Presenter:

JUDGE PHIL SMITH

BERTUCA v. BERTUCA: AN APPROPRIATE DEPARTURE FROM TRADITIONAL VALUATION METHODOLOGY?

By Philip E. Smith, Judge
Fourth Circuit Court for the Twentieth Judicial District

Bertuca v. Bertuca, 207 WL 3379668, Tenn. Ct. App. (Nov. 14, 2007), is the most recent Appellate or Supreme Court decision of significance addressing the issue of the valuation of an interest in a closely-held business. Traditional valuation methodology applies a marketability discount to an interest in a closely-held business and also applies a minority discount if the interest being valued represents 50% or less than the entire interest in the business. In 2007, the Middle Section Court of Appeals rejected the application of a marketability discount to Mr. Bertuca's interest in a closely-held business. Was there a sound reason for the Court's decision to do so?

FACTUAL BASIS

Mr. Bertuca and his father formed a general partnership (Capital Food Services) on December 29, 2000 to acquire and operate McDonald's franchises in the middle Tennessee area. Mr. Bertuca owned a 90% interest in the partnership and his father owned a 10% interest. The partners had equal rights in the management of the partnership business.

Neither of the partners could buy, sell or hypothecate any of the assets of the partnership without the consent of the other partner, other than the type of property bought and sold in the regular course of business. The Partnership Agreement also contained a buy-sell provision which required the selling partner to give the other partner written notice of his intention to sell and afforded the remaining partner the right to purchase the selling partner's interest at book value as of the end of the previous fiscal year or, in the alternative, to liquidate the partnership. The Partnership Agreement contained a similar provision relating to the death of either partner. Accordingly, the disposition of Mr. Bertuca's 90% interest in the general partnership was severely restricted.

In 2004, the partnership purchased seven franchises in Wilson County for a total of $2,345,000.00. To finance the purchase, Capital Food Services borrowed $2,230,000.00 from AmSouth Bank. The terms of the loan required interest only payments until May 2005 and monthly principal and interest payments thereafter of $42,520.12 a month beginning in June 2005 and continuing for 84 consecutive months. Mr. Bertuca, Sr. guaranteed the loan. Each partner contributed $150,000.00 to the partnership, of which Mr. Bertuca borrowed $124,200.00 from his father. This debt remained unpaid at the time of the divorce proceedings.

Mr. Bertuca, Sr. owned McDonald's Management Company, a business he established to manage the operation of 14 additional McDonald's franchises which he owned. Each franchise paid the management company a fee of 4.76% of total sales for the management services it received.

The typical business structure of a McDonald's restaurant is such that the real estate is owned by McDonald's Corporation. The franchisee pays rent as well as maintenance and upkeep of the building, and may be required to rebuild a restaurant in its entirety. At the time the franchises were acquired, McDonald's Corporation notified Capital Food Services that one of the restaurants would have to be rebuilt and at the time of trial Capital Food Services had contracted to have the restaurant rebuilt at a cost of $950,000.00.

Further, the McDonald's Corporation franchise agreement prohibits a franchisee from transferring or in assigning its interest in the franchise without prior written consent of McDonald's. The proof at trial reflects that McDonald's imposes strict guidelines on the sale of its franchises, frequently requiring a significant down payment for the purchase of the franchise and requiring the balance to be paid over a period not to exceed seven years. Further, McDonald's typically requires the franchisee to be able to service the debt with money generated from the franchise operation. All of these restrictions tend to place a ceiling on the resale value of McDonald's franchises.

