BUSINESS VALUATION

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Some divorces present the challenge of determining the fair market value of a closely held business. 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.

Terminology

"Fair 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. *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

The "book value" of a company is the value shown by the books of a business, which are kept in compliance with GAAP, in the absence of an agreement otherwise. *Chaffe v. Murray*, 492 S.W. 2d 680, 684 (Tex. Civ. App.—Corpus Christi 1973, writ ref'd n.r.e). Specifically, the term "book value" means the value of a corporation that is arrived at by taking the total value of the assets as shown on the books and deducting therefrom the total liabilities. *Id*. Book value has limited application, if any, in determining the value of stock in a small, closely held corporation.

A "closely held" corporation is a company whose shares are not publicly traded, like Apple, Inc. The stock markets set the price for publicly traded corporations. However, for smaller closely held businesses, an accountant trained in valuing businesses must apply the vague and uncertain art of the business appraisal. There are several generally accepted methods for placing a value on a business; however, ten "experts" valuing the same company might come up with ten different values and they might use three or four different methods for determining the value.

A Company Is Almost Always Worth More Than Book Value

Book value carries very little weight in determining the present value of closely held corporate stock. The Texas Supreme Court has stated,"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..." *Bendalin v. Delgado*, 406 S.W.2d 897, 900 (Tex. 1966). 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 book value should rarely, if ever, be used to value a company.

Adjusted book value is a better indicator of a company's real worth. 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 usually insignificant. The value of such a business is in its earning capacity which is not an element of adjusted book value.

Documents and Information the Appraiser Needs

If you were thinking of buying a business, there would be basic information and documentation that you, your accountant and your banker would require before making a decision on how much to offer for the businesses:

1. A detailed description of the business: its history, what the business does, its market, its competitors, its key employees, customers and suppliers
2. Balance sheet for each quarter for the past three to five years (depending on how long the company has been in existence)
3. Income statements (profit and loss reports) for each quarter for the past three to five years (depending on how long the company has been in existence)
4. Company tax returns for the last 5 years
5. Discussion of any IRS scrutiny or audits of the company and the results of those audits
6. Detailed general ledger report for the current and prior year
7. Financial forecasts, if available
8. The company's legal type and ownership structure, including owners and percentages of ownership
9. Important contracts binding the company or owners, such as franchise agreements or buy-sell agreements between the owners
10. Information on recent sales of ownership interest in the company
11. If a professional license is required to own or work in the business
12. All pending litigation and claims by or against the company
13. Current monthly payroll data - number of employees and their functions
14. Information on how many hours the business owner who is selling works on the company, his or her pay, whether his or her personal expenses are being paid through the company and what benefits he or she receives from the company (e.g. - company car, health insurance, etc)
15. A summary of product inventory amounts for each product (from physical inventory) for the past three years
16. Payment history of customers, including an accounts receivable aging report, for the past three years
17. Information on employee benefit plans and costs
18. Information on contracts with top executives and managers
19. Information on obligations for retirement plans, profit sharing, stock options and bonuses
20. Listing of all intellectual property - patents, copyrights, trademarks/service marks - and all license agreements
21. A listing of all business advisers - attorney, CPA, consultants and any contracts or retainers.

A forensic accountant assigned to value a business in a divorce would want all of the above information. A very small business, such as a solo real estate appraisal business, would not have many of the above documents simply because they just do not apply to such a small business. A family owned business with $120 million in sales and 300 employees might require many boxes to supply all of the above documents. The above list of basic documents and information can be obtained via: informal discovery and/or a Rule 11 agreement to provide it, discovery in a request for production, a subpoena to produce documents served on the corporation President or CPA and depositions.

Often, the business appraiser will want to visit the business and meet with the business owner and management.

In most cases involving a business that must be appraised, the attorneys each realize what information is needed and must be provided. The attorneys should usually agree on a deadline and method for producing the documents. Each spouse can hire his or her own business appraiser or they can save money by agreeing on one accountant to perform the appraisal.

