



# REVISITING HOLDER'S INTEREST VALUE – OR VALUE TO THE OWNER

By JOSEPH W. CUNNINGHAM, JD, CPA

Of late, the holder's interest standard – or measure – of value for appraising professional and commercial enterprises for divorce has been subject to criticism. The following addresses issues raised.

## Background

**Holder's Interest Value**—“Holder's interest” value – also referred to as investment value to the owner – of a business appraised for divorce settlement purposes is essentially the value to the current owner based on financial benefits consistently received from the business, unless there is reason to believe the business will soon be sold or discontinued.

The underpinning is that financial benefits provided by the company are often the product of contributions by both spouses during marriage such that both should share in that value in a divorce settlement.

If that value is not transferable in a sale – such as a surgeon's referral sources or a widget maker's personal relationship with a valuable customer – it will only be reflected in the business value if it is assumed the current owner will continue the enterprise after the divorce.

**Fair Market Value**—Holder's interest value is distinguished from the most commonly known standard/measure of value – fair market value (FMV) – defined as the price at which a business would sell between a willing buyer and a willing seller, both well informed and acting at arm's length, and neither acting under duress.

The principal difference is that holder's interest value is premised on the current owner retaining the business post-divorce, whereas FMV is premised on a hypothetical sale to a third party.

In determining FMV of a non-marketable closely-held business, a lack of marketability discount, typically in the 25%-35% range, is deducted from the calculated value – that is, between 1/4 and 1/3 of the total value is eliminated based on the assumption of a hypothetical sale. Aside from this significant discount, valuable but non-transferable attributes of

the enterprise – such as noted above – will not be captured in the hypothetical sale value.

**Premise of Holder's Interest Value**—Jay Fishman, a nationally renowned business valuation expert, at an American Academy of Matrimonial Lawyers 2006 seminar, presented the following quote from the California appellate court in its landmark *Golden v. Golden* opinion in support of value to the owner:

“... in a matrimonial matter, the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under the principles of community property law, the wife by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business.”

In this regard, there is no substantive difference between community property law and Michigan's equitable distribution statute concerning contribution of the non-business owner spouse.

## Michigan Court of Appeals Holder's Interest Decisions

—As summarized at the end of this article, the Michigan Court of Appeals has consistently approved use of holder's interest value where there is no indication that the owner will not continue to operate the enterprise post-divorce.

## Illustration

- H owns and operates a specialty tool & die shop – T&D Co. – as an S Corporation. He has developed unique metal fabricating expertise during his 20 year marriage to W. Lucrative contractual relationships with several customers are directly attributable to his expertise.

- Following are valuation summaries under holder's interest and FMV standards of value:

	<u>Holder's Interest</u>	<u>FMV</u>
Representative Pre-Tax Earnings Before Compensation to Owner (1)	400,000	250,000
Less Reasonable Comp to Owner (2)	<u>(200,000)</u>	<u>(200,000)</u>
Adjusted Pre-Tax Earnings	200,000	100,000
Less Tax	<u>( 80,000)</u>	<u>( 40,000)</u>
After-Tax Earnings	120,000	60,000
Earnings Multiple	_____4	_____4
Capitalized Earnings Value before Discounts	480,000	240,000
Less 30% Lack of Marketability Discount (3)	_____0	<u>( 72,000)</u>
Divorce Settlement Value	<u>480,000</u>	<u>168,000</u>
W's 50% Share	<u>240,000</u>	<u>84,000</u>

- (1) Assuming a hypothetical sale pursuant to the FMV premise, \$150,000 of annual earnings attributable to H's expertise – a non-transferable intangible asset – is lost.
- (2) In a hypothetical sale, it is assumed that the new owner would not have H's expertise and, hence, the value of his/her services would be lower.
- (3) Because the Company is not readily marketable, the value is reduced by 30% pursuant to the FMV hypothetical sale premise.

