lack of marketability for the agency is 100% because there is no willing buyer. What is the purpose of calculating a discount for lack of marketability under the standard of intrinsic value? If you are assuming that the entity cannot be sold and its only value is to its owner, what do you care about the marketability (or lack thereof) of the entity? Aren't you already assuming that the owner is not going to sell the entity to anyone? This issue illustrates yet another logical disconnect between the fair market standard of the valuation report and the intrinsic value standard testified to on the witness stand.

The Danger of *Hamby*. It is clear from the foregoing analysis that the standard of intrinsic value as accepted by the *Hamby* court is a different standard of value from fair market value. It is hoped that this article will help educate practitioners and the courts as to the numerous logical inconsistencies between the two standards of value and prevent future occurrences of business valuation experts calling something fair market value in their report and then opining to an entirely different standard of value on the witness stand. As mentioned earlier, the biggest danger in all of this is the subtle yet significant shift between standards and the resulting effect that judges and attorneys begin or continue to believe that fair market value is something that it definitely is not.

So What is the Standard of Value? Aside from the fact that *Hamby* is a great example of a very careless application of business valuation principles, there is a bigger issue in all of this. What is the proper standard of value for professional practices in equitable distribution cases in North Carolina? Fair market value? Instrinsic value? Something else? Unfortunately, there is no legislative guidance as to what the proper standard of value is or should be – all the guidance we have is from various interpretations by the courts.

Ambiguity. Not using the standard of fair market value in a divorce case in North Carolina is not necessarily wrong because neither the legislature nor case law has defined or dictated the proper standard of value to be used in such cases. The equitable distribution statutes refer to "net value," however, this is an undefined term. This is a major problem with equitable distribution business valuation cases in North Carolina – there is no guidance as to what valuation standard should be followed. With no valuation standard defined, business appraisers are free to choose whatever method best suits the interest of their client. In *Hamby*, fair market value is the preferable standard for Mr. Hamby while intrinsic value is the preferable standard for Mrs. Hamby.

FMV is accepted standard. As opposed to this ambiguity with equitable distribution valuations, the defined standard for gift and estate tax valuations is fair market value. While reasonable minds can certainly differ as to the fair market value of a particular business, at least the scope is considerably narrowed from not knowing what the standard of value is in the first place. *Hamby* reinforces a business appraiser's ability to select or modify whatever standard of value best suits his or her situation – fair market value and intrinsic value are only two of what may be many different standards of value yet to come in North Carolina equitable distribution cases.

Aside from the valuation free-for-all this creates, there are also a number of practical problems with the implementation of the *Hamby* standard of intrinsic value. One key problem is finding an objective standard by which to measure the value of the company or professional practice to the owner. A key issue in this analysis under *Hamby* is the determination of a reasonable market rate of compensation for the managerial or professional services being provided. To further explore this issue, it is necessary to examine a few key court cases.

Poore. The North Carolina courts have given us some direction in business valuation for equitable distribution purposes. While such cases as *Poore* and *Sonek* attempted to lead us out of the woods, *Hamby* has put us back into the middle of the Black Forest. 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 dental practice was an incorporated entity that was operated as a professional association.

The Court in *Poore* 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)

> "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)

> "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, 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)

As seen in the last full paragraph above, the *Poore* court gives us some possibilities for the valuation of goodwill in a professional practice. These valuation possibilities are discussed individually as follows:

1. **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.**

   Although the *Poore* court calls it "market value," this definition sounds a lot like the standard of fair market value that was discussed at the beginning of this article. After *Hamby*, however, it is not clear that fair market value is the proper standard of value in equitable distribution matters. At the very least, it appears that the Court will consider other standards of value aside from fair market value (such as intrinsic value). As discussed above, under a standard such as intrinsic value, it is clear that the price a willing buyer would pay a willing seller is an irrelevant factor in determining the value. This leads to confusion for us business appraisers. Are we to follow this fair market value standard as suggested in *Poore* or the intrinsic value standard as implied in *Hamby*?