Rules for Appraising a Business Regardless of the Valuation Method(s) Used

A forensic accountant working on a divorce in Texas must follow these rules, regardless of the method or methods used to value the business:

1. Do <u>not</u> include the value of personal goodwill but <u>do</u> include the business goodwill.

The Texas Supreme Court in *Nail v. Nail*, 486 S.W.2d 761 (Tex.1972), held that the goodwill that attaches to a professional person because of confidence in the skill and ability of the individual cannot be divided in a divorce. *Nail* involved a physician in solo practice. *Geesbreght v. Geesbreght*, 570 S.W.2d 427, 435-6 (Tex. Civ. App.—Fort Worth 1978, writ dism'd) said that the business goodwill that is separate from the reputation of the physician owner can be valued in a divorce. There, the physician husband owned 50% of a professional corporation that provided ten full-time and 50 to 100 part-time physicians to staff hospital emergency rooms. The court of appeals said:

> *"Good will" 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 in business as "The Doe Company". The "good will" 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 "good will" of customer clients of the former operators.*

Geesbreght, 570 S.W.2d at 435.

In other words, the reputation and good name of the spouse who owns the business might go away if he sold his interest, but the general reputation and business goodwill of the company would still be an asset of value to a prospective buyer.

Finn v. Finn, 658 S.W.2d 735, 741 (Tex. App.—Dallas 1983, writ ref'd n.r.e.) provides the test to be followed in a divorce for determining business goodwill and applied the test to a large law firm.

> *Read together, <u>Nail</u> and <u>Geesbreght</u> indicate a two-pronged test to determine whether the goodwill attached to a professional practice is subject to division upon divorce. First, goodwill must be determined to exist independently of the personal ability of the professional spouse. Second, if such goodwill is found to exist, then it must be determined whether that goodwill has a commercial value in which the community estate is entitled to share.*
>
> *Evidence in the present case indicates that the husband's law firm has goodwill independent of his professional ability. Like the professional corporation in <u>Geesbreght,</u> the firm does not conduct business under the names of the senior partners, but rather operates under the names of two founding partners no longer practicing with the firm. The record reflects that at the time of trial the law firm consisted of twenty senior partners, twenty-two junior partners and forty-three associates. The husband has been practicing law with the firm for over twenty-five years; however, the firm has been providing legal services to the public for more than ninety years. A large part of the firm's reputation for providing services was built upon the professional abilities of the husband's predecessors in the firm as well as the*

abilities of his present partners and professional employees. Under these circumstances we recognize that the firm has goodwill independent and apart from the professional ability of the husband.

Hirsch v. Hirsch, 770 S.W.2d 924, 927 (Tex. App.—El Paso 1989, no writ) said that if the business is a one person professional corporation conducting a business in that person's name, then it would be hard to get past the first prong of the *Finn* test and ever prove that there was any goodwill independent of the business owner.

2. **The total value of the company has to be discounted if the spouse owns a minority interest in the company and also discounted for lack of marketability.**

Assume the appraiser of Sally Green's one-third ownership of an accounting firm values the entire business at $900,000. Sally's one-third interest would be worth $300,000 but that value has to be further reduced because of a lack of marketability (there is not a fluid market for selling stock in small accounting firms) and because Sally is a minority shareholder. In Texas, a minority shareholder has few rights other than to inspect the company books and to vote for directors. In contrast, a 75% shareholder effectively controls the corporation and the value of a 75% interest would not be reduced for lack of control.

A very recent case from the Dallas Court of Appeals said:

> *...the report of Alan Tolmas (another appraiser Ann hired) examined several studies of lack of marketability and minority interest discounts and stated, "From these studies, certain generalizations can be implied. For example, the lack of marketability discounts for minority interest fall between 13%-45% and average approximately 29%." Donald Latin [another expert] testified that an appropriate discount for lack of control would be between 5%-30%, and an appropriate discount for lack of marketability would be 30%.*

Ritchie v. Rupe III 1995, __ S.W.3d __ (Tex. App.— Dallas 2011)(No. 05-08-00615-CV)(March 28, 2011).

These discounts can significantly reduce the value of a company. Assume that Jose owns a 25% interest in a business and the accountant values the total business at $200,000. Jose's 25% would be $50,000, but a 30% reduction for marketability and another 30% reduction for owning a minority interest would reduce the value of Jose's interest to $22,197.

3. A buy-sell agreement can effect or even determine the value of an interest in a business.

Small businesses with more than one owner very often have each shareholder or partner sign an agreement that says if the shareholder dies, quits, is fired or is divorced, the company buys back the owner's interest at a set price or according to a fixed equation. These buy-sell agreements can affect or even determine the value to be assigned a spouse's interest in a business.

