BUSINESS VALUATIONS IN DIVORCE

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I. INTRODUCTION

Valuation has been described as a "study of competing approaches that lead to inconsistent results and of estimates and approximations based on incomplete and sometimes unreliable information." Hamilton, Fundamentals of Modern Business -- A Lawyer's Guide, p. 354. Almost every article addressing valuation states that the valuation process is not an exact science. There are different methods that can be used in a given valuation situation, but plausible arguments can be mounted to support different valuations even when the same valuation technique is followed. Case law in Texas, however, imposes some constraints and limitations on the application of certain techniques.

Valuation problems are challenging for both the family law attorney and the expert hired to value a business or professional practice. The lawyer must gain some understanding of the possible ranges of values of the business from the expert in order to analyze a settlement or assess the likely outcome at trial. The lawyer must be able to apply case law and consider the theories and principles underlying specific cases in order to present the client's position to the judge or the jury, and to effectively avoid the consideration of inappropriate evidence that the opposition will try to introduce. Finally, the lawyer and the expert should have a firm grasp of the factual and theoretical underpinnings of a particular valuation approach in order to persuade the judge or the jury. Regardless of the manner in which a case is resolved, someone -- whether it's the judge, the jury, the other party, or our own clients -- has to be persuaded that the value being asserted is credible, reasonable and permissible under Texas law.

The purpose of this paper is to provide an overview of the legal aspects of business valuation in a divorce case. The topic of business valuation has created numerous books, articles and treaties, a comprehensive grouping of which is attached to this paper.

II. MEASURE OF VALUE

A. TEXAS PATTERN JURY CHARGE

The Texas Pattern Jury Charge Committee adopted the following instructions regarding the valuation of any asset:

PJC 203.1 Present Value

> The value of an asset is its market value unless it has no market value.
>
> "Market value" means the amount that would be paid in cash by a willing buyer who desires to buy, but is not required to buy, to a willing seller who desires to sell but is under no necessity of selling.
>
> If an asset has no market value, its value is the value of its current ownership as determined from the evidence.
>
> In valuing an asset to be received in the future, you are to find its present value as determined from the evidence. (Emphasis is added).
>
> Texas Pattern Jury Charges - Family, PJC 203.01 (1998).

B. MARKET VALUE

In Taylor County v. Olds, 67 S.W.2d 1102 (Tex. Civ. App.--Eastland 1934, writ dism'd), the Court set out, in descending order, the best measure of value: market value, intrinsic value, cost of replacement, and value to the owner.

Although market value is the most common measure of value, it is not the only recognized method of proving the value of an asset. If an asset has no market value, the present value may be determined by evidence of value to the owner. The party offering evidence of value other than market value must show that there exists no market value at the time and place in question.

The Texas Supreme Court defined fair market value as that amount of money that a willing buyer, who desires to buy but is under no obligation to buy, would pay to a willing seller who desires to sell but is under no obligation to sell. City of Pearland v. Alexander, 483 S.W.2d 244, 247 (Tex. 1972).

Section 2.02 of Internal Revenue Service Revenue Ruling 59-60 provides a similar definition for fair market value:

> [T]he price at which the 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. Rev. Rul. 59-60, 1959-1 C.B. 237.

The concept of market value presupposes an existing, established market. Wendlandt v. Wendlandt, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ). Therefore, sales of comparable closely-held businesses or professional practices are the best measure of value in divorce. However, practically speaking, there is often an absence of market transactions of like kind and quality and in sufficient quantity to establish fair market values for closely held businesses and professional practices. One of the difficulties in valuing most professional practices is that there is usually no market value.

C. INTRINSIC VALUE

Some assets do not have a market by which to measure their value. The Texas Pattern Jury Charge defines present value of an asset as "its market value unless it has no market value." PJC 203.01. "If an asset has no market value its present value is the value of its ownership as determined from the evidence." Id. This definition is derived from the Texas Supreme Court case of Crisp v. Security National Insurance Company, 369 S.W.2d 326 (Tex. 1963), where the Court uses the phrase "actual value to the owner." Id. at 326. The court may consider the use to which the property has been put, its replacement cost and its original cost.

Before turning to other methods of valuation, the court must be satisfied that there is no discernible or established market for determining the value of property. Market value is considered the best evidence and the Court will look at other valuation methods only after a determination that there is no readily available market for the asset. Beavers v. Beavers, 675 S.W.2d 296 (Tex. App.--Dallas 1984, no writ).

Intrinsic value has been defined as "...true, inherent and essential value of a thing, not depending upon accident, place or person, but the same everywhere and to everyone." Rosenfield v. White, 267 S.W.2d 596 (Tex. Civ. App.--Dallas 1954, writ ref'd n.r.e.) It has also been described as "...worth based upon such factors as cost, depreciation, present usefulness, past return on investment, etc." City of Austin v. Cannizzo, 267 S.W.2d 808 (Tex. 1954).

The importance of intrinsic value in the valuation of a closely-held business can be recognized in Beavers v. Beavers, 675 S.W.2d 296 (Tex. App.--Dallas 1984, no writ). The Beavers case involved stock in a closely-held business as the asset with disputed value. Both experts testified that, due to a restriction on the sale of stock to other existing shareholders at book value, there was no market value and therefore the value of the stock was zero. However, the Court held that "while market value is usually the best evidence of value, in the absence of a market value, the actual value of the property to the owner may be shown." Id. at 299. The Court considered testimony regarding the value of the company's assets and book value. The Court stated that "in assigning values to closely-held corporations in contested divorce actions, the value of the property to the owner may be shown and the court should also consider not only the existing assets of the company but the realities of corporate control." Id.

III. THE VALUATION PROCESS

Valuation is not a science with precise unimpeachable formulas. It is impossible to value an asset with exact, mathematical accuracy. A competent appraisal is based on facts, common sense and informed judgment. The valuation of any closely-held business or professional practice is only as good as the judgment of the appraiser, and the accuracy of the information relied upon. All appraisers must make choices, assumptions and estimates. Competent appraisers can arrive at different conclusions of value using the same information. The variance is the result of the use of different assumptions and methodology. The appraiser with the most defensible assumptions and methodology should prevail with the judge or the jury. A jury finding on valuation is binding on the court. In the Matter of the Marriage of Moore, 890 S.W.2d 821, 838 (Tex. App.--Amarillo 1994). Always remember, the value is what the fact-finder says it is, and the fact-finder may disregard every expert, although the value must be somewhere between the highs and lows offered into evidence. Interfirst Bank Dallas, N.A. v. Risser, 739 S.W.2d 882, 890 (Tex. App.- Texarkana 1987, no writ); Salinas v. Rafiti, 948 S.W.2d 286, 289 (Tex 1997) (no evidence supported jury’s finding that a medical partnership’s value was $4,284,000, where the expert testimony placed the value of the partnership between $756,821 and $2,940,000.) Remember that the ultimate goal is to convince the other side, or the finder of fact (the judge or the jury) if that fails, of the value of the business that will benefit your client. Many experts make the mistake of confusing or boring the judge or jury with minor theory points and neglecting the “big picture.”

It has been suggested that the value of a business for divorce purposes is substantively different from its value to a "willing buyer." Several reasons are given to support this thesis. The most important reason is that in a divorce there is no "willing buyer" and the business is not being sold. Another reason is that a "willing buyer" looks to the future profitability and future earnings of a business in making a valuation decision. Therefore, post-divorce earnings are an element of the value of the business. Post-divorce earnings are separate property and not divisible upon divorce in Texas.

The value of a closely-held business or of a professional practice is obtained from either the assets of the business, its earning capacity, or a combination of both. Although there is a great deal of subjective judgment involved, the appraiser should rely upon certain generally accepted methodologies as well as restrictions imposed by established case law.
While not an exact science, valuation of closely-held businesses and professional practices is not purely subjective. There are well-established methods, procedures, and guidelines. Since no one method of valuation is without question, the party who presents credible expert testimony and who impeaches the opposing expert is the one who will most likely persuade the judge or the jury. The choice of the method to be used depends on the type of business being valued and the judgment of the appraiser.

A valuation normally starts with a comprehensive checklist for requesting documents from the business being appraised. An example of a checklist is attached to this paper.

IV. GENERAL FACTORS TO CONSIDER WHEN VALUING A BUSINESS

There are a number of questions which the attorney and the appraiser should consider with respect to the valuation of a closely-held business. These include, but are not necessarily limited to:

A. What is the extent of ownership and who really controls the company?

B. What are the specific and legal agreements regarding equity ownership, such as buy-sell agreements, and how do they impact, if at all, on the business?