## Comments

1. Under the FMV valuation, W would receive \$84,000 while H receives a business worth \$480,000 as a going concern, consistently providing him \$200,000 annually in excess of paying him \$200,000 for his services.
2. Substitute for the talented tool & die maker a lawyer, CPA, doctor, sales rep, consultant, or any owner of an enterprise with non-transferable intangible value – same result.
3. Under the holder's interest standard, the value attributable to non-transferable intangible value – or, personal goodwill, inseparable from the owner - established during marriage is recognized and subject to division.
4. In this regard, the Michigan Court of Appeals panel stated in its unpublished *Conger* decision (see summary attached) that they were “unpersuaded of the need to adopt a distinction between personal and business goodwill, for

purposes of valuing business assets in the context of a divorce.”

5. Based on the author's experience, use of the “pure” FMV standard has declined considerably over the last ten years or so. For instance, subtracting a large lack of marketability discount is not nearly as prevalent as in years past. It appears that appraisers, when not using holder's interest, are using a modified FMV standard of value.

## Issues Raised Concerning Holder's Interest Values

### Excessive Values

It has been alleged that use of holder's interest value results in excessive values. However, based on the author's extensive experience performing holder's interest valuations, the high majority of good will values range between 50% and 150% of the owner's total annual pre-tax income from the enterprise. The average is around one times the owner's annual pre-tax income from the enterprise.

In the above example, the \$480,000 value is 120% of the owner's annual income from the business. And, it is just 2.4 times the annual \$200,000 goodwill earnings.

A value of one times what the owner receives each year does not seem excessive.

### Valuing Future Income – Unwarranted Invasion of Post-Judgment Separate Property

The objective of the income approach to valuation, often used for profitable businesses, is to capture the value of future earnings or cash flow. This is not unique to holder's interest value calculations for divorce. The buyer of any business is buying future earnings and wants a valuation which estimates the value of the same.

Commonly used under the income approach is the discounted cash flow method which involves projecting future years' cash flows and discounting them to current value. Thus, the calculation under this oft used method “by definition” uses future years' income or cash flow.

And, under the capitalization of earnings method, used in the illustration, a determination of “representative earnings” is necessary. Representative earnings are the appraiser's best estimate of future earnings.

Commercial rental property is often valued by applying a cap rate to annual cash flow. Once again, the current value is intended to capture the value of future cash flows.

Basically, all values of profit-making enterprises, or other types of investments, are based on expected future returns. This does not involve inappropriate invasion of post-divorce separate property. It is determining current, date-of-divorce value based on expectations of the future.

## Double Dipping

Using the above example, if H's \$400,000 total income from T&D Co. is used to determine spousal support, the top "layer" \$200,000 goodwill earnings capitalized into value would be, to some degree or other, received by W both as property settlement and as spousal support. Limiting H's income for spousal support to the \$200,000 value of his services avoids the double dipping.

The Michigan Court of Appeals has ruled several times, essentially, that the fact that the top layer of the owner's income is incorporated into the business value does not automatically eliminate it from consideration in determining spousal support. Rather, the Court has said, a proper balancing of incomes and needs takes precedence.

In the Court's 2012 published *Loutts* decision (Mich App No. 297427 (9/4/12)) on, *inter alia*, double dipping, it ruled that "there is no room for the application of any rigid and arbitrary formulas when determining the appropriate amount of spousal support. \*\*\* Accordingly, we decline to adopt a bright-line rule with respect to 'excess' income and hold that courts must employ a case-by-case approach when determining whether 'double dipping' will achieve an outcome that is just and reasonable within the meaning of MCL 552.23(1)."

Thus, essentially, if it is not necessary to double dip to provide an appropriate award of spousal support, than double dipping should be avoided. Or, if some of the excess income incorporated into value is required to provide an equitable spousal support award, it should be considered to the extent necessary. As the Court ruled, "a case-by-case approach" \*\*\* "must" be used.

Double dipping applies to any situation in which (1) a company is valued based its earnings and (2) the owner's compensation is adjusted in the calculation – regardless of whether holder's interest, FMV, or some other standard of value is used.

## Concluding Comments

Use of holder's interest – or value to the owner on a going concern basis—is aimed at dividing value which provided financial benefits to the family while intact that will accrue 100% to the owner post-divorce. Most closely-held businesses and professional practices are not sold incident to divorce. Thus, it is important that their value – attributable to both tangible and intangible factors – be appropriately captured and divided equitably in the divorce settlement.