Two questions should be answered in analyzing the effect of such a buy-sell agreement in light of Texas appellate cases:

1. Is the business a partnership or a corporation?

2. Does the agreement address valuation in the event of divorce or only in the event of a shareholder or partner dying or otherwise leaving the firm?

Mandell v. Mandell, 310 S.W.3d 531(Tex. App.—Fort Worth 2010, no pet.) is the key case if the business is a corporation and if the agreement addresses valuation in the event of divorce. *Mandell* involved a husband physician who owned one-fourth of an oncology-hematology professional association. The husband had signed a stock purchase agreement that sold the husband 22,000 shares at 50 cents each. The stock purchase agreement also required the husband and his wife to sign a shareholders agreement which said that in the event of divorce, the shareholder would have to sell his stock back to the professional association for the same 50 cents per share. Neither the husband or wife signed the shareholder agreement but the trial court ruled that the stock purchase agreement made the unsigned shareholders agreement valid and enforceable against the wife.[1] The trial court excluded the wife's expert who would have testified that the husband's 25% interest was worth $794,000 or $1.1 million or $ 943,000 defending on the method used. The trial court valued the husband's interest at $11,000 per the unsigned shareholder's agreement.

The Court of Appeals affirmed and said:

> *...Susan also contends that she is not bound by the "buy-sell provision in the Shareholders Agreement setting the stock's value at $.50 per share because she never signed the Shareholders Agreement and that, accordingly, the trial court abused its discretion by determining that as a matter of law Lance's 22,000 shares of the Association were valued at $11,000. It is undisputed that every shareholder of the Association paid $11,000 for their 22,000 shares of stock when the stock was issued to them and that every shareholder that left the Association was paid $11,000 for the Association to repurchase their 22,000 shares of stock. It is undisputed that Lance and Susan's community estate paid $11,000 to the Association for the issuance of Lance's 22,000 shares of stock. And finally, it is undisputed that Lance can never sell his 22,000 shares of stock for more than $11,000; the stock's value in the closely held Association is contractually set at $11,000. Nonetheless, Susan claims the stock should be valued at either $794,000 (book value under GAAP); $1,100,100 (fair market value considering Association equity as a stand alone business); or $943,000 (fair market value considering Association equity as a component of Matrix).* ***But Susan cites no authority for the proposition that a community asset (22,000 shares of the Association's stock) which is to be divided in a divorce, may have one monetary value as to one spouse ($11,000 as to Lance) and a wholly different value to the other spouse ($794,000, $1,100,100, or $943,400 as to Susan). Nor have we located any such authority.*** *Because the evidence establishes the "comparable sales value" for Lance's 22,000 shares of the Association's stock was $11,000 based on prior sales by former physician-shareholders and because $11,000 is the only price that Lance's stock may be sold at, the trial court did not abuse its discretion by valuing the stock at $11,000 under a comparable sales valuation and as mandated by the Shareholders Agreement even though Susan did not sign it.*

Mandell, 310 S.W.3d at 540 (emphasis added).

So, what value should a divorce court place on shared in a closely held corporation that are controlled by a shareholder buy-back agreement? First, the value should certainly include the price the shareholder is promised under the shareholder agreement. In addition, the trial court can consider the value of the property interest to the owner, as explained in *Mandell*:

> *A straight fair market value is not an appropriate valuation method, however, when a community estate owns shares in a closely held corporation and, by agreement, any sale of the shares of stock is restricted to the corporation or other stockholders. When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. In this situation, the parties may show the actual value of the property interest to the owner. Such evidence might include the value of being able, by virtue of ownership of the closely held stock, to drive a new automobile, to have health insurance paid for by the company, to have a company-financed life insurance policy, to belong to a county club at company expense, and other similar financial benefits.*

Mandell, 310 S.W.3d at 537.

This is basically intrinsic value, which is,"the actual monetary value of the property's use to the owner." *Crisp v. Security Nat'l Ins. Co.*, 369 S.W.2d 326, 328 (Tex.1963). Evidence of a property's intrinsic value can be presented when the property has no fair market value. *City of Austin v. Canizzo*, 267 S.W.2d 808, 812

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[1] Actually, the professional association (after the wife filed for divorce) refunded the husband the $11,000 and said since you and your spouse never signed the shareholder agreement, you never bought your shares. The wife sued the Professional association which filed and won a summary judgment that the shareholder agreement was enforceable. The Professional association and the wife then settled and the 22,000 shares were re-issued.