2. **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.**

   Although this may sound good in theory, the use of the capitalization of excess earnings method in many cases may indicate little or no goodwill value for the professional practice. As noted in *Poore*, "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." Taking these *Poore* factors into account, the earnings of a particular professional must be compared to the earnings of a professional with similar education, experience, skill, and in the same location.

   For example, assume you are valuing a medical practice. The sole physician in this medical practice is an ophthalmologist, Dr. Seegood, who also has a Ph.D. in biochemistry. Dr. Seegood also has specialized training in a new technique that corrects near- and far-sightedness. This new technique does not require a scalpel or a laser but instead utilizes a short blast of chemically-treated air that permanently reshapes the eye to its proper shape. The procedure lasts less than one second, there is no pain to the patient, no recovery period, and the procedure is 100% successful in correcting to 20/20 vision every time. Dr. Seegood is one of only ten physicians in the United States who is approved to perform this procedure. All ten of these ophthalmologists also have their Ph.D. in biochemistry which is necessary training to be able to understand and implement the chemical treatment of the air used in the procedure.

   Assume an average ophthalmologist makes $500,000 per year and an average ophthalmologist specializing in laser eye surgery makes $1 million per year. Each of the ten specialized ophthalmologists using the air procedure makes $2 million per year. The specialized ophthalmologists make more per year due to the numerous benefits of the particular procedure in which they are trained and skilled. How do you properly adjust Dr. Seegood's compensation to determine the goodwill inherent in his practice?

   Should you compare Dr. Seegood's earnings to the $500,000 earnings of an average ophthalmologist, indicating that Dr. Seegood has $1.5 million in annual "excess" earnings? Based on the *Poore* standards, Dr. Seegood has a greater degree of education, experience (and probably skill) as evidenced by his being one of only ten such specialized ophthalmologists in the United States. It is not logical to assume that you could "plug in" an average ophthalmologist into this practice and have him perform at the same level as Dr. Seegood. You certainly could not go out and hire an average ophthalmologist and expect him to replicate Dr. Seegood's services. For the same reasons, it is not reasonable to use a $1 million laser specialist as a salary comparable. While it is true that the $1 million laser physician and Dr. Seegood are doing basically the same thing, they have different levels of "education, experience, and skill" as required by *Poore*. This difference is evidenced by the fact that the market pays the Dr. Seegood $1 million more than the laser ophthalmologist.

   Under *Poore*, then, we are left with the fact that a fair market rate of compensation for Dr. Seegood is $2 million. His "excess" earnings, therefore, are zero (calculated as $2 million actual compensation less $2 million fair market compensation). This result is entirely logical. In a personal service business (and particularly a solo practice), there is a very strong argument that each individual practitioner is being paid a fair market rate of compensation for the services provided.

   In the September/October 2000 issue of *The Valuation Examiner*, Ronald Seigneur, CPA\ABV, CVA, expressed it this way when discussing the valuation of a law practice:

   > "Many valuation specialists believe the excess earnings method of valuation is overused and abused. It has gained such a wide acceptance in dissolution of marriage proceedings, that

often it seems to be the method of choice by the bench merely because it is the one method that has been used so routinely that most everyone, including the judge, thinks they understand it. One critical problem in applying this method is in the precise measurement of the excess earnings base to be capitalized. Often valuation professionals attempt to compare a specific practitioners performance to economic survey statistics produced by local bar associations and nationally by Altman Weil Publications, Inc. based in Philadelphia, Pennsylvania. These direct comparisons can lead to very misleading conclusions due to the fact that the survey data typically is not adjusted for differences in the underlying work ethic between practitioners. In other words, if an individual makes more money merely because they choose to work harder than the 'average,' this excess income is not necessarily an indication of excess earnings and, in turn, professional goodwill, but rather is indicative of someone who works harder than their peers."