C. If key management left or were replaced, how would the business be affected?

D. How commingled are the business and personal expenses of the owners and are salary and bonus amounts below market, above market or at market?

E. Are the earnings as reflected in its financial statements realistic?

F. Is the company a recent start-up, or more well-established with a sound reputation?

G. What is the restated book value based upon consistent recording of inventory, depreciation and interest expenses?

H. Is net working capital adequate or excessive for normal cycles?

I. What are the key operating ratios for this business?

J. How well does this business perform according to those ratios?

K. What is the dividend-paying capacity and the history of dividends?

L. What are the extraordinary income and expense items?
M. Does the firm advertise?

N. What are the tangible assets and what is the true value of those assets?

O. What are the intangible assets of the business which are not reflected on the company's balance sheet?

V. **METHODS OF VALUATION**

The goal of valuation is to determine the "market value" of a business, or in the absence of a market, its "intrinsic value." There are many valuation methods an appraiser may use in the valuation of a business. Following are some of the more commonly used valuation methods.

A. <u>REVENUE RULING 59-60</u>
The Internal Revenue Service has published several Revenue Rulings regarding business valuation. These have been developed in connection with its effort to collect taxes upon the transfer of the business. The concepts contained in these Revenue Rulings have become guidelines for use by business appraisers.

Before turning to some of the more readily acceptable and utilized methods for valuing marital assets and for valuing stock in a closely held business, it is advisable to look at Revenue Ruling 59-60, which provides a starting point and basic understanding of the important factors to be considered in determining asset values. Revenue Ruling 59-60 remains the single most important doctrine in the valuation of closely-held businesses. Any business appraiser unfamiliar with it should not be allowed in the courtroom.

Revenue Ruling 59-60 has become the cornerstone for determination of methods and factors relevant to determination of the fair market value of a business. Although its initial purpose was to outline and review the approach, methods and factors to be considered in valuing shares of the capital stock of closely-held corporations for estate and gift tax purposes, Revenue Ruling 59-60 has become the touchstone for the valuation of all types of business interests. In the general statement of its approach to valuation, the following concepts are set out:

> "A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. <u>No formula can be devised that will be generally applicable to the multitude of different valuation issues</u>.... Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. <u>A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance</u>." (Emphasis Added).

1. <u>Factors to Consider</u>

   In valuing a business, the Revenue Ruling notes that "all available financial data, as well as all relevant facts affecting the fair market value, should be considered." The Revenue Ruling enumerates eight fundamental factors to be given consideration and careful analysis in each case when valuing a closely-held business. These factors are not all-inclusive.

   a. The nature of the business and the history of the enterprise from its inception.

   b. The economic outlook in general and the condition and outlook of the specific industry in particular.

   c. The book value of the stock and the financial condition of the business.

   d. The earning capacity of the company.

   e. The dividend-paying capacity.

   f. Whether or not the enterprise has goodwill or other intangible value.

g. Sales of the stock and size of the stock to be valued.

h. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

The Revenue Ruling contains a brief discussion of each of these enumerated factors. Additionally, the Revenue Ruling provides specific guidance in regard to the capitalization rate and notes that its determination should take into account the nature of the business involved, the risk involved and the stability or regularity of earnings. In spite of noting the difficulty in determining the capitalization rate, the Revenue Ruling discourages the use of the averaging of the fundamental factors by the assignment of various weights to specific factors to arrive at fair market value as an average.

2. Dividend Paying Capacity

"Primary consideration should be given to the dividend paying capacity of the company rather than to the dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have had any relation to the dividend paying capacity."

3. Goodwill

"In the final analysis, goodwill is based on earning capacity. The presence of goodwill and its value therefore rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value."

4. Restrictive Covenants

"Where the option, or buy and sell agreement, is a result of a voluntary action by the stockholders and is binding during the life as well as at death of the stockholders, such agreements may or may not, depending upon the circumstances of each case, fix the value of the business. However, such agreements are a factor to be considered with other relevant factors in determining fair market value."

5. Capitalization Rates

"In the application of certain fundamental valuation factors such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of the corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely-held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings." (Emphasis added).

6. Average of Factors

"Because valuation cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance." (Emphasis Added).

B. REVENUE RULING 68-609

Revenue Ruling 68-609 sanctions a "formula" method for valuing goodwill:

> "The question presented is whether the "formula" approach, the capitalization of earnings in excess of a fair rate of return on net tangible assets, may be used to determine the fair market value of the intangible assets of a business.
>
> The "formula" approach may be stated as follows:

A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say 15 to 20 percent, is the value of the intangible assets of the business determined under the "formula" approach . . .
The "formula" approach should not be used if there is better evidence available from which the value of intangibles can be determined. If the assets of a going business are sold upon the basis of a rate of capitalization that can be substantiated as being realistic, though it is not within the range of figures indicated here as the ones ordinarily to be adopted, the same rate of capitalization should be used in determining the value of intangibles....

Accordingly, the "formula" approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefor available.

C. ASSET METHODS OF VALUATION

The following methods of valuation focus solely upon the tangible assets of a business. No weight is placed upon the earning capacity of the business. Both book value and adjusted book value are not seen as persuasive valuation techniques in the context of the division of the marital estate as these methods have the inherent flaw of looking at an asset's value as cost and unrelated to the potential earnings the asset could generate. Therefore, it is inappropriate to use this method to value intangible assets.

This method does, however, set a "floor value" for determining total entity value, i.e., the value of existing assets less related debt. This method is used where the business earnings are not sufficient to create an intangible value, such as when it would be better to incur the cost of starting a new business rather than purchase an existing business.

1. BOOK VALUE.

Book value as a valuation method carries little weight in determining the value of a closely-held corporation for purposes of division upon divorce.

Book value is defined as the sum of the asset accounts, net of depreciation, less the liability accounts. Since it is reflected routinely on the financial statements of a business, book value is the easiest method of valuing a closely-held business or professional practice. But book value can be misleading. First, financial statements reflect historical data only and contain numerous accounting entries which are mere estimates. Second, book value does not take into account the actual value and possible appreciation of assets.

The relative insignificance of book value in the valuation of closely-held businesses has been confirmed by the Texas Supreme Court. Bendalin v. Delgado, 406 S.W.2d 897, 900-901 (Tex. 1966); Beavers, 675 S.W.2d at 296. While this method might have some relevance if liquidation of a business is contemplated, it carries very little weight in determining the present value of closely held corporate stock. In Bendalin, a corporate financial statement showing book value was the only evidence of the value of a closely-held corporation. The Texas Supreme Court stated:

> "Consumers was a small, closely-held corporation and there was no market for its stock...Book value is entitled to little, if any, weight in determining the value of corporate stock, and many other factors must be taken into consideration... [T]he book value of the Consumers stock constitutes nothing more than a scintilla of evidence as to its reasonable worth. Id. at 900."

Although book value is cited as one of the eight "factors to consider" by Revenue Ruling 59-60, it is rarely equal to fair market value. However, it remains important to the extent it permits a business appraiser to understand fully the business' financial condition.

In Chaffe v. Murray, 492 S.W.2d 680, 685 (Tex. Civ. App. -- Corpus Christi 1983, writ ref'd n.r.e.), the Court stated that this method of valuation should rarely, if ever, be used. The Court further stated that "market value of a business and book value thereof are not synonymous."

2. ADJUSTED BOOK VALUE.

Adjusted book value is somewhat more indicative of value than simple book value. The tangible assets of a business are appraised and reflected at market value, then the business' liabilities are subtracted to arrive at adjusted book value.

Despite this adjustment to book value, adjusted book value still reflects a relatively low value for a business interest. A typical service-oriented business has a low adjusted book value because tangible assets are relatively insignificant. The value of such a business is in its earning capacity which is not an element of adjusted book value.

Although the "adjusted book value" is intended to more accurately reflect the fair market value by taking into account inflation, appreciation and intangible assets such as goodwill and making the appropriate adjustment to net book value before it is reduced by liabilities, this method is equally unpersuasive unless liquidation of the business will occur.

3. LIQUIDATION METHOD

As with the adjusted book value method, the liquidation method requires an individual appraisal of all tangible assets. But, in addition to subtracting the business' liabilities, this method requires that the cost of liquidating the tangible assets of the business also be taken into account.
The marital asset value is based on the sales proceeds of the assets less payment of outstanding liabilities. In addition to the liabilities, the cost of liquidation and the income taxes resulting from the sale should also be taken into account and subtracted to arrive at this measure of value. This method is without merit for use in valuing a service-orientated business which has relatively few assets. Further, this method does not take goodwill into consideration.