(Tex.1954). The Texas Pattern Jury Charge 2010, Family, PJC 203.1 instructs the jury:

> *The value of an asset is its fair market value unless it has no fair market value...If an asset has no fair market value, its value is the value of its current ownership as determined from the evidence.*

The *Mandell* case involved a professional association (which is treated like a corporation), not a partnership. *Mandell* also involved a shareholder's agreement that addressed valuation in the event of a divorce. Other appellate cases provide guidance if the business is a partnership or if the agreement does not specifically address valuation in the event of divorce.

Finn v. Finn, 658 S.W.2d 735 (Tex. App. - Dallas 1983, writ ref'd n.r.e.) involved a law firm partnership and a partnership agreement that said how much the husband would get if he died or withdrew from the firm. The majority decision in *Finn* held that the only way the husband could realize the value of accrued goodwill would be to keep practicing with the firm since the partnership agreement did not include good will in the valuation formula. Thus, the majority concluded that the husband's future work for the firm after divorce and the resulting goodwill was not community property. *Finn* at 742. The *Finn* decision was an en banc ruling that involved four justices joining the majority opinion, two justices concurring and five justices dissenting. Justice Stewart wrote a concurring decision that has since been followed by other courts and almost universally praised by seminar authors for the last 20 years. Justice Stewart wrote:

> *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 as a going business, not his contractual death benefits or withdrawal rights. The formula in the partnership agreement may represent the present value of the husband's interest, but it should not preclude a consideration of other facts. 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. Goodwill is property and, although intangible, it is an integral part of a business, the same as its physical assets. Whether the law firm possessed goodwill, and, if so, its value are fact questions for the trier of facts.*

Finn at 749 (citations omitted).

The Fort Worth Court of Appeals followed Justice Stewart's concurring opinion in *Keith v. Keith*, 763 S.W.2d 950, 952 (Tex. App. - Fort Worth 1989, no writ) and held that because a partnership is not being terminated, the provision in the partnership agreement determining the value of the business in the event of the partner's withdrawal or death is not applicable. *Keith* at 953. The court stated that the formula in a partnership agreement with respect to death or withdrawal is not necessarily determinative of the value of a spouse's interest in an ongoing partnership as of the time of divorce.

The Tyler Court of Appeals also followed Justice Stewart's concurrence in *Von Hohn v. Von Hohn*, 260 S.W.3d 631, 641 (Tex. App. - Tyler 2008, no pet.), a case that involved another law firm partnership agreement that did not address valuation in the event of divorce.

The *Mandell* decision discussed above said that the *Finn*, *Keith* and *Von Hohn* cases did not apply to a divorce involving a professional association or corporation because of the difference in how the law treats profits in a partnership versus a corporation. The *Mandell* court noted that,"Partnership profits, by law, belong to the individual partners; the assets and profits of a professional association belong to the entity" and the asset being valued was 22,000 shares in a professional association, not a partnership interest in an on-going partnership. *Mandell* at 539-540. The *Mandell* court also said:

> *Second, the partnership agreements in Von Hohn, Keith, and Finn, unlike the Stockholders Agreement here, did not mandate application of a particular value to the spouse's partnership interest in the event of a divorce..Because the Shareholders Agreement here does contain a specific contractual provision*

addressing stock ownership and value in the event of a shareholder's divorce and does restrict who may own and purchase the Association's stock as well as the price at which the stock may be sold, Von Hohn, Keith, and Finn are not controlling.

Mandell at 540.

So, what would happen if a partnership agreement did address how the partnership interest would be valued in the event of divorce? The rationale from the *Mandell* case would seem to apply since it would be hard to understand why the spouse who is the partner would be bound by the price set forth in the partnership agreement but not the divorcing spouse.

The Business Valuator Has to Determine if the Spouse Who Owns the Business Is Free to Compete if He or She Sells or if There is A Non-Compete Agreement

No Texas case has explicitly said it, but rulings such as *Nail* and *Geesbreght* and *Finn* imply that the divorce court must assume the spouse who owns all or part of the business is leaving and taking his personal professional reputation with him, which is why his personal goodwill cannot be included as part of the value of the business he is selling. This makes sense, as a buyer will pay less for Adam Thompson Photography if Adam Thompson will no longer work for the business after the case.

