Business Valuation in Divorce Cases -- 101 — What A Family Lawyer Needs to Know to Competently Represent Your Client

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I. EXECUTIVE SUMMARY

The most factually and legally complex area of divorce law is business valuation. In the 1980s and 1990s huge strides were made in business valuation techniques due in large part to personal computers and the ability of business appraisers to develop intricate spreadsheets. These spreadsheets and "canned" computer valuation programs have allowed valuators to create models for valuing businesses which would have been virtually impossible before the advent of the personal computer. An additional reason for the progress in business valuation technique has been the mergers and acquisitions which occurred during this same period. These mergers and acquisitions provided a database to more accurately gauge the value of businesses based on actual transactions. Moreover, case law regarding business valuation in divorce cases is more complex than in other areas of law because the states have different positions on whether the business appraiser must differentiate enterprise goodwill from personal goodwill in valuations of closely held businesses.

Family law lawyers handling business valuation cases face an additional challenge in presenting these issues as many family law judges have very little of the accounting or financial theory background necessary to readily understand the testimony of the business appraisers. Therefore, a lawyer handling a business valuation issue in a matrimonial case has to be able to effectively work with the valuator to simply explain to the court the series of complex calculations which are at the heart of a business valuation.

Business valuation requires an unusual degree of cooperation between the lawyer and the expert business appraiser. This material is written for use by either the lawyer or the business appraiser. A divorce lawyer should keep in mind that **all** correspondence sent to the business appraiser may be subject to discovery. Therefore, it is suggested that this outline could be forwarded by the lawyer to the business appraiser to provide the business appraiser with additional background about legal issues necessary for the appraiser to effectively work with the lawyer through the business valuation process.

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II. BACKGROUND REGARDING INITIAL ISSUES IN BUSINESS VALUATIONS IN DIVORCE CASES

A. Forms of Business Organizations

There are four basic forms of business organizations: sole proprietorships; general or limited partnerships; limited liability companies and corporations. I am assuming that these types of business organizations will be covered in Session II of our materials and therefore this discussion will be general in nature.

Sole Proprietorship: The simplest form of business organization is the sole proprietorship. All earnings and losses of the business are taxed to the sole proprietor personally on their personal tax return, Schedule C. The sole proprietor bears all the risks of the business. In divorce cases, often a sole proprietorship is a service oriented business.

Partnerships: A partnership may be the most common form of business enterprise. Partnerships range from relatively informal associations to highly structured organizations. A partnership is an association of two or more persons to carry on as co-owners of a business for profit.

C Corporations: Generally, divorce case valuations will not involve valuations of "C corporations." C corporations pay income taxes on taxable income, so the shareholder-owners may be subject to double taxation: once at the corporate level and again when corporate earnings are distributed as dividends. Rather than pay additional taxes on dividends, the owners of closely held corporations often pay themselves additional compensation which reduces the corporation's taxable income.

S Corporations: The double taxation problem can be avoided by electing "S corporation" status. Generally, an S corporation's earnings are taxed only to the shareholders. In an S corporation, all shareholders must participate in the allocation of profits, losses and distributions according to their percentage of ownership. The distributions of an S Corporation will be shown on the corporation's I.R.S. form K-1. Only common stock can be issued by an S corporation. Finally, the S corporation may not have more than one class of common stock, although there can be voting and non-voting shares of stock in an S Corporation. All distributions to shareholders must be based in proportion to their ownership.

LLCs: Limited Liability Companies (LLCs) are the newest form of business entity. They have characteristics both of corporations and of partnerships. LLCs are created through specific state legislation and most states have enacted such legislation. Many believe that LLCs may become the predominant form of organization for small businesses. LLCs generally shield their owners from personal liability in the same manner as corporations. Similar to S corporations, in limited liability companies, owners are taxed on earnings once. Before LLCs were created only Subchapter S corporations permitted the combination of corporate and partnership traits, and then at the cost of relatively burdensome requirements under the provisions of the Internal Revenue Code. An LLC may issue more than one class of equity, i.e., stock, giving them greater flexibility than an S corporation.