As with all asset methods, the liquidation method disregards the earning capacity of a business. It would seem inappropriate to consider liquidation costs and income taxes unless liquidation was actually to occur in the near future. The best use of this method is to establish a minimum for sale of the business.

D. INCOME METHODS

Income methods of valuation focus mainly on the earning capacity of a business rather than its tangible assets. Earnings are the most important indicator of value when valuing many companies, particularly those engaged in the sale of services.

One of the key decisions is whether to measure a business' earnings capacity based on historical data or future projections. Each approach has its shortcomings. Historical data is not necessarily representative of the value of the business on the date of the valuation. Future projections are somewhat speculative and often unreliable. Due to the unreliability of future projections, historical data is most often employed in utilizing the income methods. As indicated by Pratt, a pragmatic solution is to rely on historical data:

> "[T]his difference in focus between the historical record and future projections is dictated by what the respective decision makers are willing to rely on... Business people can and should use their knowledge and experience in allocating resources entrusted to them for the purpose of taking business risks, and accept calculated risks inherent in decision making based on forecasts of an uncertain future. The court typically acknowledges that it lacks such expertise and that its mandate should be to reduce the element of uncertainty or risk to the greatest possible extent in its decision-making process. To be practically useful, the business valuation procedure selected must conform to the criteria acceptable to those who ultimately decide what action to take as a result of the valuation process. Pratt, Shannon, <u>Valuing Small Businesses and Professional Practices</u>, (Second Edition, Irwin Professional Publishing, 1993).

At least one court has approved the use of an income method in the valuation of a closely-held corporation. In <u>Morgan v. Morgan</u>, 657 S.W.2d 484 (Tex. App.--Houston [1st Dist.] 1983, writ dism'd), the trial court's division relied, in part, on the testimony of a CPA who evaluated a machine shop business using the "capitalization of earnings" method. The wife's expert chose a capitalization rate of 15% to arrive at $567,000 as the fair market value of the corporation. The husband offered no expert testimony, but testified that the business was worth nothing or $75,000, at most. The $75,000 appears to have been the adjusted book value of the corporation. The Court of Appeals approved this capitalization of earnings approach as one of the acceptable methods of valuing a closely-held corporation and affirmed the trial court's judgment.

1. Discounted Future Earnings Method

This income method is based on the theory that the value of the business is the present value of its future income. The business appraiser must forecast the future earnings stream that will be available to a hypothetical purchaser, then apply an appropriate discount rate to arrive at the business' present value.

This method employs the use of two subjective variables. One is the discount rate at which the income stream is adjusted to its present value. There is also some subjectivity and speculation in regard to the business' future earnings. Although theoretically sound, this method is subject to some criticism because of the subjective factors. To minimize the damage when the expert is being cross-examined, the expert should show the extent to which all factors and information regarding past income were used in predicting future earnings.

One court found that this method was inappropriate in the context of a particular divorce because value was based on post-divorce earnings and profits. Smith v. Smith, 836 S.W.2d 688 (Tex. App.--Houston [1st Dist.] 1992, no writ). The business involved in Smith was a sole proprietorship. The Court stated that the expert's findings reflected the husband's personal future earning capacity and not the value of the business. Therefore, this method generally should not be used in a divorce case since future earnings are not divisible in a dissolution of the marriage because they are post-divorce earnings and therefore are the separate property of the divorced professional or business owner.

2. Excess Earnings Method

This is the "formula" approach described by Revenue Ruling 68-609. This method is an income and asset-based method. This method determines an appropriate rate of return for the business' tangible assets, then subtracts that return from the business' historical earnings stream. The remainder is deemed "excess earnings." These excess earnings are "capitalized," then the value of such capitalized earnings are simply added to the value of the business' tangible assets to arrive at fair market value.

Thus, the "formula" approach is as follows:

a. Determine the net tangible assets of the business.
b. Determine an appropriate rate of return for those tangible assets.
c. Determine the business' historical earnings.
d. Subtract the return determined in "2" from the historical earnings determined in "3" to find "excess earnings."
e. Capitalize the "excess earnings" at an appropriate rate.
f. Add the capitalized earnings from "5" to the net tangible assets from "1" to arrive at fair market value.

The weakness of this method is the relatively arbitrary use of an "appropriate rate of return" with respect to the net tangible assets, and the equally arbitrary capitalization rate with respect to the "excess earnings." These two subjective decisions by the business appraiser can change substantially the result of the "formula" approach.

Revenue Ruling 59-60 recognized this problem:

> "In the application of certain fundamental valuation facts such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. Rev. Rul. 59-60, 1959-1 CB 237.

Even with its significant limitations, the excess earnings method has become a commonly used method of valuation. It is appealing due to its simplicity, its reliance on historical data, and its combination of the two valuable elements of a business: tangible assets and earnings capacity.

3. <u>Price Earnings Method</u>

The price earnings ratio is a conventional and highly regarded measure of business value because it gives an indication of price measured against the business' earning power.

The price/earning ratio of a common stock is the market price of the stock divided by the current per share earnings. For example, if XYZ Corporation common stock sells for $42 per share at a time when its reported earnings over the last 12 months amounted to $3 per share, its price/earning ratio would be 14 ($42 divided by 3).

This income method theorizes that price/earnings information obtained from publicly-held and traded businesses comparable to the closely-held business being evaluated is indicative of value.

One of the problems with this income method is the difficulty in obtaining price/earnings ratios from businesses which are truly comparable. Absent comparable companies, any conclusion of value is necessarily flawed. Furthermore, price/earnings ratios from small companies, or companies with erratic earnings records, often do not provide dependable data upon which to base opinions of value.

4. <u>Dividend Capacity Method</u>

This income method focuses on the ability of the business to pay dividends. Whether the business actually pays dividends is not relevant. The "dividend capacity" of the closely-held business in question is compared with current dividend yields of publicly-held companies. In theory, businesses with similar dividend capacity have similar value.

Although this income method focuses on current and historical data, its weaknesses are apparent. The first problem is the difficulty in determining the ability of any business to pay dividends. This is a very subjective judgment. A careful analysis of the current business is essential. The second problem is the payment of dividends by a publicly-held corporation is a function of many variables, not necessarily profitability. Finally, it is quite disadvantageous from a tax perspective for a closely-held corporation to remove earnings as dividends rather than through other methods such as salaries which are tax deductible.

E. <u>COMPARABLE SALES METHOD</u>

The comparable sales method of valuation permits the appraiser to research the market and find sales of business entities similar to the business being appraised. The appraiser adjusts for any differences between the businesses and arrives at a value of the business being appraised on a comparison with the similar business. In order for this method to be a realistic measure of value, the businesses must be similar in terms of size, location, nature and earnings history. The greater the difference between the businesses, the more suspect the valuation will be and the more subject to challenge.

This method can be the most reliable measure of value because it focuses on relatively objective information rather than the judgment of the business appraiser. But comparable transactions must be explained carefully to determine if the elements of fair market value are evident, i.e. willing buyer, willing seller, lack of compulsion to buy or sell, etc. Further, the characteristics of the business being appraised and the comparable company must be examined carefully, including such things as the markets operated in, management, position in the industry, earnings, and competitive environment.

When reviewing the sale of the business, the appraiser must also take caution that the comparable sale was made as an arms length transaction. If the "comparable" sales of corporate stock were generally to insiders, officers, directors or employees of the company or between family members, it is likely that the court would find the sale suspect and without merit for comparison. Interfirst Bank Dallas, NA v. Risser, 739 S.W.2d 882, 890 (Tex. Civ. App.--Texarkana 1987, no writ).

Some courts have noted that comparable sales are of minimal assistance when valuing an operating business. Morgan, 657 S.W.2d at 489.
A variation on the comparable sales method is the comparable company price method where the appraiser looks at a company whose stock is publicly traded but is similar to the marital asset being valued. However, often the mere fact that a company is a public company rather than a private one is enough of a variation to discount this method. As a practical matter, closely-held businesses are difficult to compare with publicly-held entities for several reasons:

1. When the closely-held business is small, the size differential alone makes comparison impossible.

2. Publicly-held companies have access to credit unavailable to closely-held businesses.

3. Publicly-held entities have a depth of management that closely-held businesses lack.

4. Closely-held businesses usually are limited to one product while the comparable publicly-held company makes the same product

plus numerous unrelated products.