But, can you assume that the spouse who is selling his or her interest in the business is free to set up a competing business?[2] This is a huge question regarding the value of a small business or professional practice. If Dr. Aguilar is selling his dental practice but is free to set up shop across the street, the young dentist considering buying the practice will pay a lot less. On the other hand, if Dr. Aguilar signs a non-compete agreement, his current practice will likely be sold for a higher price.

Rathmell v. Morrison, 732 S.W.2d 6 (Tex. App.—Houston [14th Dist.] 1987, no writ) involved the husband's interest in two insurance agencies. In this case, there were no non-compete agreements in existence at the time of the divorce and this complex bifurcated bill of review case, which retried part of the divorce, certainly involved a business owner who could and would open a competing business if he sold his current agencies. The wife testified her husband threatened to do so if she insisted on appraising his businesses in the divorce. Here, the Houston 14th Court of Appeals said:

In connection with the second contention under point ten appellant complains of the court's refusal to make additional findings of fact requested by appellant. Appellant's request was as follows:

***Respondent requests that the Court find what portion, if any, of the value of the companies ... was attributable to** (a) the personal good will of the Respondent and/or (b) the time, toil and talent of the Respondent to be expended following the divorce and/or **(c) his willingness not to compete with the companies.** [emphasis added]*

***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*

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2 The question of whether the divorce court can assume the spouse who owns the business interest will not compete was raised in the unpublished opinion of *Geaccone v. Geaccone*, No. 01-03-00006-CV (Tex. App. — Houston [1st Dist.] July 28, 2005, no pet.), but the court of appeals ruled that the error was not properly raised before the trial court and was thus waived.

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. ***Had the second portion of this bill of review been tried to a jury, appellant would have been entitled to an instruction to the jury that in determining the value of the Rathmell companies the jury should exclude value attributable to such listed factors.***

Rathmell, 732 S.W.2d at 18.

In response to *Rathmell* the Texas Pattern Jury Charge was changed in instruct juries asked to find the fair market value of a business:

You are to determine the present value of the ownership interest in the business as if the party participating in it will no longer continue to do so and will be free to compete directly with it.

5 TEX.PATTERN JURY CHARGES, PJC 203 (1989).

Then came *Collins v. Collins,* 904 S.W.2d 792, 803 (Tex. App.—Houston [1st Dist.] 1995, writ denied), 923 S.W.2d 569 (Tex. 1996). In this case there were three signed non-compete agreements between the corporation, the husband and his fellow shareholder, Mr. Hickson. The jury was given the above instruction over the wife's objection and told to assume the husband would be free to compete with the company. The wife's expert testified the company was worth over $17 million, the husband and Mr. Hickson testified the company was worth $2.2 million, and the jury found the company was worth $2,189,482.90.

The court of appeals held:

Because CIC had an enforceable non-competition agreement signed by both the husband and Hickson, the jury should not have been instructed to disregard it as having no value to CIC. The trial court erred in its instructions to jury question number three.

Collins, 904 S.W.2d at 803.

After *Collins*, the Texas Pattern Jury Charge was again amended to take out any reference to the owner competing with the business from the jury instruction. The recommended jury instruction on the value of a business now says:

"Personal goodwill" is the goodwill that is attributable to an individual's skills, abilities, and reputation.

. . . .

In determining the value of Acme Partners, LLC, 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 commercial goodwill, if any, of Acme Partners, LLC that is separate and apart from personal goodwill.

Texas Pattern Jury Charges 2010, Family, PJC 203.3.

However, the comment to PJC 203.3 points out:

In Rathmell, the court suggested that that the jury be instructed, in connection with valuing the business, to disregard the personal goodwill of the spouse; the time, toil and talent of the spouse to be expended after the *divorce; and the spouse's willingness to compete with the business. The composition of commercial goodwill varies from case to case, depending on the nature of the business entity or professional practice.*

It would appear, according to *Rathmell*, that in a divorce where there is no existing non-compete agreement between the spouse and the business, the assumption in valuing the business should be that the spouse who would be selling his or her ownership interest is free to compete with the business being sold. If there is much personal goodwill in the business, this assumption will dramatically reduce the value of the business to a prospective buyer. If there is an existing non-compete agreement, as in *Collins*, the business valuator should, according to *Collins,* take that into account and consider the value of the non-compete to a prospective buyer.