3. **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.**

   This is a highly flawed and simplistic method of valuation. Assuming that the *Poore* court defined average gross income as revenues, utilizing this figure (or some percentage thereof) results in meaningless estimates of value, as illustrated by the following hypothetical:

   Assume two practices, A and B, each of which has $1 million in revenues (or average gross income). Income statements for both practices are shown in **Table 1.**

Table 1
Hypothetical Income Statements
Practices A and B

	Practice A	Practice B
Revenues	$1,000,000	$1,000,000
Expenses	($500,000)	($1,500,000)
Net Income	$500,000	($500,000)

Assuming that one times the average gross income is the accepted valuation method for a practice, both practices would have a value of $1 million, yet one of the practices is highly profitable while the other practice is highly unprofitable. This illustrates one of the many problems inherent with a gross income multiplier as a valuation method. If such a simplistic method were accurate and reliable, you wouldn't need business appraisers as a third grader could do this math.

4. **Evidence of sales of comparable practices is relevant to the determination of its value.**

   This can be an excellent valuation approach. Note that the emphasis of this approach is *actual transactions* that occurred – not the intrinsic value to a particular owner. There are several challenges, however, to using this method. First, it is crucial to determine that the sold practices you are using are truly comparable to the practice you are valuing. Secondly, in many cases it is difficult or impossible to get enough detail on sold practices to conclude that they are truly comparable to the practice you are valuing. Also, it is crucial that the valuator is familiar with the circumstances of each particular sale. Distressed sales, buy-in or buy-out sales, etc., may not capture the true fair market value of the entity. Despite these potential limitations, this remains a sound valuation approach.

Summary of Valuation Approaches Under *Poore*. Therefore, under *Poore*, we are given four valuation suggestions: (1) a fair market value standard that was entirely ignored in *Hamby*, (2) an excess earnings approach that likely results in little or no goodwill value once the professional's salary is adjusted to the compensation of someone with the same "education, experience, and skill," (3) a simplistic and highly flawed gross revenue multiplier, and (4) actual transaction data. In the real world, suggestions (1) and (4) are the only ones that make sense, however, after *Hamby*, there is no clear direction as to what the accepted valuation methodologies should be. *Hamby* relied on suggestion (2) above, however, as mentioned above and discussed in more detail below, there are significant problems with this method.

Sonek. The *Sonek* case was another attempt in trying to define and determine the goodwill value of a professional service provider. 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 has 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 wife argued and the trial court held that the medical practice as of the date of separation had goodwill that was included as a marital asset. The Court of Appeals reversed the trial court and held that "a salaried employee who maintains no ownership interest in the particular place of employment does not possess goodwill." *Id.* at 250.

Two Components of Compensation. In North Carolina, therefore, the key valuation issue appears to be determining the total amount of compensation realized by an individual and then apportioning that compensation into its two components: (1) the component that represents the fair market compensation for the efforts of the individual's labors, and (2) the component that represents the excess compensation to the individual. Under the current case law in North Carolina, it appears that the component in (1) has no goodwill value and is not a part of the marital estate (per *Sonek*) while the component in (2) does have goodwill and is a part of the marital estate (per factor number 2 noted in *Poore* above).

Take the situation in *Hamby*. When Mr. Hamby ran the agency, he earned about $105,000 in total compensation (salary plus agency profits) in the latest full year before his separation. In his valuation report, however, Mrs. Hamby's expert opined that Mr. Hamby's fair compensation for the services he provided was only approximately $47,000. Applying the *Sonek* holding to these figures, of the $105,000 in total compensation earned by Mr. Hamby, $47,000 of that was due to the efforts of his labors and is identical to the compensation that would be paid to a salaried employee (as in *Sonek*). Implicit in this *Hamby* logic is that Mr. Hamby could hire an unrelated, non-owner, third party employee to perform his executive duties at the insurance agency and pay that person an industry average compensation of $47,000 per year. Under *Sonek*, the $47,000 component of Mr. Hamby's total compensation of $105,000 does not represent goodwill and is not a part of the marital estate. Under *Poore* factor number 2 (see above), the $58,000 in excess compensation (total compensation of $105,000 less the industry average compensation of $47,000) that represents the fruits of ownership of the agency does have goodwill and is a part of the marital estate.