None of the criticisms noted above justify abandoning holder's interest—or, value to the owner—as the appropriate divorce standard of value for an enterprise that the owner will continue to operate post-divorce.

## Michigan Court of Appeals Cases

### ***Kowalesky* – Dental Practice – 148 Mich. App. 151 (1986)**

This was the initial Michigan Court of Appeals decision establishing holder's interest value as appropriate if there is no intent to discontinue or sell the practice. "We believe that neither Revenue Ruling 59-60 nor any other single method should be uniformly applied in valuing a professional practice."

### ***McNamara* – Law Practice – 178 Mich. App. 382 (1989)**

Citing *Kowalesky*, the Court upheld the use of holder's interest standard to value a law practice. The court stated: "Thus, a valuation of the law practice should amount to its value to the defendant husband as a going concern."

### ***Johnson* – Medical Practice – Mich. App. No. 132388 (1993)**

Application of the "value to owner" standard to a medical practice was upheld. In doing so, the Court said - "The chief reason for the difference was the defendant's expert assumed that the practice would be sold and utilized a high capitalization rate, while plaintiff's expert used a lower rate on the assumption that defendant would stay with the practice."

### ***Corcoran* – Operating Businesses – Mich. App. No. 215484 (1999)**

One appraiser used the FMV standard, the other holder's interest. Their respective values differed widely. The trial court split the difference. The Court noted the reason for the substantial disparity in values was due to, in effect, use of different standards of value.

One expert "allowed very little discount" for minority status and valued the business "as a going concern." The other "applied a very high discount" for lack of marketability and "virtually ignored that the business was valuable as a successful ongoing business, wholly owned by family members."

The Court noted that the trial court did not state that the average of values "would yield the fairest approximations of accurate values for the businesses" but upheld the decision on values since they were within the range of testimony. Judge Jansen dissented stating that the trial court had an affirmative obligation to make a determination of value, not simply split the difference.

### ***Conger* – Computer Software Engineers – Mich. App. No. 219373 (2000)**

Husband claimed holder's interest standard "had been limited to professional practices" and should not be applied to his software consulting business.

The Court responded – "...the holder's interest method is equally applicable to professional practices and closely held corporations offering personal services." The Court also stated that, after citing an excerpt from a 1993 Michigan State Bar

Journal article on the issue, “the corporation was worth more to the defendant than the fair market value of the business, based on the assumption that defendant would continue to operate the business after the parties’ divorce.”

The Court also indicated personal goodwill is distributable in Michigan.

***Folkmier – Medical Practice –  
Mich. App. No. 229387 (2002)***

Husband’s expert used the FMV standard in valuing his practice. The wife’s expert used holder’s interest. The trial court adopted holder’s interest value. In upholding the trial court, the Court stated:

“On appeal, defendant specifically contends that the trial court erred by failing to adopt his expert’s valuation, where it properly reflected the fair market value of the business. The gravamen of defendant’s argument is that plaintiff’s expert’s valuation was unreliable because it was not based on the value of the business pursuant to an ‘arm’s length transaction,’ but was, as noted above, based on its value to defendant. However, in *McNamara v. McNamara*, 436 Mich. 862 (1989), we opined that the value of a law practice ‘should amount to its value to (the) defendant as a going concern.’ **Moreover, the purpose of valuing the asset was to guide the trial court in its distribution of the marital assets between the parties. Logically, the value of the business interest to defendant was substantially more than the value of the business interest to plaintiff or any third party.**”

(Emphasis added.)

***Greenslait – Medical Practice –  
Mich. App. No. 254236 (2005)***

The four experts involved used holder’s interest standard, agreeing that the 1993 Bar Journal article “set forth the basic formula” they employed. The trial court also agreed with use of holder’s interest. However, the experts significantly disagreed on the incremental earnings (goodwill) value, ranging from \$0, \$0, \$275,000, to \$614,255. The trial court ruled the value was \$136,000, evidently attributing \$36,000 to goodwill value. The Court upheld the trial court.

## 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.*