The courts of other states which, like Texas, distinguish between personal goodwill and business goodwill, have held that if there is no actual non-compete agreement in place, then the business evaluator and the divorce court can assume that the spouse who owns the business interest is free to compete if she sells. *Held v. Held*, 912 So.2d 637 (Fla. 4th Dist. App. 2005); *Gaskill v. Robbins*, 282 S.W.3d 306 (Ky. 2009); *Slater v. Slater*, 2010 WL 5356556 (Or. App.)(Dec. 29, 2010).

A trial court cannot 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)(husband ordered not to compete with janitorial business awarded wife for one year). If a trial court cannot order a party not to compete with a business awarded the other spouse, then it should not be able to assume the spouse will not compete if he sells his business interest.

Methods for Valuing a Business

The generally accepted methods for valuing a business would better be described in a book or very long article and are best understood by accountants or folks who majored in math. In general, all of the accepted valuation methods are basically mathematical hocus-pocus akin to forecasting the national debt ten years from now – experts can debate endlessly on the proper method to use and regardless of the method utilized, the answer is completely different depending on the method and assumptions applied. For example, most of the business valuation methods require the expert to select a capitalization rate and discount rate and there are several methods for determining both and no sure answer on which to use, particularly in the current times when the rate of return on investments is so very low. As noted above, the discount for minority ownership and for lack of marketability can also vary widely. In summary, ten different valuation experts can examine the same business, and not agreeing on the method to use, can come up with ten different answers for the company's value.

The best bet for the divorce lawyer is to use a valuation expert who is reasonably priced and who can come across as reasonable and knowledgeable. A lawyer who has to cross-examine the other side's valuation expert should consult his own expert and be prepared to show there were other methods and other rates that could have been applied that would have resulted in a vastly different result.

Regardless of the valuation expert, the first step in valuing a company after the basic information and documents described above are obtained is to adjust the financial statements of the company to reflect reality. This process is called normalizing. It starts with "normalizing" the company's accounting records. The balance sheets and income statements of a small, privately held companies may not bear much relationship to reality. For example, the balance sheet may show an unrealistic value of the company's building and the income statement may list as expenses personal expenditures for the business owner (his girlfriend's car note) that are not legitimate business expenses.

Once the company's books are normalized, the business valuator must apply one or more methods to value the business.

The valuation method which is easiest to explain to a judge or jury is the market approach, which looks at recent sales of the same or similar companies. If another shareholder in the company being valued just sold her 10% interest for $100,000, then your client's 50% interest is probably worth $500,000. However, small businesses are seldom bought or sold, so most divorces do not involve evaluating the recent sale of the same company.

Some types of businesses are frequently valued and sold. There are professionals who deal only in selling those types of businesses. For example, unlike law firms, dental practices are frequently bought and sold; there is at least one business in the Houston area specializing in valuing and brokering the sale of dental practices. AFTCO Transition Consultants (800-232-3826) would be the best expert for you if your case involves valuation of a dental practice.

The various methods that have been approved by Texas courts and which are generally accepted in the valuation industry are:

1. Adjusted 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. Adjusted book value still reflects a relatively low value for a business interest because for most small businesses, the 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.

2. Income Approaches - Most income approaches are based on the concept that the money an investor pays for a business is a function of the amount of money the investor will receive over time as a benefit of ownership. So, each method basically estimates how much income will be generated by the business in the future and then decides how much an investor seeking a reasonable rate of return would invest in order to obtain that stream of income. The income approaches or methods for valuing a business are:

    A. Capitalized Returns Method, of which there are two variations: the Capitalization of Earnings Method and the Capitalization of Cash Flow Method.

    At least one court has approved the use of an income method in the valuation of a closely-held corporation. In *Morgan v. Morgan*, 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.

    B. Discounted Future Returns 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. 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.

3. As noted above there is the Market Approach, which looks at recent sales of the same company but also often looks at comparable sales of similar businesses.

4. The Excess Earnings Method, which takes pages to describe in detail but is very commonly used to value small businesses and professional practices. Based on the 1968 IRS 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.