Huh? Does this scenario really make sense? This scenario implies that Mr. Hamby could have paid a third-party manager $47,000 and realized the remaining $58,000 as profit without having to lift a finger to run the business. Could you really find a person to run this business for $47,000? Does such a person exist? Ask yourself – if you were this $47,000-a-year person, why would you want to work as an employee in someone else's insurance agency and make only $47,000 per year when you have the capabilities to run your own agency and earn $105,000 per year? If you had the choice between two identical jobs with identical hours and identical responsibilities, would you choose the one paying $47,000 per year or the one paying $105,000 per year?

As you can see, this issue of adjusting compensation to a fair market rate gets very fuzzy when dealing with professional practices. Remember Dr. Seegood earlier? It is very difficult to argue that Dr. Seegood is not being compensated at a fair market rate for the services he provides. Even an average doctor, lawyer, accountant, etc., is likely being compensated at or very near to his or her fair market compensation (when compared to the *Poore* standard of other practitioners of similar "education, experience, skill, and in the same general locale"). It makes no sense that an "average" lawyer would make an above-average compensation – our free market just won't pay it. Likewise, it makes no sense that an "above-average" lawyer would make an average compensation.

Tiger Woods makes much more money than the average pro golfer because his golfing ability far exceeds that of the average pro golfer. Tiger does not make any more or any less than what he is worth. No matter how obscene his compensation may be, Tiger makes exactly what the market will pay for his services, skills, and endorsement ability. If you want to adjust his compensation, the only person you can use in comparison is … Tiger Woods. Adjusting Tiger's compensation to that of an average pro golfer does not meet the *Poore* requirement of comparison to someone of the same degree of "education, experience, and skill."

Reasonably Adjusting Compensation. There are situations, however, where there is little or no controversy concerning an adjustment to a market rate of compensation. For example, assume a manufacturing company generates $10 million per year in revenues and has total expenses before owner's compensation of $9 million. The owner of this company pays himself $1 million each year in compensation, showing no net profit for the company. Also suppose that a standard industry compensation for the CEO of such a business is $300,000 per year. That is, the owner could retire from the company, find a suitable CEO and pay him $300,000 per year, and realize $700,000 per year in net profit. Assuming a 20% capitalization rate and no income tax or other adjustments, the comparison of value between the two scenarios is as shown in **Table 2.**

As seen in **Table 2,** the adjustment of owner's compensation to a "market rate" can have a significant impact on the value of a company. This is a common adjustment to make even when the owner remains an active manager of the company. The adjustment isolates the amount of total compensation that is earned by the owner as the CEO of the company and the amount of total compensation that is earned by the owner as the owner of the company. The above adjustment assumes that the managerial duties provided by the "market CEO" are

Table 2
Normalizing Owner's Compensation [1]

	Without Adjustment	**With Adjustment**
Revenues	$10,000,000	$10,000,000
Less: Expenses	($9,000,000)	($9,000,000)
Profit before Owner's Comp.	$1,000,000	$1,000,000
Less: Owner's Comp.	($1,000,000)	$0
Less: CEO Market Comp.	$0	($300,000)
Net Profit	$0	$700,000
Divided by: Cap Rate	20%	20%
Total Value	**$0**	**$3,500,000**

[1]All figures are hypothetical. Does not include other potential adjustments.

similar to the managerial duties provided by the owner. In contrast to the illogical assumption that the $47,000-per-year manager exists for the Hamby insurance agency, the existence of a $300,000-per-year non-owner CEO is far more likely and supportable. Our firm does a number of valuations of family owned businesses where a non-owner actually runs the company.

Adjustments of this nature are very common and, for certain types of companies, can be readily supported through the use of industry compensation data. Subjectivity problems begin to creep in, however, when an owner starts to exhibit managerial or other characteristics that are unique to him and may be difficult or impossible to replicate by other "industry average" managers. This problem becomes especially prevalent in the valuation of many professional practices, especially in smaller practices where the success of the practice is entirely dependent on one or a few people (as in *Hamby*).