VI. GOODWILL AND COVENANTS NOT TO COMPETE

The appraiser must be aware that certain factors generally included in the valuation methods must be separately accounted for in a divorce case. The expert must consider the spouse's personal goodwill and the willingness of the party not to compete with the business. Value attributable to the personal goodwill of a divorcing spouse must be excluded from the value of the business or professional practice being evaluated. Nail v. Nail, 486 S.W.2d 761 (Tex. 1972).

A. TEXAS PATTERN JURY CHARGE

The Texas Pattern Jury Charge attempts to account for these facts in its instruction in PJC 203.2 which states:

> **PJC 203.2. Factors to be Excluded for Valuation of Business**
>
> "Personal goodwill" is the goodwill that is attributable to an individual's skills, abilities, and reputation.
>
> In determining the value of PARTY A's *medical practice*, you are not to include the value of personal goodwill or the value of time and labor to be expended after the divorce. However, you may consider the goodwill, if any, of the *practice* that is separate and apart from personal goodwill.
>
> Texas Pattern Jury Charges - Family, PJC 203.2 (1998).

The comment to the Pattern Jury Charge states that suitable descriptive terms should be substituted for the phrase "medical practice" and the word "practice" in the instruction.

B. GOODWILL IN GENERAL

Goodwill is probably the least tangible of the intangible assets, and it is the only intangible asset that is not to be considered in valuing a business or professional practice. It is nothing which may be seen or touched; however, if it exists the firm will receive a flow of funds which would not be present without it. It may be said to be the reputation of the firm, the good name of the firm, or the prestige of the firm. It is something which is usually acquired over a number of years, and it results from producing an excellent product or providing good service to customers or clients. A good reputation allows the firm to earn a greater income than an identical firm which is unknown to the public. If two firms are in the same business and have exactly the same amount of assets and liabilities, but one firm earns a larger amount because of its reputation, this difference in income is generated because of the goodwill of the firm. Because it generates income, goodwill should be considered an asset just as any other income producing item is listed as an asset on the balance sheet.

It is generally recognized in Texas that goodwill is property and it can be the subject of bargain and sale. It may be damaged or destroyed and, as in other property, the owner may recover for its destruction. In Taormina v. Culicchia, 355 S.W.2d 569 (Tex. Civ. App.--El Paso 1962, writ ref'd n.r.e.), the Court described goodwill:

> "Goodwill is generally understood to mean the advantages that accrue to a business on account of its name, location, reputation and success. The fact that the goodwill of a business was created by or resulted from years of hard work and business effort on the part of only one or two of the several partners does not necessarily render the goodwill of the business personal to them. The value of the goodwill of a business depends on the fixed and favorable consideration of customers arising from an established and well known and well considered business."

Goodwill for divorce purposes is substantively different from goodwill for business sale purposes. The general definition of goodwill is in terms of the amount a willing buyer might pay in addition to the value of the tangible assets of a business. But in divorce there is no willing buyer and no sale. Furthermore, goodwill is generally based on the expectation of future earnings which is outside the court's power to divide. Nevertheless, there can be goodwill existing at the date of divorce that does not relate to post-divorce efforts or earnings.

C. TWO TYPES OF GOODWILL

There are two types of goodwill: “business” goodwill (also called “commercial” goodwill) and “professional” goodwill (also called “personal goodwill”). The importance in this distinction is that professional goodwill is not divisible on divorce and is not to be considered in the valuation of the professional's practice. Only business goodwill is divisible.

1. Business Goodwill. Business goodwill is the business' reputation and ability, as an institution, to attract and hold business even with a change in its ownership. Peat Marwick Main & Co. v. Haass, 818 S.W.2d 381, 389 (Tex. 1991). This type of goodwill can be transfered to a buyer. Business goodwill is different from another intangible asset known as "going-concern" value. "Going-concern" value refers to the intangible value of the physical assets of the business. It is the value of walking into a successful business with equipment, workforce and inventory in place.

   Business goodwill is not concerned with the actual physical assets, but with the excess profits that are created by the continuing business because of reputation, skill, etc. Business goodwill applies to the business as a whole, and is not tied to the individual professional. It is not unusual for a sole proprietorship professional practice to have little or no business goodwill.

2. Professional Goodwill. Professional or "personal" goodwill is associated with the individual professional, not the practice or business as a whole. Because it is personal as to the professional, it cannot be transferred to a buyer. Personal goodwill does not possess value or constitute an asset separate and apart from the person of the professional, or from the professional's ability to practice the profession. Nail v. Nail, 486 S.W.2d 761 (Tex. 1972); Smith v. Smith, 836 S.W.2d 688 (Tex. App.-Houston [1st Dist.] 1992, no writ).

   Personal goodwill is extinguished upon death, retirement, disability, upon the sale of the business, or loss of clients. Nail, 486 S.W.2d at 764. It is based on the professional's individual reputation, training, skill, experience, ability, social contacts and notoriety. If the professional left the current practice for another practice in the same area, it is assumed the clients or patients would follow.

D. DISTINGUISHING BUSINESS GOODWILL FROM PROFESSIONAL GOODWILL

The failure to differentiate and exclude professional or personal goodwill from the value of a business will render the expert's opinion inadmissible. Smith v. Smith, 836 S.W.2d at 690; Parker v. Parker, 897 S.W.2d 918, 933 (Tex. App.- Ft. Worth 1995, no writ.) This is a difficult task, and even more difficult when an individual accrues professional goodwill, while the business or practice accrues business goodwill. Examples of this "mixed" goodwill has occurred in large medical practices (Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex. Civ. App.- Ft. Worth 1975, writ dism'd), as well as other businesses. Since the existence of goodwill is a question of fact, evidence must be presented whether or not professional goodwill exists, and if so, the value of the professional goodwill which must be excluded from the value of the business. Parker, 897 S.W.2d 918. If an expert does not understand the concepts as are applicable to goodwill and professional businesses and/or cannot appraise the business exclusive of professional goodwill, the expert's testimony should be excluded.

As will be discussed in much greater detail below, the courts have looked to several factors in separating professional goodwill and business goodwill. In determining whether business goodwill exists apart from the professional goodwill, the court should consider whether:

*the business name is different from the individual professional. Geesbreght, 570 S.W.2d at 435; Finn v. Finn, 658 S.W.2d 735, 741 (Tex. App.- Dallas 1983, writ ref'd n.r.e.); Hirsch v. Hirsch, 770 S.W.2d 924, 927 (Tex. App.- El Paso 1989, no writ.)

*The business employees many employees. Geesbreght, 570 S.W.2d at 435; Finn, 658 S.W.2d at 741, Rathmell v. Morrison, 732 S.W.2d 6 (Tex. App.- Houston [14th Dist.] 1987, no writ); Finch v. Finch, 825 S.W.2d 218, 224-25 (Tex. App.- Houston [1st Dist.] 1992, no writ).

*The business, not the professional, contracts with customers. Eikenhorst v. Eikenhorst, 746 S.W.2d 882, 888 (Tex. App.- Houston [1st Dist.] 1988, no writ); Simpson v. Simpson, 679 S.W.2d 39, 41 (Tex. App.- Dallas 1984, no writ).

*The business supplies competitive prices and services. Rathmell, 732 S.W.2d 18.

*The business serves many customers, particularly in the absence of direct participation of the professional. Geesbreght, 570 S.W.2d at 435; and Eikenhorst, 746 S.W.2d at 888.

*Business profits are created separate from the income of the individual professional, such as the profits created by the separate billings of other professional, nurse practitioners or legal assistants. See Finn, 658 S.W.2d at 740 and Geesbreght, 570 S.W.2d at 435.

E EXCLUSION OF PROFESSIONAL (PERSONAL) GOODWILL

The Texas Supreme Court has said that, in valuing the practice of an unincorporated professional for purposes of divorce, the Court cannot include the value of goodwill that has accrued to the individual and that is not separate and apart from the individual's person or that individual's ability to practice the profession. Nail v. Nail, 486 S.W.2d 761, 764 (Tex. 1972). Since Nail, courts of appeals have considered the question of goodwill of a professional medical corporation, Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex. Civ. App.--Fort Worth 1978, writ dism'd); goodwill of a law partnership, Finn v. Finn, 658 S.W.2d 735 (Tex. App.--Dallas 1983, no writ); and proceeds from the sale of an accounting practice, including sums paid for goodwill, Austin v. Austin, 619 S.W.2d 290 Tex. Civ. App.--Austin 1981, no writ). These and other cases suggest that goodwill that exists separate and apart from the individual professional is property that can be considered and divided on divorce. Some courts have applied this rationale to nonprofessionals. See Rathmell v. Morrison, 732 S.W.2d 6, 18; Finch v. Finch, 825 S.W.2d 218, 224 (Tex. App.--Houston [1st Dist.] 1992, no writ).