   The excess earnings method involves these steps (which should be enough to both put you to sleep and convince you that business valuation is a bunch of subjective hocus-pocus pretending to be a science):[3]

   Step 1: Determine the normalized earnings of the business per year. There are several different methods to do this.

   Step 2: Identify and value the tangible assets of the business.

   Step 3: Estimate a capitalization rate for the tangible assets. The capitalization rate for the tangible assets should equal the rate of return one reasonably would expect to receive for the use of the tangible assets. According to Revenue Ruling 68-609, the rate of return for tangible assets should equal between 8% and 10%, but valuation expert may use different rates because the expected return on investments in 1968 was different than it is today.

   Step 4: Multiply the capitalization rate for the tangible assets by the value of the tangible assets. This calculation will yield the amount of the annual earnings of the business attributable to the tangible assets.

   Step 5: Subtract the amount of the annual earnings of the business attributable to the tangible assets from the yearly earnings of the business. What is left is the “excess” earnings of the business, or in other words, the amount of the business’ earnings attributable to intangibles which in the case of a professional practice will be goodwill.

   Step 6: Determine a capitalization rate with respect to the excess earnings of the business. The capitalization rate should reflect the rate of return an investor would demand to invest in the business, taking into account the level of risk involved. On selecting a capitalization rate, Revenue Ruling 68-609 states: “Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.” The Revenue Ruling suggests a capitalization rate in the range of 15% to 20%, but bear in mind the economic conditions prevalent when the IRS promulgated Revenue Ruling 68-609.

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[3] This explanation comes from an excellent seminar article by Jimmy L. Verner, Jr., “VALUATION OF DIFFICULT PROPERTY,” Family Law Practice Institute, University of Houston Law Foundation, September 1997.

Step 7: Divide the excess earnings by the capitalization rate selected. The quotient is the value attributed to intangible assets, or goodwill.

Step 8: Add the value of the business' tangible assets (Step 2) and the value of the business' intangible assets (Step 7) to determine the value of the business.

Step 9: Texas law requires an additional valuation step, segregation of that goodwill into goodwill personal to the business owner and commercial goodwill attached to the business. Upon divorce, one must exclude personal goodwill from calculation of the value of a spouse's interest in a business. This is really just a subjective guestimate on the part of the expert.

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.

Standards for Business Valuation

Texas accountants are required to follow the Statements on Standards for Accounting and Review Services (SSARS) issued by the American Institute of Certified Public Accountants. 22 T.A.C. §501.62. This very detailed standard (70+ pages) addresses issues such as the scope of the valuation assignment and the methods for valuing a business and can be a useful resource for preparing to cross-examine a business valuator. A complete copy of the current June 2007 SSARS standard can be downloaded in PDF format at http://www.aicpa.org/InterestAreas/ForensicAndValuation/DownloadableDocuments/SSVS_Full_Version.pdf.

The SSARS standard explains the difference between a valuation engagement and a calculation engagement and includes a very useful glossary of terms. If a Texas accountant hired to value a business does not follow the SSARS standard, which he or she is required by Board Regulations to do, it would seem a *Daubert/Robinson* challenge to the reliability of the accountant's methods should succeed.

Qualifications of the Forensic Accountant

The divorce attorney looking for an expert to value a business should:

1. Use a Certified Public Accountant licensed by the State of Texas who has real world practical experience serving business clients in valuing businesses outside of the courtroom.

2. Check with other attorneys to find an expert who is respected, diligent, not overly expensive, not too busy for your case and most importantly, who can explain these complicated accounting principles in friendly layman's terms while still coming across as authoritative.

3. Check on the judge who will hear your case and see if there are accounting experts that judge particularly likes or dislikes.

4. Check with the expert and find out what he or she charges and how available he or she is to promptly do the job.

5. Check the expert's resume and see what training he or she has in business valuation. Look for special credentials in business valuation:[4]

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[4] The descriptions of the various organizations and certifications are from Ike Vanden Eykel, "Use and Misuse of the Forensic Accountant," State Bar of Texas, 34th Annual Advanced Family Law Course, August 11-14, 2008, Chapter 44.

A. National Association of Certified Valuation Analysts (NACVA) - NACVA is a global, professional association supporting the business valuation, litigation consulting and fraud deterrence disciplines within the CPA and professional business advisory communities and provides the following certification programs:

1. Accredited Valuation Analyst (AVA): professionally trained to perform business valuations as a service to both the consulting community and the users of their services; requires training as a prerequisite to certification; must hold a business degree from an accredited institution of higher education and demonstrate substantial business valuation experience among other requirements.

