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COURT OF APPEALS
DIVISION ONE

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NO. 73746-5-I

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION ONE

In re the Marriage of

LILY MORELLI,

Appellant,

and

KENNETH MORELLI,

Respondent.

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COURT OF APPEALS
STATE OF WASHINGTON

ON APPEAL FROM THE SUPERIOR COURT OF THE
STATE OF WASHINGTON FOR WHATCOM COUNTY

The Honorable Deborah Garratt

REPLY BRIEF OF APPELLANT

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ORIGINAL

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In addition to the issues and arguments presented in the Appellant's Opening Brief, Ms. Morelli respectfully offers the following for the consideration of this Court.

A. INTRODUCTION

Ms. Morelli requested at trial that Ken's Tree Service be valued in its entirety and she provided an expert valuation that used a standard accepted method for evaluating the fair value of the business, including intangible assets and goodwill. The issue was therefore not raised for the first time on appeal.

Two competing valuation methods were offered to the trial court, book value and the income capitalization method. Berg holds that book value is not appropriate in closely held businesses such as this, therefore the trial court erred in valuing the business at book value. The trial court's book valuation is unsupported by substantial evidence because book value is not a permissible method for valuing the business. The trial court's failure to apply a capitalization rate was error because the business was a going concern and a future income stream was reasonably expected.

Attorney's fees are not appropriate in this appeal because Ms. Morelli has correctly interpreted case law, made well-founded arguments, raised only arguments that were raised below, and stands to gain a meaningful sum should she prevail on appeal.

B. ARGUMENT

1. MS. MORELLI OFFERED THE TRIAL COURT A VALUATION THAT VALUED KEN'S TREE SERVICE IN ITS ENTIRETY, INCLUDING BOTH TANGIBLE AND INTANGIBLE ASSETS, AND GOODWILL

Ms. Morelli raised the issue of valuation, including valuation of goodwill and intangible assets, through her financial expert's report and testimony. In his Brief of Respondent, Mr. Morelli concedes that a trial court "must" evaluate goodwill when a party claims it. Brief of Respondent at 12. Here, Ms. Morelli claimed it by asking the trial court to accept her expert's valuation of the business, a valuation that used the income approach and a capitalization rate, which is the standard method for calculating goodwill. Exhibit 121, p.7.

Mr. Morelli misunderstands the testimony and evidence when he claims that Ms. Morelli's financial expert, Mr. Guerrero, presented the court a valuation method that did not involve "finding or valuing goodwill. Mr. Guerrero's analysis relies only on the revenues and expenses of the business - its cash flow." Brief of Respondent at 6. This assertion is flatly wrong on a concept that is central to this case and to all valuations using the income approach and capitalization method.

Mr. Guerrero's valuation did indeed derive a normalized cash flow for Mr. Morelli's business as shown in Appendix 2: of

his report, Valuation Calculation. Exhibit 121, p.7. Approximately two-thirds of the way down page 7, the 2014 normalized Cash Flow figure is shown to be \$53,868. *Id.* This Cash Flow figure is also commonly known in accounting practice as "excess" income; the income to the business after all its costs have been met, after Mr. Morelli has been paid, and after all taxes and capital expenditures and other needed outlays have been paid. *Goodwill Valuation Approaches, Methods, and Procedures*, Financial Advisory Services Insights, by Robert F. Reilly, CPA, Willamette University, Spring 2015.

Directly under the Cash Flow line of the valuation calculation is the critical line in which Ms. Morelli asks for goodwill and all the intangibles of the business to be valued: the Capitalization Rate. *Id.* According to the standard accounting method used by Mr. Guerrero and approved in In re Marriage of Hall, 103 Wn.2d 236, 692 P.2d 175 (1984), this excess income is "capitalized as an annuity in perpetuity ... by a risk-adjusted and growth-adjusted direct capitalization rate. The result of this direct capitalization procedure indicates the goodwill value." *Goodwill Valuation Approaches* at p. 12.