A Practical Illustration. Consider the following illustration. Suppose there are three insurance agencies, all of which sell exclusively Acme Insurance products. Agency A is owned and managed by Steve Sharp. Steve is a go-getter who has built his agency into an above-average performer. Agency B is owned and managed by Nate Normal. Nate is an average insurance salesman whose agency is an average performer. Agency C is owned and managed by Larry Lethargic, a below-average performer who runs a below-average agency. Steve, Nate, and Larry all are getting divorced and need their respective agencies valued for equitable distribution purposes. The income statements for the three agencies are shown in **Table 3.**

As indicated in **Table 3,** Steve Sharp at Agency A is a go-getter who generates twice the annual revenues of the average normal Acme agency. Steve also incurs the average amount of agency expenses each year (50% of agency revenues), netting himself a $200,000 annual profit (which is taken out as owner's compensation). Nate Normal at Agency B, on the other hand, is an average producer who generates the average annual amount of Acme revenues, or $200,000 per year. Nate also incurs the average amount of agency expenses each year of $100,000, netting himself a $100,000 annual profit (or owner's compensation). Nate's agency is reflective of the average Acme agency. Finally, Larry Lethargic at Agency C is a below-average producer who plays a lot of golf and generates only $100,000 in revenues per year. Larry has the same average level of operating expenses, however, and therefore only nets himself a $50,000 annual profit (or owner's compensation).

Table 3
Annual Income Statements [1]
Agencies A, B and C

	Agency A	Agency B	Agency C
Revenues	$400,000	$200,000	$100,000
Less: Expenses	($200,000)	($100,000)	($50,000)
Less: Owner's Compensation	($200,000)	($100,000)	($50,000)
Equals: Net Income	**$0**	**$0**	**$0**
Owner	Steve Sharp	Nate Normal	Larry Lethargic

[1] Each owner takes out as compensation whatever is left over after the payment of all expenses. This is a typical scenario in a professional practice.

Steve Sharp. First, consider Steve's agency. Steve generates $400,000 in annual revenues and makes $200,000 in annual compensation, both above the Acme average. The improper way to value Steve's agency is to assume that you could hire one Nate who would come in and continue to single-handedly generate $400,000 in annual revenues yet only earn the average $100,000 in annual compensation. Under this scenario, the agency would have $400,000 in annual revenues, $200,000 in annual expenses and $100,000 in annual compensation paid to Nate. This would leave $100,000 left over as annual profit to you as the owner which could then be capitalized to derive some goodwill value for the agency.

This may sound good in theory, however, this is not a realistic scenario for two reasons:

1. It is not realistic to assume that Nate could come in and begin to produce at Steve's level. Steve is an above-average producer who has an innate intelligence, determination, and sales ability to generate his above-average production and above-average compensation. Nate, however, is an average producer of average intelligence, determination, and sales ability. It is not reasonable to assume that Nate could duck into a phone booth and suddenly emerge as Steve, producing twice as much as he did before.

2. Even if Nate did find that phone booth and did begin to produce at Steve's level, it is not realistic to believe that Nate would be satisfied with his old compensation of $100,000. If Nate is producing like Steve, he will demand and ought to be paid like Steve, at $200,000 per year. This rate of compensation will result in no excess earnings and no goodwill value at the agency.

Valuing Steve's agency by assuming that Nate could come in and generate an above-average $400,000 in annual revenues while being compensated at an average annual rate of $100,000 is a common valuation error made by many valuation practitioners using the excess earnings method. It is this very error that enables some level of excess earnings to be calculated and goodwill value to be capitalized. Unfortunately, this erroneous assumption is frequently accepted by courts as a reasonable valuation technique. If courts would only stop and think a moment about the irrational assumptions embedded in this calculation, many of these illogical and unreasonable decisions (such as *Hamby*) might be avoided.

One logical way to value Steve's agency is to assume you could hire two Nates to run the agency. If you did this, you could expect to generate $400,000 in revenues (each Nate would generate $200,000), incur $200,000 in expenses, and pay a total of $200,000 in salaries ($100,000 each to both Nates). As owner of this agency, you would show no profit at the end of the year. Again, this illustrates the point that, whether you have one Steve or two Nates, these guys are fairly compensated for the professional services they provide. It is difficult if not impossible to prove that any portion of their earnings are excess.