Therefore, it is clear in Texas that the goodwill of a professional based on his personal skill, experience, and reputation is not a community asset or an asset that exists separate and apart from the person. Business appraisals must separately account for personal goodwill. Smith v. Smith, 836 S.W.2d 688 (Tex. App.--Houston [1st Dist.] 1992, no writ).

As discussed in greater detail below, the Dallas Court of Appeals created a two-pronged test to determine whether goodwill is divisible upon divorce. Finn, 658 S.W.2d at 740. In order to have business goodwill, it must:

1) Exist independently of the personal goodwill of the professional; and
2) Have a commercial value in which the community is entitled to share. Id.

Although the Court in Finn found that goodwill existed independent of the lawyer professional, it found that there was no commercial value due to the existence of a partnership buy-sell agreement that restricted the transfer of the lawyer's interest.

The three leading cases in Texas dealing with professional goodwill have addressed each of the three forms of professional practice: sole proprietorship, partnership, and corporation. Therefore, each business form and its treatment of professional goodwill can be examined separately.

F. SOLE PROPRIETORSHIP

1. Generally.

The value of the professional practice of a sole practitioner has a value at least equal to its adjusted book value: the fair market value of the tangible assets (including inventory, receivables, fixtures, furniture, accounts, etc.) less any debts and liabilities. However, in many cases, the most valuable asset of a professional practice operating as a sole proprietorship is its goodwill. Thus, a professional practice operated as a sole proprietorship oftentimes can have value in excess of its adjusted book value due to the goodwill that is attributable to the practice as a "going concern." For example, a business may have a customer base completely unrelated to the professional due to factors separate and apart from the professional, such as the location of the business or a unique product sold by the business. Sole proprietorship professional practices, such as dental, veterinary and accounting practices are frequently sold for more than adjusted book value. This is usually due to factors separate and apart from the professional, i.e. established client base, location, etc.

It is common for a dental practice to be sold for an amount greater than its adjusted book value. Another dentist would pay such a "premium" is for the "purchase" of patients. The assumption is that a certain number of patients will come to the same location to the new dentist after the departure of the selling dentist.

2. Nail v. Nail

The leading case regarding the valuation of the goodwill of a professional practice operated in the form of a sole proprietorship is Nail v. Nail, 486 S.W.2d 761 (Tex. 1972). In Nail, the Texas Supreme Court held that the goodwill of a doctor spouse's medical practice "did not possess or constitute an asset separate and apart from his person, or from his individual ability to practice his profession" and may not be included in the value of his practice.

Dr. Nail was an ophthalmologist who had been operating as a sole proprietor for about 15 years. His wife filed for divorce, and a trial was held before the court. The Texas Supreme Court held:

> "In any event, it cannot be said that the accrued goodwill in the medical practice of Dr. Nail was an earned or vested property right at the time of the divorce or that it qualifies as property subject to division by decree of the court. It did not posses or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in an event of this death, or retirement, or disablement as well as in the event of the sale of his practice or the loss of his patients, whatever the cause . . . That it would have value in the future is no more than an expectancy wholly dependent upon the continuation of existing circumstances. Id. at 764.

3. Austin v. Austin

In Austin v. Austin, 619 S.W.2d 290 (Tex. Civ. App.--Austin 1981, no writ), the Court considered the valuation of the solo professional practice of a certified public accountant and elaborated on the evaluation of goodwill in a solo professional practice. The Court stated:

> The goodwill of an ongoing non-corporate, professional practice is not the type of property that is divisible as community property in a divorce proceeding . . . Once a professional practice is sold, the goodwill is no longer attached to the person of the professional man or woman. The seller's actions will no longer have significant effect on the goodwill. The value of the goodwill is fixed and it is not property that may be divided as community property. Id. at 292.

4. Other Cases

Following Nail, the First District Court of Appeals in Houston threw out an appraisal of the husband's Respiratory Care Services that did not separately account for goodwill. Smith v. Smith, 836 S.W.2d 688 (Tex. App.--Houston [1st Dist.] 1992, no writ). The Court found that "the value of the business would be extinguished in the event of his death, or retirement, or disablement, as well as in the event of the sale of the practice or loss of his patients, whatever the cause." Id. at 690, quoting Nail, 486 S.W.2d at 764.

There has been at least one case where a court found general goodwill in a sole proprietorship. Finch v. Finch, 285 S.W.2d 218 (Tex. App.--Houston [1st Dist.] 1992, no writ). In the Finch case, the husband owned an automobile repair business. He had several employees assist him in the repair work. On appeal, the husband argued that the trial court erred in considering the goodwill of the business. However, the Court of Appeals found that the goodwill that existed was separate from the husband's reputation, skills, and abilities. The Court focused on the fact that much of the work handled at the automotive shop was performed by employees other than the husband. Id. at 224-25.

In Guzman v. Guzman, 827 S.W.2d 445 (Tex. App.--Corpus Christi, 1992, writ den'd 843 S.W.2d 486 (Tex. 1993), the Corpus Christi Court of Appeals followed the Texas Supreme Court 's ruling in Nail and found that the professional goodwill of the husband, the sole owner of a CPA firm, was not marital property subject to division on divorce. However, in a footnote, the Court questioned the fairness of the result. The Court stated that while professional goodwill may not have value separate from the individual, that goodwill could have increased in value during the marriage. The Court suggested that goodwill that arises during the marriage could be determined and should be subject to division by the trial court.

Whether a sole proprietorship has goodwill should be a business-by-business determination. Nail should be limited to cases where the goodwill of the sole proprietorship is totally indistinguishable from the sole proprietor. If goodwill is separate and apart from the person of the sole proprietor, its value should be considered. However, finding that goodwill is separate from the person may be a difficult task. In Hirsch v. Hirsch, 770 S.W.2d 924, 927 (Tex. App.--El Paso 1989, no writ), the Court stated that in cases where a person is conducting business under his name, it is almost impossible to have goodwill independent of the person.

G. PARTNERSHIP

1. Generally.

Valuation of a professional partnership is treated similarly to a sole proprietorship. The practice is worth at least the professional spouse's percentage interest in the adjusted book value of the partnership. Partnership assets include capital contributions, capital accounts, accounts receivable, work in progress, tangible personalty and realty, etc. Further, the goodwill of the partnership must be accounted for in the valuation process.

2. Texas Uniform Partnership Act

The provisions of the Texas Uniform Partnership Act (the "Act"), the Texas Revised Partnership Act (the "Revised Act"), and the actual partnership agreement of the professional practice must be considered in valuing a partnership. The Act is effective for partnerships formed prior to January 1, 1994, until it expires by law on January 1, 1999, except for those pre-1994 partnerships that have expressly elected to have the new law apply.

The sections of the Texas Uniform Partnership Act relevant to valuation are as follows:

> Section 26. Nature of Partner's Interest in the Partnership. A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property for all purposes.
>
> Section 28-A. Extent of Community Property Rights of a Partner's Spouse.
>
> (1) A partner's rights in specific partnership property are not community property.
>
> (2) A partner's interest in the partnership may be community property.
>
> (3) A partner's rights to participate in the management is not community property.
>
> Tex. Rev. Civ. Stat. Ann. Art. 6132b (Vernon 1990).

The Act adopts the "entity" theory of partnership. The rights of a divorcing spouse of a partner attach only to the partnership interest, not to the assets of the partnership. Specific partnership assets belong to the partnership entity, not to either the separate or community estates of the partners. It is error for a court to divide partnership assets in a divorce setting. Jones v. Jones, 699 S.W.2d 583 (Tex. App.--Texarkana 1985, no writ). Under the Revised Act, which applies to partnerships created on or after January 1, 994, and all partnerships as of January 1, 1999, similar rules apply. However, the Revised Act defines a partner's interest less restrictively than the Act, i.e., a "partnership interest" is the partner's interest in the partnership, including the partner's share of profits and losses or to receive distributions.