There was specific discussion of this Capitalization Rate at trial, and the trial court's ultimate ruling on the Capitalization Rate indicated that unfortunately the court simply did not grasp what the

Capitalization Rate was for or why it was important to the valuation in this case. 2 RP 310-11, 334-36; 3 RP 9-10. The presence of the Capitalization Rate in Ms. Morelli's valuation shows that contrary to Mr. Morelli' position on appeal - that Ms. Morelli did not request goodwill at trial - Ms. Morelli clearly presented and repeatedly argued for a valuation that included goodwill and all other intangible business assets at trial.

2. MS. MORELLI'S VALUATION WAS THE MOST ACCURATE WAY TO VALUE THE COMPANY AND THE TRIAL COURT LEGALLY ERRED IN DECIDING INSTEAD TO USE BOOK VALUE

a. This Court reviews the valuation issue *de novo*.

Mr. Morelli's brief incorrectly characterizes the standard of review of the trial court's classification of Ken's Tree Service as an abuse of discretion standard. But the question of whether the trial court's chosen valuation method is legally permissible is a question of law, to be reviewed *de novo*. In re Marriage of Skarbek, 100 Wn. App. 444, 447, 997 P.2d 447 (2000).

b. Of the two valuation options offered at trial - Mr. Morelli's book value approach and Ms. Morelli's income capitalization method - only Ms. Morelli's is legally acceptable for valuing a closely held business.

i. Standard accepted methodology for calculating the value of a business like Ken's Tree Service includes calculating goodwill. Mr. Guerrero's valuation used the income

approach, and within the income approach he used the Capitalization method. Exhibit 121 at 2, 7. Capitalization is "[A] conversion of a single period of economic benefits into value." International Glossary of Business Valuation Terms, American Institute of Certified Public Accountants, Statement on Standards for Valuation Services at 40. "A capitalization model uses a current benefit stream and assumes that the particular stream of income will be received into perpetuity." Trugman, Gary Understanding Business Valuation, 4th ed., American Institute of Certified Public Accountants, at 410.

Standard accepted methodology for calculating value of a business like Mr. Morelli's includes calculating goodwill. Our Supreme Court has held that the income capitalization method, which includes valuation of goodwill, is appropriate when the subject property is designed as a profit-making venture. Sahalee Country Club, Inc. v. Bd. of Tax Appeals, 108 Wn.2d 26, 35, 735 P.2d 1320 (1987). This is because "[t]he potential income-producing ability of the property appropriately influences its value. Cascade Court Ltd. P'ship v. Noble, 105 Wn.App. 563, 570 n. 32, 20 P.3d 997 (2001).

According to Goodwill Valuation Approaches, the generally accepted standard income interpretation of goodwill, which Mr. Guerrero used in the valuation, involves quantifying

"the portion of the entity's income that cannot be associated with any other tangible or intangible asset" Id. at 10, 17.

This income approach valuation method used by Mr. Guerrero is the method most commonly used to calculate goodwill. Id. at 16. This income approach method is "based on the concept of goodwill as the present value of future income not associated with the entity's tangible assets or identifiable intangible assets." Id. at p. 17. In Mr. Guerrero's valuation on p. 7, he quantifies Invested Capital Net - Cash Flow for 2014 - the "excess income." Exhibit 121 at p. 7; *Goodwill Valuation Approaches* at 10. According to the standard accounting method used by Mr. Guerrero and approved in Hall, this excess income is "[C]apitalized as an annuity in perpetuity ... by a risk-adjusted and growth-adjusted direct Capitalization Rate. The result of this direct Capitalization procedure indicates the goodwill value." *Goodwill Valuation Approaches* at p. 12.

ii. Application of a Capitalization Rate is necessary to express the expected future business income stream as a present-day value, an amount of capital. Use of the Capitalization Rate is key to measuring the present value of the entire business, including goodwill, when a significant part of the value of that business is that it will continue to produce income in the future. That expectation of future income (the expectation of future events

that are not directly related to the entity's current operations) must be quantified as a present value; and that is the purpose of the Capitalization Rate in a goodwill analysis. Id. at 11. It quantifies "the net present value of the expected future income associated with assets that are already in existence." Id. at 11.

The income approach is the one most commonly used to measure goodwill. Id. at 15. This income approach is what Mr. Guerrero used, and with it he measured goodwill using standard valuation methods approved by Hall . "...[g]oodwill may be quantified using either a residual analysis or an income analysis. In either type of analysis, goodwill is the residual business value (or capitalized excess income) that is not allocated to any of the following assets: working capital assets, tangible personal property, real estate, intangible personal property, intangible real property." Id. at p. 16. The Capitalization Rate presented by Ms. Morelli's expert therefore explicitly includes goodwill. It also includes the tangible assets, the other assets, and everything of worth in the business.