Mr. Bertuca's expert was a certified public accountant who represented 14 McDonald's franchises, including Capital Food Services. He had been involved in the purchase or sale of 125 McDonald's franchises. Mr. Bertuca's expert testified that as of June 25, 2005, the McDonald's restaurants owned by Capital Food Services were worth no more than the gross price which had been paid for them the preceding year. In arriving at his opinion, Mr. Bertuca's expert used what he characterized as a standard valuation methodology employed in valuing McDonald's franchises. He applied a multiple of five (i.e., a 20% rate of return) to the net income of each franchise reduced by interest expense, depreciation, amortization, and general and administrative expenses. This resulted in a gross value for each franchise which was further adjusted by adding current assets minus current liabilities and notes payable. Using this methodology, Mr. Bertuca's expert determined that the value of the seven stores was approximately $500,000.00. However, Mr. Bertuca's 90% interest in the stores had a negative value because of the obligation to rebuild one of the restaurants and his obligation to repay his father $124,200.00.

Ms. Bertuca's expert valued the seven franchises at approximately $3,000,000.00 net of debt using a 12% capitalization rate. However, Ms. Bertuca's expert's opinion was subject to a number of criticisms. He then adjusted his opinion using cash flow figures supplied by Mr. Bertuca's expert and concluded that Mr. Bertuca's 90% interest was worth approximately $1,700,000.00.

Mr. Bertuca, in rebuttal to the testimony of Ms. Bertuca's expert, presented the testimony of a certified public accountant and managing partner from a Florida litigation support firm. The rebuttal expert specialized in the valuation of McDonald franchises and was chairman of a consultant alliance comprised of nine certified public accounting firms throughout the United States that predominantly represent McDonald's franchises. The rebuttal expert concluded that the seven franchises had not increased in value from what Capital Food Services had paid for them the preceding year. However, the partnership had accumulated some excess cash providing a capital equity of $493,000.00. The expert then reduced Mr. Bertuca's 90% interest by 20% for a marketability discount, and deducted the $124,200.00 owed by Mr. Bertuca to his father. As a result, Mr. Bertuca's interest had a value of $231,000.00. Further, the rebuttal expert criticized the testimony of Ms. Bertuca's expert who selected a 12% capitalization rate resulting in a cash flow multiple of 8.33. According to the rebuttal expert, she had never seen a sale of a McDonald's restaurant at such a high multiple.

The trial court considered all of the testimony offered and concluded that the fair market value of Capital Food Services had increased by $1,000,000.00 during the marriage, making $900,000.00 the value of the Bertuca marital interest. The trial court awarded Ms. Bertuca $450,000.00 to be paid in monthly installments over a period of seven years, without interest, in the amount of $5,357.14 per month. Mr. Bertuca appealed complaining that the trial court erred by failing to consider a marketability discount and the impact of the Buy-Sell Agreement contained in the Partnership Agreement between Mr. Bertuca and his father, and by failing to deduct the debt owed by Mr. Bertuca to his father.

The Court of Appeals issued two Opinions on November 14, 2007. The first Opinion affirmed the decision of the trial court and the second Opinion reduced the valuation assigned to Mr. Bertuca's interest by approximately $200,000.00. Both Opinions note that the Court of Appeals was uncertain as to how the trial court arrived at its determination that the value of Capital Food Services had increased in value by $1,000,000.00. Finding that the parties are entitled to a trial *de novo* upon issues presented to the Court of Appeals, in both Opinions the Court of Appeals conducted its own analysis to arrive at the value of Mr. Bertuca's interest. In doing so, the Court of Appeals discussed, and criticized, to some extent, the testimony of all three experts. The Opinions are unusual in that the Court of Appeals adopts portions of each expert's analysis, and adds its own analysis to arrive at its conclusion rather than simply holding that the decision of the trial court was within the range of values established by the proof at trial. For example, the Court of Appeals capitalized the income of the partnership at 12%, the capitalization rate used by Ms. Bertuca's expert, in deference to the capitalization rate of 20% used by both of Mr. Bertuca's experts. The Court of Appeals offered no explanation for why it believed a 12% capitalization rate was preferable to a 20% capitalization rate considering the unique facts and circumstances of this particular business. Further, the Court of Appeals made its own calculations concerning asset depreciation and the amortization of franchise fees. It did, however, explain its reasons for doing so.