What is the value of a partnership interest? Section 26 of the Act says that the interest is the partner's share of "profit and surplus." "Profits" are the "net pecuniary gain from a transaction, the gross pecuniary gains diminished by the cost of obtaining them." Miller v. Lone Star Tavern, 593 SW.2d 341 (Tex. Civ. App.--Waco 1979, no writ). "Surplus" is defined as the excess of assets over liabilities. Bader v. Cox, 701 S.W.2d 677 (Tex. App.--Dallas 1985, no writ). Obviously the Act's definition of a partnership interest does not account for the possible value of goodwill.

The value of an interest in a partnership can be determined in part by reference to its underlying assets. Thus, a starting point in valuation should be adjusted book value. Whether partnership goodwill should also be considered will be determined by the facts and circumstances of the particular business. Its value, as always, has no precise standard for measurement.

The applicable partnership agreement, under the law of contracts, also governs the rights of partners. See Dobson v. Dobson, 594 S.W.2d 177, 180 (Tex. App.- Houston [1st Dist.] 1980, wirt ref'd n.r.e.).

3. Finn v. Finn

The leading case regarding the valuation of the goodwill of a professional practice operated in the form of a partnership is Finn v. Finn, 658 S.W.2d 735 Tex. App.--Dallas 1983, writ ref'd n.r.e.). In Finn, personal goodwill is distinguished from the general goodwill associated with a business which does not bear the name of the individual and has goodwill generated by the other participants. Finn v. Finn, 658 S.W.2d 735 Tex. App.--Dallas 1983, writ ref'd n.r.e.); See also Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex. Civ. App.--Fort Worth 1978, writ dism'd).

The Finn Court established a two-prong test for determining whether goodwill should be included or excluded in the value of a marital asset:

(1) Determine whether goodwill exists independently of the personal ability of the professional spouse.

(2) If the first step is satisfied and such goodwill is found to exist, then determine whether that goodwill has commercial value in which community estate is entitled to share. Id. at 741.

During the marriage, the husband practiced law with a prominent Dallas law firm. The law practice was structured as a partnership in which the husband had been a senior partner for over ten years. Under the terms of the partnership agreement, if the husband died or withdrew from the partnership, he was only entitled to (1) the amount contributed in his capital account; (2) any earned income which had not been distributed; and (3) his interest in the firm's reserve account less ten percent (10%) of his proportionate share in the accounts receivable for client's disbursement. The agreement did not provide for compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill.

In Finn, the court found that the first prong of the test was met. However, when it turned to addressing the second prong of the test, the court was confronted with a partnership agreement that stated that the withdrawing partner was entitled to no value attributable to partnership goodwill, the goodwill independent from the individual professional. The Court found that the restrictions in the husband's partnership agreement deprived him of any legal entitlement to the value of the firm's goodwill. Thus, the goodwill attributable to the husband's partnership interest was not divisible upon divorce. Finding that the party was bound by the partnership agreement, the second prong of the Finn doctrine could not be met and therefore there was no commercial value in the goodwill in which the community estate had an interest.

In a concurring opinion, Justice Annette Stewart strongly disagreed with the majority opinion in Finn:

> "The partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership, not his contractual death benefits or withdrawal rights... The value

> of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any.... Id. at 749.

The Finn case raises the question: does a partnership agreement govern the rights of the non-partner spouse in the value of the partnership?

4. Taormina v. Culicchia.

In Taormina v. Culicchia, 355 S.W.2d 569 (Tex. Civ. App.--El Paso 1962, writ ref'd n.r.e.), the Court allowed a recovery for goodwill upon the dissolution of a partnership even though the partnership agreement did not expressly provide for it. The partnership agreement, which terminated the partnership by its own terms, had no provisions for the distribution of the partnership' assets on termination, and the issue of goodwill was determined under principles applicable in the absence of definite agreement. In Taormina, the Court found that goodwill existed separate and apart form the individual partners when the former partners continued business in the same place with the same name and continued use of trademarks and brands after dissolution of the partnership.

5. Keith v. Keith

In Keith v. Keith, 763 S.W.2d 950 (Tex. App.--Fort Worth 1989, no writ), the Fort Worth Court of Appeals rejected the reasoning of the Finn majority opinion, and adopted the rationale of the concurring opinion. The Court did not accept the restrictive provisions in a partnership agreement containing a formula to calculate the partner's interest upon termination. The Court noted that since the partnership was not being terminated, the formula in the agreement was not relevant to the determination of its value in the context of the divorce of the parties. Id. at 953.

The conflict between the Finn case and the Keith case has yet to be resolved. Neither of these cases contained a partnership agreement that specifically included a provision stating a divorce to be an event of withdrawal, which is allowed under the Texas Revised Partnership Act. If a partnership agreement contains language related to divorce, and the non-partner spouse knowingly and voluntarily signs the agreement, the Finn two-prong test should determine that there is no commercial value and therefore no business goodwill. This situation, in this author’s opinion, should be distinguishable from the Keith case. Further, the rationale of the Finn two-prong test is valid. If the express terms of the partnership agreement put into play the value contained in the partnership agreement, the agreement should control and the rationale of the Keith court should not apply.

H. CLOSELY-HELD CORPORATIONS

Ownership in a corporation is determined by the number of shares owned, and the value to a particular shareholder is determined by the value of the shares of stock owned.

1. Geesbreght v. Geesbreght

The leading case relating to the valuation of the goodwill of a professional practice operated as a closely-held corporation is Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex. Civ. App.--Fort Worth 1978, writ dism'd). Geesbreght involved a doctor in a professional corporation -- an emergency medical practice. Dr. Geesbreght and another doctor formed a professional corporation called Emergency Medicine Consultants. Each doctor owned 50% of the stock as the only shareholders in the company. Ultimately, the corporation was supplying hospital emergency room services by other physicians in its employ at eight different locations and was grossing more than $1 million annually. On Dr. Geesbreght's divorce, the value of his interest in the professional corporation was at issue.

The Court in Geesbreght distinguished the case from Nail and held that the value of the stock in Emergency Medicine Consultants was enhanced by goodwill separate and apart from the person of Dr. Geesbreght. The Court stated:

> "Goodwill" is sometimes difficult to define. In a personal service enterprise such as that of a professional person or firm, there is a difference in what it means as applied to "John Doe" and as applied to "The Doe Corporation" or "The Doe Company." If "John Doe" builds up a reputation for service it is personal to him. If "The Doe Company" builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business

> but the sale of such business naturally involves the right to continue the business as "The Doe Company." The "goodwill" built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the "goodwill" of customer clients of the former operators. Id. at 435.

The Texas Supreme Court recently expressly endorsed Geesbreght in Salinas v. Rafati, 948 S.W.2d 286 (Tex. 1997).

2. Rathmell v. Rathmell

In Rathmell v. Morrison, 732 S.W.2d 6 (Tex. App.--Houston [14th Dist.] 1987, no writ), the Houston Court of Appeals expanded upon the usual concept of professional goodwill.

The Court compared the personal goodwill of the husband, who was the key man in two insurance agencies, with the professionals in Nail, Geesbreght, and Finn:

> "Appellant is not a lawyer or a doctor, as were the professionals in Nail, Geesbreght, and Finn. Nevertheless, it is clear that appellant did develop professional goodwill as the term is used in Nail. The Rathmell companies specialized in providing insurance to large businesses and associations. Several witnesses testified that the key to financial success of the Rathmell companies was John's personality, social contact, and specialized knowledge of the problems and solutions peculiar to insuring businesses and associations. Personality and social contacts are important in business because they help "get a foot in the door." specialized knowledge is needed to get customers the right kind of insurance for a good price. It is undisputed that John was the major "producer" in the companies, meaning he brought in most of the customers. The goodwill that arose because of these attributes in John attached as a result of confidence in his skill and ability, and did not possess value or constitute an asset separate and apart from John's person or his individual ability to practice his profession, and would be extinguished if he died, or retired, or disabled. Id. at 18.

The Court found that the trier of fact must take into account, in connection with valuing the business, what portion of total value is attributed to the following:

a. Personal goodwill of the spouse;
b. Time, toil and talent of the spouse to be expended after the divorce; and/or
c. The spouse's willingness to enter into a non-competition agreement.

The Court stated:

> "We hold that in finding the value of the Rathmell companies the trial court should have excluded value attributable to the factors listed. If the value found by the court did exclude such factors, the court should have so stated in additional findings of fact. Without such additional findings, it is impossible to determine whether the trial court included or excluded them. In making this ruling, we are not saying that the trial court should find a value including the above-listed factors and then make separate findings of what portion of such value is attributable to each factor. It is only necessary that the trial court's findings show clearly that the value found by the court excluded such factors. Id. at 18.