In simplest terms, the Capitalization Rate serves to quantify the reality that Mr. Morelli's business was not a one-time, one-year-only business deal; it has a history of many years of steadily rising earnings and an expectation of continued rising earnings in the future. The purpose of the Capitalization Rate is to express in

one figure the present-day value of the reasonably expected continued existence and income of the business; to turn the expected stream of future income into capital.

A single present-day figure for the business value, the capital, is necessary because the business is property and it must be valued and disposed of at the time of trial. Part of the intrinsic value of a business like Mr. Morelli's is that it will provide income in the future; and the dollar value arrived at using the Capitalization Rate tells the court what figure to assign to the present-day value of that future income.

By refusing to apply a Capitalization Rate to the cash flow/excess earnings, the trial court valued Mr. Morelli's business as if it were a one-time-only deal, or as if it were expected to close at the end of the year. No evidence supported either proposition. Therefore, Ms. Morelli's valuation method was the more appropriate way to value the company. Indeed, it was the only legally permissible method offered at trial.

This Court has provided a helpful discussion of the income capitalization method in Washington Beef, Inc. v. County of Yakima, 143 Wn.App. 165, 172, 177 P.3d 162 (2008). According to Washington Beef, "There are three general approaches to arrive at market value: capitalization of income, cost, and market." Id. at 172. The Washington Beef court explains why the income

capitalization method is appropriate for profit-making businesses:

[the income capitalization method] assumes value is approximately equal to the present value of the future benefits of property ownership. Sahalee Country Club, Inc. v. Bd. of Tax Appeals, 108 Wash.2d 26, 33, 735 P.2d 1320 (1987). An appropriate annual rate of capitalization is applied to a forecast of annual net income. Id. Unlike the cost approach, the income approach "explicitly considers the impact of economic obsolescence by relying on the cash flow generated by the assets as of the valuation date, given the known economic and financial factors facing the Company."

Income capitalization converts anticipated cash flows into present value by capitalizing (converting to an asset) net operating income or cash flow by using capitalization rate. Sahalee, 108 Wash.2d at 33, 735 P.2d 1320.

The idea is to place a present value on a future stream of income, [citation omitted] because how much the plant is expected to generate in the future is an indicator of what it is worth now.

There are two essential variables to this approach. The first is the anticipated income stream or cash flow. The experts did not agree on the appropriate value of the cash flow here. The second factor is the capitalization rate: the rate to be divided into the income or cash flow to arrive at a present value of the facility (capitalized value). Here, the parties disputed the appropriate rate to be applied. The rate makes a big difference in the value because the higher the rate, the lower the value of the plant and vice versa, the lower the rate, the higher the value.

143 Wn. App. at 173. (Emphasis added.)

Washington Beef approved the process Ms. Morelli's

expert used in his valuation:

The direct capitalization approach considers the historical performance of the business. It is averaged to arrive at a normalized cash flow estimate that is then capitalized.

Id. at 177.

As the above discussion demonstrates, the goodwill and other intangible business value that Ms. Morelli requested the trial court assign a value to was well within the evidence; contained within the Capitalization Rate, it was a critical component of Mr. Guerrero's valuation. The error that occurred was not that Ms. Morelli failed to ask for goodwill, or for the court to assign a value to the intangible part of the business, but that the trial court failed to do so when asked by Ms. Morelli.

iii. The trial court failed to recognize goodwill or "other value" in Ken's Tree Service, instead assigning it book value. In the Brief of Respondent at 10, Mr. Morelli quotes the court's first oral ruling to rebut Ms. Morelli's claim that the trial court assigned the business book value. In this preliminary oral ruling, the trial court assigned \$50,000 of "other value" to Ken's Tree Service, to come up with the total value of \$128,000. But this was only the court's preliminary ruling: the trial court changed its mind in its second ruling on April 20, and decided that there was no "other value" in the business. 4 RP 417.