Nate Normal. Now look at Nate's Agency B. Again consider the valuation from the perspective that you wanted to buy the agency and employ somebody to run it. You would not do any work, you would purely be the sole investor in and owner of the agency. The key question for you is: what kind of return can I expect on my investment? Your analysis would be as follows: Industry data indicates that an average insurance agent produces $200,000 per year and earns $100,000 per year in compensation. Therefore, if you went out and hired Nate Normal to run your agency, you would expect Nate to generate annual revenues of $200,000 and incur annual expenses of $100,000. You would also have to pay Nate $100,000 in annual compensation to retain his services as that represents a fair market rate of compensation for such services (as illustrated by other Acme agents). Therefore, at the end of the year, you would show zero profit on your investment. Aside from whatever internal joy you derived from owning your own profitless business, there would be no goodwill value to your company.

Larry Lethargic. Finally, consider Larry Lethargic's Agency C. Assuming you are the willing buyer and Larry is the willing seller, how much are you willing to pay for this agency? Based on his financial performance, you know that Larry is a below-average producer who is not surprisingly compensated at a below-average rate. The normal analysis in determining the value of Larry's agency involves adjusting Larry's actual rate of compensation ($50,000) to a market rate of compensation ($100,000). When you do this, however, Agency C shows a net loss of $50,000 (total revenues of $100,000 less expenses of $50,000, less owner's compensation of $100,000). But wait a minute. If you assume a normal rate of compensation ($100,000), shouldn't you also assume a normal rate of production ($200,000 in revenues)? If you are saying that a normal insurance agent should be paid $100,000 per year, shouldn't that agent be expected to generate a normal amount of revenues per year? Wouldn't that agency then look a lot like Nate Normal's Agency B where no goodwill value was present?

No Goodwill Value. As you can see from the analysis above, none of the three agencies has any excess earnings or any demonstrable goodwill value under the "similar education, experience, and skill as an employee in the same general locale" requirement of *Poore*. Again, this highlights the fact that each agency owner is being paid a fair market compensation for the level of services he provides. There is a compelling argument that none of the compensation earned by any of the three agency-owners is due to their ownership of that agency – it is all due to the efforts of their labors. Under *Sonek*, these earnings do not represent goodwill and are not a part of the marital estate.

Inequitable Treatment. Another problem with the intrinsic value standard suggested by *Hamby* is that it unfairly singles out professional providers who happen to own all or a part of their company. Mr. Hamby had the unfortunate occurrence of owning his own insurance agency. If, on the other hand, Mr. Hamby had worked as an employee of Nationwide (which he did prior to owning his own agency), there would be no asset to value (under the *Sonek* logic discussed earlier). Presumably, the Hamby marital estate would have been divided based on the existing assets (without the value of any insurance agency) and alimony would have been established based on Mr. Hamby's earnings. Ironically, Mr. Hamby might have made more as an employee of Nationwide than as the owner of his own agency.

What about high-powered investment bankers who may make millions each year? These investment bankers may work for large corporations and have no ownership interest in their company. There is no corporate asset to value and divide in these instances and any alimony amount is presumably determined by level of income and/or accustomed standard of living. Why not do the same for a *Hamby*-type situation and eliminate this valuation hocus-pocus on the professional practice?

Human Capital. As seen above with the Steve Sharp example, adjusting the compensation of the above-average professional practice provider to an industry average compensation is not reasonable or logical. Whatever skills, intelligence, drive, ambition, and other factors that drove that practitioner to be above average and successful were skills inherent to that individual that existed before, during, and after the marriage. Isn't this really an issue of human capital? How are we supposed to value that? Does human capital qualify as property in the equitable distribution context?

