



VALUING A SMALL MINORITY INTEREST IN A LARGE PERSONAL SERVICES FIRM

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In recent columns (October 2016 and March 2017), various aspects of using “value to the owner,” sometimes referred to as “Holder’s Interest” value, were presented.

Background

As noted in the October column, the Michigan Court of Appeals has ruled in a number of cases that if a business providing personal services is worth more to the owner than the price at which it could be sold, the value for divorce purposes is value to the owner, unless there is reason to believe the enterprise will be sold. *Kowalesky v. Kowalesky*, 148 Mich App 151; 384 NW2d 112 (1986), and several other Court of Appeals (COA) cases cited in the column.

As noted in the March column, the underlying logic is as follows:

If there is no intent to sell or discontinue a business or professional practice, it should be valued for divorce based on its intrinsic value to the owner on a going concern basis. The financial benefits from *that value* are what have been conferred on the family

while intact and will be conferred solely on the owner post-divorce.

If there is no intent to sell, under what rationale should any value other than the value based on current financial benefits provided by the enterprise be used in a divorce settlement?

No other value is relevant to this family or, hence, to this divorce.

Application to Small Minority Interest in a Large Firm

There are many large law firms, accounting firms, engineering firms, medical practices, etc. operating in Michigan. How is the “value to the owner” determined for a member holding a minority interest in such an enterprise?

Binding “Buy/Sell” Agreements Generally Not Applicable

Most large personal service firms require individual members to sign binding agreements providing (1) restrictions on transfer and (2) a set price or formula to determine the price of a member’s interest on termination. Quite often such prices include no goodwill value.

It is well established that such agreements are not determinative of value for divorce because none of the events to which they apply—death, disability, or termination of interest for other reasons—are occurring.

Valuing Entire Firm and Applying Member’s Ownership Percentage Is Generally Not Representative of Value

For example, assume two partners—A and B—work at a large accounting firm. Both own 1% of the practice. But, A makes \$500,000 annually while B makes \$300,000. This disparity is due to different performance levels which may ultimately result in A being awarded a higher ownership interest than B, but currently they both own 1%.

Large accounting firms—similar to other large personal service firms—are generally highly leveraged. Non-partner staff are billed out at multiples of what they are paid. This results in “override” income divided among the owners. This is es-



entially “goodwill” compensation they receive in addition to being paid for their individual personal services.

In our example, both the \$500,000 paid to A and the \$300,000 B receives include some of this goodwill income, though A receives more than B. But, if the entire firm was valued and their respective 1% ownership percentages applied to the value, the values for their interests would be the same – which would not be representative of the disparate financial benefits each is receiving from the firm.

As an aside, it is very difficult to obtain the “sensitive” financial information from such firms needed to value them.

Use of “Silo” or “Practice Within a Practice” Method

The most effective way to determine the value of an interest in a large personal service firm is to value the individual owner’s interest based on the financial benefits he/she receives.

Using our example, after reviewing what A has received in recent years from the firm and determining prospects going forward, \$500,000 appears representative of A’s annual compensation from the firm. A’s interest is valued as follows:

Representative Earnings	\$500,000
Less “Market” Value of A’s Services Based on Statistics for the Profession	<u>(300,000)</u>
 Goodwill Earnings.....	200,000
Less Federal & State Income Tax	<u>(75,000)</u>
 After-Tax Goodwill Earnings.....	125,000
Earnings Multiple Based on Various Risk Factors	<u>4</u>
 “Value to Owner” of A’s Interest	<u>500,000</u>

If the same methodology were applied to B’s interest, the value would be lower, as it should be, notwithstanding that they both own 1%.

Concluding Comments

To determine the value to owner of a minority interest in a large personal service firm, the most effective method is to determine the value based on what financial benefits this particular owner receives from the firm. This is sometimes referred to as using a “silo” approach, or valuing a “practice within a practice.”

About the Author

Joe Cunningham has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy, though his practice is statewide.