2. Certified Valuation Analyst (CVA): professionally trained to perform business valuations as a service to both the consulting community and the users of their services; requires training as a prerequisite to certification; must hold a valid license as a Certified Public Accountant.

3. Certified Financial Forensic Analyst (CFFA): this credential is designed to demonstrate to the legal community that the designee possesses a level of experience and knowledge deemed acceptable by the National Association of Certified Valuation Analysts (NACVA) and the Forensic Institute for Financial Experts (FI) to provide competent and professional forensic financial litigation support; the training includes economics, statistics and calculating damages, followed by a five-day practicum in which participants learn about commercial damages and participate in a damages study which takes them through the processes of deposition, mediation and jury trial.

B. American Society of Appraisers (ASA) - The ASA is a self-supporting and independent organization of appraisal professionals and others interested in the appraisal profession. The ASA originated in 1936 and is the oldest and only major appraisal organization representing all of the disciplines of appraisal specialists. The ASA has a mandatory re-accreditation process whereby designated members must regularly submit evidence of professional growth through participation in professional activities and continuing education. The ASA provides the following certification programs:

1. Accredited Member (AM): each accredited member of the American Society of Appraisers has earned a professional designation in one or more specialized areas of appraisal; must complete intensive course work and pass written examinations, including an examination on the Uniform Standards of Professional Appraisal Practice (USPAP); must submit representative appraisal reports and an appraisal experience log for at least two years; requires a college degree or its equivalent.

2. Accredited Senior Appraiser (ASA): in addition to the qualifications set forth for an accredited member, the ASA designation demonstrates a minimum of 5 years of full-time equivalent appraisal experience and a college degree or its equivalent.

3. Fellow of the American Society of Appraisers (FASA): to achieve the Fellow, an Accredited Senior Appraiser must be recognized by ASA's International Board of Governors for outstanding services to the appraisal profession and/or the society.

C. Institute of Business Appraisers (IBA) - The Institute of Business Appraisers is the oldest professional society devoted solely to the appraisal of closely-held businesses and provides the following valuation certifications. All holders of the designations are required to document 24 hours of continued professional development every 2 years. The IBA provides the following certification programs:

1. Accredited by IBA (AIBA): must posses a 4-year college degree or equivalent; successfully complete an 8-day workshop in valuing closely held businesses, or hold a journeyman level designation in business valuation from organizations recognized by the Institute of Business Appraisers; pass a comprehensive written examination on current business valuation theory and practice.

2. Certified Business Appraiser (CBA): available to those members of The Institute of Business Appraisers, Inc. who are able to demonstrate that they have attained a high level of professional competence and conduct; requires a 4-year college degree or equivalent; in addition to the 4-year college degree, the applicant must have successfully completed at least 90 classroom hours of upper level course work; at least 24 hours of this coursework must have been in courses offered by the Institute of Business Appraisers; in lieu of the 90 classroom-hour requirement, the applicant may demonstrate 10,000 hours active experience as a business appraiser; experience must include valuation of a variety of business types and appraisals for a variety of purposes; complete a 6 hour, proctored, CBA written examination covering the theory and practice of business appraisal.

3. Master Certified Business Appraiser Accreditation (MCBA): the Master Certified Business Appraiser is the highest professional designation awarded in the business valuation industry; requires a 4-year college degree and a 2-year post-graduate degree; must have held the Certified Business Appraiser designation for not less than 10 years, and must have 15 years full-time experience as a business appraiser: experience must include valuation of a variety of business types and appraisals for a variety of purposes; must hold a professional designation awarded by one or more compeer professional business appraisal societies such as those issued by the American Society of Appraisers, the National Association of Certified Valuation Analysts, and the American Institute of Certified Public Accountants.

4. Business Valuator Accredited for Litigation (BVAL): this designation is designed to recognize experienced business appraisers who demonstrate their ability to competently present expert testimony which supports their objective conclusion of value; must attend 5 days of IBA course; must pass the 4 hour proctored written exam; hold a business appraisal related designation from IBA, ASA, AICPA or NACVA, or be a CBA candidate who has passed the CBA examination; provide references of trial performance from at least two attorneys.