In addressing Mr. Bertuca's complaint that the trial court failed to consider the lack of marketability of his interest in the partnership, the Court of Appeals stated: "[s]ince our determination as to value is based upon the earnings value of the partnership, that value would not be impacted by the lack of marketability of Mr. Bertuca's interest unless it appeared from the record that his needs or situation were such that a sale of his interest would be necessary or desirable."

In short, the Court of Appeals has now held that marketability discounts are not to be applied in the valuation of an interest in a closely-held business unless it appears from the record that the sale of the interest is "necessary or desirable." Because the trial court allowed Mr. Bertuca to pay his interest in installments over a period of seven years (84 months), the Court of Appeals concluded that Mr. Bertuca would not have to sell his interest in order to satisfy the award. Further, there was no indication in the record that Mr. Bertuca had any intent to sell his interest in the partnership. For these reasons, the Court of Appeals concluded that the value of Mr. Bertuca's interest was not affected by the lack of marketability and a marketability discount would be improper. Similarly, the Court of Appeals dismissed Mr. Bertuca's complaint that the trial court failed to reduce the value of his interest in the partnership by virtue of the Buy-Sell Agreement between Mr. Bertuca and his father. The Court of Appeals acknowledged that the trial court should consider such agreements in determining the value of a business interest. However, according to the Court of Appeals, such a provision only affects the value of Mr. Bertuca's interest if he plans to sell the interest. Because the record reflects no intent to do so, the buy-sell provision does not affect the value of Mr. Bertuca's interest.

The Court of Appeals' decision in *Bertuca* has had a seismic effect on valuation experts in Tennessee and has generated significant discussion among lawyers. The applicability of a discount for lack of marketability, in valuation theory, has never depended upon the present intention of the owner of an interest in a closely-held business to liquidate that interest. The marketability discount has been viewed from the perspective of a hypothetical buyer considering the time and expense which would be required to make a relatively illiquid interest in an asset equivalent to cash, among other considerations. In light of *Bertuca*, until the Supreme Court addresses the issue of the propriety of a marketability discount in valuing an interest in a closely-held business, should the trial courts now disregard such discounts when presented by experts as part of their valuation methodology? Or, is there something unique about *Bertuca* which dictates that the holding has limited application? In fact, when valuing an interest in a closely-held business for non-estate tax purposes, should any discounts be applied? Suppose Mr. Bertuca's interest in Capital Food Services had been 50% or less. Would the Court of Appeals have recognized the validity of a minority discount? Is it fair to the non-owning spouse to apply either a minority discount and/or a marketability discount knowing that the owning spouse will continue, in all likelihood, to maintain an ownership interest in the business until the entire business is liquidated, at which time no discount will be realized?

John Markus, a noted expert in the area of business valuations in divorce cases, stated:

> "When a credentialed expert values a business, we pay particular attention to the standard of value. We know that fair market value is the standard used by the IRS and in most types of litigation. We understand fair value is usually used in shareholder disputes . . . We are even familiar with the concept of intrinsic value and investment value, but the standard of value that baffles even the most experienced valuator is what we sometimes refer to as divorce value."[1]

Is it now time for Tennessee to consider adopting a "divorce value" which declines to take into consideration discounts of any type?

---

[1] John W. Marcus, "Where Have the Experts Gone?" American Journal of Family Law, Volume 17, Number 4 (Winter 2004).

CONCLUSION

The *Bertuca* case has raised the question about where Tennessee is currently regarding the appropriate standard of value to be applied. While there is no definitive answer to the appropriate standard to be used, what is clear is that discretion afforded the trier of fact in both the use and application of any standard of value will often clash with the traditional approach in selecting the standard of value to be used. Every case is different factually and as long as discretion is afforded the trier of fact regarding the choice of the standard of value used and the application of the standard of value, the trier of fact will be better able to place a value on the business in the case.