While the trial court's second oral ruling, which was memorialized in the final documents, does contain reference to a \$50,000, this amount was not "other value in the business." 4 RP 416-17. Rather, the court explicitly stated that the \$50,000 was the value of assets acquired during the two years of committed intimate relationship, arriving at a ruling which recognized no "other value" in the business beyond equipment. 4 RP 416-17. The trial court termed it a "coincidence" that the value of the "other value" from her first ruling and the \$50K she now attributed to the value of assets acquired during the two years of committed intimate relationship were the same amount. Id.

Mr. Morelli relies on this preliminary, later-overruled oral opinion to defend against Ms. Morelli's argument that the trial court valued Ken's Tree Service at book value. Brief of Respondent at 14-15. But as the trial court's final ruling demonstrates, the court did not find any "other value" in the business. 4 RP 416-17. No intangible assets, accounts receivable, or future income were considered by the trial court when assigning value to Ken's Tree Service. The court valued the business at book value, precisely the method prohibited in In re Marriage of Berg, 47 Wn. App. 754, 737 P.2d 680 (1987).

3. THE TRIAL COURT'S VALUATION IS UNSUPPORTED BY SUBSTANTIAL EVIDENCE BECAUSE BOOK VALUE IS NOT A PERMISSIBLE METHOD FOR VALUING THE BUSINESS

Mr. Morelli argues that substantial evidence supports the trial court's valuation, but this argument has no weight unless one accepts that the trial court did not err in using a book value method of valuation. Ken's brief 15-16. The trial court did not even accurately determine book value; the court arbitrarily changed asset values and failed to include accounts receivable.¹

The trial court's use of an incorrect valuation method resulted in a significant undervaluation of the business, and therefore of the community assets as a whole. For this reason, this Court should remand for revaluation of the business in conformity with the valuation offered by Ms. Morelli, a method approved by Hall, and for a redistribution of the community assets that takes into account those assets' true and correct value.

4. ATTORNEYS FEES ARE NOT APPROPRIATE IN THIS APPEAL

Mr. Morelli bases his claim for fees on Ms. Morelli having raised "new arguments not presented at trial," having

¹ Mr. Guerrero was unable to determine the exact amount of accounts receivable because Mr. Morelli refused to cooperate in providing information about accounts receivable, refused to allow a site visit, and refused to speak with Mr. Guerrero regarding the business or to allow any of the business' employees to speak with Mr. Guerrero. Exhibit 121, p. 3; 2 RP 312, 323; 3 RP 9-10.

"misinterpreted case law on valuing goodwill, and having "delayed resolution of this controversy for no apparent gain." Brief of Respondent at 17. None of these claims are accurate. At trial, Ms. Morelli offered a valuation that included all intangible assets including goodwill, and on appeal she asks this Court to reverse the trial court's valuation and remand for valuation consistent with what she requested at trial.

Ms. Morelli did not misinterpret case law on goodwill; Mr. Morelli's claim of misinterpretation is based on the mistaken notion that Ms. Morelli did not request that the court value all the business' assets, tangible and intangible assets, including goodwill. Rather it is Mr. Morelli who has misinformed this Court by inviting it to rely on a preliminary oral ruling that was changed in the final documents. Further, holding a differing, reasonable view on the interpretation of case law is not grounds for attorney's fees.

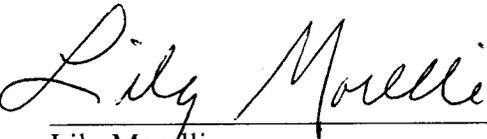
Finally, Mr. Morelli's claim that Ms. Morelli is extending the controversy for "no apparent gain" is illogical. Appropriate valuation of Ken's Tree Service, a community asset, will result in a figure almost triple that which the trial court assigned to it. Disposition of this properly valued community asset will not result in "no apparent gain" to Ms. Morelli; quite the opposite, it will result in a significant gain in the value of her share of the community estate.

C. CONCLUSION

Ms. Morelli respectfully requests this Court reverse and remand for revaluation of Ken's Tree Service consistent with the valuation she presented at trial, direct the trial court to characterize the business as a community asset, and deny Mr. Morelli's request for attorney's fees on appeal.

DATED this 16th day of February, 2016.

Respectfully submitted:



Lily Morelli
pro se