In *Valuing Professional Practices and Licenses*, Editor Ron Brown includes an article by Robert B. Moriarty entitled "A Formula Solution to Distributing Professional Degrees and Licenses." In this article, Mr. Moriarty discusses the *O'Brien* case. In *O'Brien*, the New York Court of Appeals ruled that a medical license is marital property that can be valued and distributed as part of a divorce settlement or decision. Mr. Moriarty points out the significant problems in assuming that all of the value of the license is the result of the efforts of the non-professional spouse and failing to consider the human capital component of a license:

> "In my view, the trial court's failure to view the doctor's license as the product of his life's experience, and not just the product of his marriage, is grossly inequitable. To look at the license as marital property *only* is to ignore reality. O'Brien was not a clean slate when, at the age of 24, he

married. He was an elementary and a high school graduate with three and one-half years of college behind him and a private school teacher. He would, upon marriage, return to finish his undergraduate degree and complete the pre-medical courses necessary to enter medical school. These facts we know from the decisions of the courts.

What we do not know – because they don't appear to have been considered by the trial court – are the many facts about Dr. O'Brien that would illuminate his eventual career choice and attainments. Was he a good student in grade school? In high school? Did he show an early interest in science, biology, or other courses that might hint at the medical education that was to follow? Was he encouraged by parents, teachers, professors, or others who recognized his abilities? Was he inspired by an event or events – the illness or death of someone close to him perhaps? Did he have a role model in his family, extended family, friends, or perhaps a public figure?

It takes intelligence, drive, hard work, and an aptitude for the natural sciences to successfully pursue and obtain a license to practice medicine. No matter how hard Mrs. O'Brien worked, no matter what her contribution might have been, her husband would not have made it to and through medical school if he had not possessed within him substantial qualities and skills that predated his courtship of and marriage to his wife. He was not formed or given shape by her. He was an adult, with a full set of mental and physical faculties, when he married. The raw material was there – formed to that point presumably at substantial expense to, and with substantial effort on the part of, his parents, extended family, schools, mentors, and others, not to mention his own contributions. No one questions that O'Brien's wife made direct and indirect contributions to the acquisition of this item of marital property. But there are many other reasons for his achievement, none of which appears to have been considered!"

Allen M. Parkman, JD, Ph.D., in "An Investment Approach to Valuing Spousal Support of Education" (also found in *Valuing Professional Practices and Licenses*) makes a similar point:

"Closer scrutiny illustrates the problems with treating Mrs. O'Brien's investment as creating an equity interest in her husband's degree. While the framework used is appropriate for determining the incremental value of an *average* medical degree compared to an *average* bachelor's degree, it has a fundamental flaw when applied to a particular individual. Admission to and completion of medical school is difficult. Individuals who receive a medical degree are presumably more intelligent or ambitious than the average college graduate and therefore probably would have earned more than the average college graduate even if they had not received a medical degree…It would be difficult to determine how much more an individual who could have gone to medical school, but did not, would have earned compared to the average college graduate."

Although the above two quotations deal with some of the many logical problems with license valuation (see related article in this issue of *Fair Value*), the underlying issue that is addressed is one of human capital. Those qualities that make the professional (whether a doctor, lawyer, insurance agent, or whatever) successful are innate abilities unique to that individual. Can this human capital be accurately valued in the first place and, if so, how is it to be equitably distributed in a divorce?

Summary. As you can see, the issue of professional practice valuations in North Carolina equitable distribution cases is a mess. Although the Courts appeared to be moving in a somewhat forward direction with such cases as *Poore* and *Sonek*, they took a giant step backwards with *Hamby*. *Hamby* is a very slippery slope upon which no business appraiser can gain any solid footing to take a firm position as to an independent opinion of value. Indeed, *Hamby* has thrown open the door for all kinds of subjective and illogical assumptions as to value, none of which are likely to result in a reasonable, logical, and well-supported opinion of value. Instead of clarification and progress, the Court has given us confusion and regress.

Finally, if you have dismissed this article as the misogynistic rantings of a "pro-husband" or "anti-wife" valuation madman, please understand one thing – I am not saying that the professional spouse should walk away with everything in a divorce while the non-professional spouse gets nothing. What I am saying is that decisions such as *Hamby* are very dangerous because the courts actually believe they have reached an equitable division of the marital estate through sound valuation techniques and practices. In fact, nothing could be further from the truth. Solutions such as in *Hamby* are not the answer as they are fraught with illogical assumptions and create far more problems than they solve. The legislature and the courts need to find a better way. ♦

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