These adjustments must be made to a valuation. The expert may approach the valuation of the closely held business as he would any other, however, these particular factors must be separately evaluated and taken into account in his testimony as to the value of a business in the divorce context. Again, it should be pointed out that an appraisal or valuation is generally done in the context of a sale of the business and in most divorce situations the business will not be sold but rather must be appraised for the value it contributes to the marital estate.

3. Hirsch v. Hirsch

In Hirsch v. Hirsch, 770 S.W. 2d 924, 927 (Tex. App.--El Paso 1989, no writ), the Court found that in the instance where a single person was conducting business in his professional name, it was almost impossible to have goodwill independent of the person. Hirsch involved a practicing attorney in a professional association. He was the sole owner. The Court focused on the two-prong test established by Finn v. Finn and held that the first prong of the Finn doctrine could not be met. The Court stated:

> It has become relatively clear that goodwill is not to be included or considered when placing a value on a professional corporation unless it can be determined first, that the goodwill exists independently of the personal ability of the professional person, and second, that if such goodwill does not exist, it has commercial value in which the community estate is entitled to share... Where the entity is a one person professional corporation conducting a business in that person's name it would be difficult to get past the first prong of the test. In this case, there is no evidence that goodwill existed independently of Appellant. Id. at 927. (Emphasis added).

I. SHAREHOLDER'S BUY-SELL AGREEMENT

It is common for the shareholders in a closely-held or professional corporation to execute a shareholder's buy-sell agreement. The terms of such an agreement are similar to the terms contained in a partnership buy-sell agreement, so the analysis and discussion in the sections on partnerships and Finn would apply to corporations.

An important distinction, however, is that a partnership can be terminated by a partner, and upon withdrawal, the partnership entity ceases to exist. In a corporation, a minority shareholder cannot easily dissolve the corporation. If a shareholder wants to sell his or her stock, and withdraw from ownership in the corporation, the corporation entity does not cease to exist. In many buy-sell agreements, the corporation is a party to the agreement and has the right to repurchase the stock from the withdrawing shareholder.

J. THE IMPACT OF SALINAS V. RAFATI

Although not a family law case, the Texas Supreme Court in Salinas v. Rafati, 948 S.W.2d 286 (Tex. 1997), specifically addressed the issue of whether a dissolved partner is entitled to the professional goodwill of the remaining partners in an accounting for the dissolution of the partnership. In Salinas, upon dissolution of a professional partnership of radiologists and the formation of a new partnership by two of the former partners, the plaintiff (the third of the partners) sued his former partners, alleging a breach of fiduciary duty and wrongful dissolution, and that he had not been fully paid for his share of the partnership. The Supreme Court held that earning capacity of former members of a partnership was personal to each of them and was not a partnership asset divisible upon dissolution. Id. at 288.

The Supreme Court held that to the extent that the valuation of the dissolved partnership was based on the goodwill attributable to the personal skills and talents of the former partners, it improperly took into account intangibles that were not partnership assets. Id. at 289. The Supreme Court stated that the plaintiff's attempt to harness the future earning capacity of the former partners highlighted "the incongruity of a rule of law that would allow a partner to recover a share of a former partner's ability to generate income under the guise of goodwill." Id. at 291. The Supreme Court commented favorably on Geesbreght v. Geesbreght, 570 S.W.2d 427 (Tex. App.--Fort Worth 1978, writ dism'd). Logically, Salinas would require that the professional goodwill of shareholders must be excluded in the valuation of the commercial goodwill of a corporation.

K. VALUATION OF GOODWILL

As an element of the assets of the business entity, goodwill may be valued by using several methods. A common method is capitalization of excess earnings. This method is recognized in Revenue Rulings 59-60 and 68-608. It computes goodwill by capitalizing earnings which exceed the average rate of return within the business.

Business goodwill for divorce valuation purposes is the reasonable value, in the hands of the current business owner, of the average excess earnings of the business, at the valuation date, based exclusively on the historical earnings of the business and without reference to projected future earnings. The excess earnings of the business are those earnings in excess of a reasonable return on the cost of tangible property of the business that represent a value attributable to the intangible goodwill existing at the date of valuation. The value of the business goodwill is determined by capitalizing the excess earnings by an appropriate rate which represents a reasonable value for the excess earnings capacity of the business developed during the marital period and existing at the date of divorce.

Notice that this definition excludes post-divorce earnings from consideration in the valuation process. Further, the value of the goodwill is not made with reference to a willing buyer. Rather, the reference is in the value of the hands of the present owner. The presumption is that the goodwill existing on the date of divorce was developed during the marriage and is manifested by the ability of the business to currently earn an income in excess of a mere return on the investment of the tangible business property. The goodwill is measured on the basis of historical excess earnings and reflects the concept that goodwill represents some advantage currently possessed by the business, as shown by its historical ability to earn income in excess of that which would be earned if the owner had invested intangible property and leased it to other businesses.

At least two Texas cases have approved the use of the capitalization of excess earnings approach to value a closely-held business' intangible assets. See Morgan v. Morgan, 657 S.W.2d 484 (Tex. Civ. App. --Houston [1st Dist.] 1983, writ dism'd); Taormina v. Culicchia, 355 S.W.2d 569 (Tex. Civ. App.--El Paso 1962, writ ref'd n.r.e.)

As discussed above, separating goodwill and commercial goodwill depends on the circumstances of the business and the owner spouse. Texas case law requires a business appraiser to separate profession commercial goodwill by distinguishing the future earnings of the company that the community estate is entitled to share from the earnings that are tied to the professional spouse.

VII. **ADJUSTMENT FACTORS**

In determining value, by whatever method is used, adjustments may have to be made by the expert in order to set a more accurate value. The following are some common adjustments that can be made in valuing a business.

A. “LACK OF MARKETABILITY” DISCOUNT

An adjustment associated with the closely-held business and professional practice is the lack of marketability discount. The lack of marketability discount has emerged due to the recognition of the fact that there is little or no market for the stock of a closely-held corporation. The lack of marketability discount is recognized in the IRS Valuation Guide and used consistently by the courts. The discount is based upon the absence of a ready or existing market for the sale or purchase of the asset being valued. Obviously, willing buyers prefer an asset which is easy to sell.

According to this doctrine, the fair market value of a closely-held business is calculated according to established valuation criteria, then discounted for its lack of marketability. The discount may be a percentage of fair market value or a determination of the cost of creating the marketability for the closely-held business being evaluated. Wallace v. United States, 556 F. Supp. 904 (D. Mass. 1981); Estate of O'Connell v. Commissioner, 37 T.C.M. (CCH) 82 (1978). There is no general rule regarding the size of the permissible lack of marketability discount. Generally, it has ranged from 20 to 35 percent. Id.

Tax cases have consistently allowed substantial marketability discounts in valuing interests in corporations that own investment assets or that constitute operating entities. Estate of Albert L. Dougherty, T.C. Memo. 1990-274 (35% marketability discount on valuing stock of holding company holding real estate and other non-liquid assets); Estate of Mark S. Gallo, T.C. Memo. 1985-363 (36% "illiquidity" discount for 2% interest in stock of wine-making company); Estate of Clara S. Roeder Winkler, T.C.Memo. 1989-231 (voting stock in oil refinery business valued using 25% lack of marketability discount, and an additional 20% minority discount allowed for valuing nonvoting stock).

B. MINORITY DISCOUNT

The minority discount reflects the minority interest owner's inability to control dividend payments, company policy or liquidation of company assets. Estate of Estate of Newhouse v. Commissioner, 94 T.C. 103, 203 (1990).

Revenue Ruling 81-253 sets forth the Internal Revenue Service's position concerning the allowance of minority discounts in valuing the stock of closely-held family corporations. Ordinarily, no minority discount will be allowed with respect to stock transfers among family members where control of the corporation exists within the family at the time of the transfer. But if there is evidence that the family would not act as a unit in controlling the business, a minority discount may be allowed. Revenue Ruling 81-253.

The size of minority discount may vary, and the courts have allowed a 20 to 35 percent discount for minority ownership. Ward v. Commissioner, 87 T.C. 78 (1986)(33 1/3%); Northern Trust Co. v. Commissioner, 87 T.C. 349 (1986)(25%). Discounts for minority and lack of marketability have been allowed. Estate of Newhouse v. Commissioner, 94 T.C. Memo. 103, 203 (1990).

Estate of Jung v. IRS, 101 T.C. Memo. 412, 434 (1993), defines minority and marketability discounts as follows:

> Conceptually, (1) a minority discount reflects a minority shareholder's inability to compel liquidation and this inability to realize a pro rata portion of the corporation's net assets value, while (2) a marketability discount reflects the hypothetical buyer's concern that there will not be a ready market when that buyer

decides to sell the stock. Each of these prospects (lack of control and lack of ready market) is likely to depress the price that a hypothetical buyer is likely to be willing to pay for the stock. Although we analyze them separately, it is likely that there is a significant real-world overlap between these two discounts.

C. CONTROLLING INTEREST PREMIUM

If a party holds a controlling interest, valuation of the controlling party's interest may include a premium, or increase in value. Estate of Salsbury v. Commissioner, 34 T.C.M. 1441 (1975). In Estate of Salsbury, the Tax Court stated:

> [T]he payment of a premium for the control is based on the principle that the per share value of minority interest is less than the per share value of a controlling interest. A premium for control is generally expressed as the percentage by which the amount paid for a controlling block of stock exceeds the amount which would have otherwise been paid for the stock if sold as minority interests and is not based on a percentage of value of stock held by all or a particular class of minority stockholders. Id. at 1451.

In Estate of Chenweth v. Commissioner, 88 T.C. 1577, 1581 (1987), the Tax Court noted when more than one adjustment is made, the calculation must result in a realistic appraisal overall. "...[T]he sum of the parts cannot equal more than the whole, that is, the majority block together with the control premium, when added to the minority block of the company's stock with an appropriate discount for minority interest, should not equal more than the total 100 percent interest..."

The realities of corporate control and its effect on value was recognized in Beavers, 675 S.W.2d at 299.

D. COVENANT NOT TO COMPETE EXCLUSION

If a partner or shareholder has executed an agreement that contains a covenant not to compete if he or she leaves, the value of that agreement not to compete with the business is to be excluded from the value of the business. Rathmell v. Morrison; 732 S.W.2d at 18.

Regarding covenants not to compete, Shannon Pratt writes:

"Two types of assets are frequently created specifically for the

> purpose of facilitating the sale of a business or professional practice. These two types of intangible assets include covenants not to compete and employment agreements.
>
> We would estimate that in well over one-half of the sales of small businesses and professional practices, the seller provides the buyer with a covenant not to compete.
>
> Many small businesses and professional practices would have little or no value without such agreements."

A controversy exists between the appraisal community and the legal community on this topic. The appraisal community believes that a covenant not to compete is the same thing as goodwill and not based on future earnings. Rather, it is protection afforded the buyer that the seller will not destroy the sold business.

On the other hand, the legal community's position was reflected in Dillon v. Anderson, 358 S.W.2d 694 (Tex. Civ. App.--Dallas 1962, writ ref'd n.r.e.). A covenant not to compete is compensation for future earnings of the covenanting spouse. The focus is on the time of payment and transactional form instead of the underlying cause and substance.

The Court in Rathmell v. Morrison, discussed above, identified this additional factor which is authority for the proposition that a covenant not to compete should be excluded from the valuation of a business entity, on the grounds that it represents personal goodwill and thus cannot be divided by the trial court.

It should be noted that a trial court may not order a covenant not to compete provision as a part of its divorce decree. Ulmer v. Ulmer, 717 S.W.2d 665 (Tex. App.--Texarkana 1968, no writ). Such an injunction would deprive an individual of the ability to practice his or her profession, which is part of the definition of professional goodwill.

VIII. **CONCLUSION**

When valuing a closely-held business, it is essential to have a thorough knowledge of the measures of value, the methods of valuation and Texas case law. The valuation of professional practices requires a clear understanding of professional goodwill, whether the practice is a sole proprietorship, partnership or corporation. Finally, there may be a need for adjustments to the apparent value of a business due to its lack of marketability, the size of the interest (minority or majority), and the existence or non-existence of a covenant not to compete.

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DOCUMENT AND INFORMATION CHECKLIST
FOR VALUATION OF CLOSELY-HELD BUSINESSES

I. <u>Company Documents</u>

1. If a corporation, Articles of Incorporation, By-Laws, any amendments to either and corporate minutes. It will be rare that anything of real use will be found here, but these documents should be examined. Occasionally, transfers of stock or buy-sell agreements will be noted in the minutes just prior to a divorce, and the timing of these documents may be suspect.

2. If a partnership, partnership agreement, with any amendments.

3. Buy/sell agreements, options to purchase stock or partnership interest, or rights of first refusal. The further removed the date of execution of the agreement from the divorce action, the more likely it is to be fair. Depending upon the resolution of the conflict between the views of the majority in <u>Finn</u> and the view of <u>Keith</u>, such agreements may be determinative of the value or ignored. Presently such agreements can be viewed under either position.

4. Original Purchase Documents. These are useful if the business owner recently acquired assets or even the entire business. They can provide information for a starting point for the value of major assets.

II. <u>Financial Statements</u>

1. Balance sheets, profit and loss statements, income statements, statements of changes in financial position, and statements of stockholders' equity or partners' capital accounts for up to the last five fiscal years, if available, budgets and ledgers.

   Most businesses will maintain these monthly or quarterly reports that provide basic information as to the fixed assets, debts, receivables, income and expenses of the business. Find out whether the business internally prepared the reports or whether they are prepared by an "independent" accountant. These reports should be compared to the tax returns for the business.

2. Individual Partnership and Corporate income tax returns. These should be compared with other accounting records of the business, and all depreciation and amotorization schedules should be reviewed.

3. Latest interim statements if valuation date is 90 days or more beyond end of last fiscal year and interim statements for the comparable period the year before.

4. List of subsidiaries and/or financial interests in other companies, with relevant financial statements.

III. Other Financial Data

1. Equipment list and depreciation schedule.

2. Aged accounts receivable and payable list at last fiscal year end and latest interim statement.

3. List of prepaid expenses.

4. Inventory list, with any necessary information as to inventory accounting policies (including work in progress, if applicable).

5. Leases of real estate and equipment. If a lease does not exist or is not transferable, determine when the new lease or rental terms will be. Favorable lease terms may add value to the intangible assets of a business.

6. Any existing contracts (employment agreements, covenants not to compete, supplier and franchise agreements, customer agreements, royalty agreements, equipment lease or rental contracts, loan agreements, labor contracts, employee benefit plans, and so on).

7. List of stockbrokers or partners, with number of shares owned by each or percentage of each partner’s interest in earnings and capital.

8. Compensation schedule for owners, including all benefits and personal expenses.

9. Schedule of insurance in force (key-man life, property & casualty, liability).

10. Budgets or projections, if available.

IV. Other Information

1. Loan applications and financial statements.

2. Personal property tax renditions. Every year the county tax appraisal office sends all businesses a form requiring businesses to declare the year of purchase and price of its fixed assets. It is optional for the business to declare its opinion on current value. These records may provide a starting point to value fixed assets, but the values are usually low for obvious reasons.

3. Real estate tax rolls.

4. Brief history, including how long in business and details of any changes in ownership and/or bonafide offers received.

5. Brief description of business, including position relative to competition and any factors that make the business unique.

6. Marketing literature (catalogs, brochures, advertisements, and so on).

7. List of locations where company operates, with size, and whether owned or leased.

8. List of states in which licensed to do business.

9. If customer or supplier base concentrated, list of major accounts, with annual dollar volume for each.

10. Resumes of, or list of, key personnel, with age, position, compensation, length of service, education, prior experience.

11. Trade associations to which company belongs or would be eligible for membership.

12. Relevant trade or government publications.

13. Any existing indicators of asset values, including latest property tax assessments and any appraisals that have been done.

14. List of patents, copyrights, trademarks, and other intangible assets.

15. Any contingent or off balance sheet assets or liabilities (pending lawsuits, compliance requirements, warranty or other produce liability, and so on).

16. Any filings or correpondence with regulatory agencies.

17. Information on prior stock or equity transactions.

18. Grantee-Grantor Indexes. It may be worth it to hire a title search company to look into deed records for real estate bought or sold in past years. The search could be concluded in an individual's name as well as business names.

19. Commerical Property and Disability Insurance policy documents. A review of the declarations of the value of fixed assets and income for insurance purposes may be helpful. The source documents used by the business when the application for the insurance was submitted should be obtained.