III. HIRING AN EXPERT — TYPES OF BUSINESS APPRAISERS, PROFESSIONAL ACCREDITATION CRITERIA AND STANDARDS OF BUSINESS VALUATION

A. Payment of Experts

The associate will likely be assisting the partner with arranging for payment of experts, etc. The method of payment to the expert should be indicated in the expert's engagement letter. Most valuation experts require a retainer. Some may requirement payment for services rendered to date before releasing their valuation report. If the lawyer represents the non-owner spouse who does not have sufficient funds available, an interim fee petition should be filed early. The expert's engagement letter should be attached to the petition along with an affidavit from the expert defining the scope of services and minimal anticipated fees. It should be noted that the appraiser's retainer is just that, and funds to complete the assignment should be budgeted. A projected budget and total fee estimate should be brought to the court's attention as part of the interim fee petition so that funds will be available not only for payment of the initial retainer but for payment of the expert's additional fees needed to complete the assignment. Also, the interim fee petition should clearly set forth any specific assignments the expert will be performing in addition to the valuation so that the fee is supportable.

A good valuation expert, experienced with divorce cases, can serve many functions for divorce attorneys and their clients. Areas of assistance can include: preparing for the deposition of the opposing expert; preparing for cross examination of the opposing expert; educating the attorney on the business and the fine points underlying the valuation; drafting of a comparison schedule using both experts' valuation reports which outline their differences; analyzing the economic value of "perks" taken by business owners; performing a cash flow analysis; and assisting the lawyer in structuring an appropriate settlement of the business valuation issue.

B. Certifications and Qualification of the Business Appraiser

Finding the right expert is important in preparing a business valuation case. The appraiser should be familiar with state divorce law, especially in those states that differentiate between enterprise and personal goodwill. A skilled appraiser should have good oral and written communication skills and be able to coherently integrate quantitative and subjective data. Business appraisal designations are available to all appraisers and counsel should note the substantial differences among these designations. For example, one difference is the requirement of peer review. It is possible for a business appraiser to be granted a professional designation without having to author a single report in an actual client assignment... For these reasons, designations that involve peer review offer some assurance that the business appraiser's work product has passed juried scrutiny.

In hiring a business appraiser the lawyer should examine a number of factors. These include:

— The formal credentials of the business appraiser, the number of reports the business appraiser has completed, both in family law cases and in non-family law settings;

— The number of times the appraiser has testified previously — either in a family law case or in a non-family law setting.

— The number of times the evaluator has submitted a written report. The lawyer may ask to review sample reports of the appraiser, not for the purpose of reviewing the appraisers methodology but to determine if it appears that the appraiser has a knowledge of case law that would apply to the proceedings. Additionally, the lawyer should be able to evaluate a report and determine if the evaluator writes well, especially in those jurisdictions where the court may accept the report of the appraiser into evidence.

— The evaluator's knowledge and experience in the subject type of business. It is clearly helpful if the appraiser has valued businesses of the same general type as the subject business.

Today there are many nationally recognized business valuation organizations that a business appraiser may join. To become certified under a particular organization, the appraiser usually needs to take an exam and submit samples of their valuation work product. These organizations are the American Institute for Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), the Institute for Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA). On a local basis, there is the Chicago Business Valuation Association. This group consist of local business appraiser in various fields of business and academia.

CPAs as Business Appraisers: Certified Public Accountants have many of the necessary tools required to render sound business valuations. State law is relatively lenient in the issue of qualification of an expert to testify as to business value. See, for example, *In Re Marriage of Olson*, 585 N.E.2d 1082, 160 Ill.Dec. 60 (2d Dist. 1992), which held that being an experienced CPA qualifies one as a witness for valuation of a business. *See also, In Re Marriage of Blinderman*, 283 Ill.App.3d 26, 669 N.E.2d 687, 218 Ill.Dec. 544 (1st Dist. 1996). Nevertheless, the position of the American Institute for Certified Public Accountants (AICPA) is that specific specialized training is needed to be a professional / specialist in business valuations. Thus, the creation of the ABV (Accredited Business Valuator) designation. The prerequisites for the ABV certification is that the member must be a member of the AICPA with a current CPA license. To obtain an ABV accreditation the applicant must be experienced in at least 10 business valuation engagements. There is a one day examination. To maintain the accreditation, a member must complete 60 hours of related continuing professional education during the three year period after obtaining the ABV accreditation.

In selecting a business appraiser, the lawyer may review certain on-line resources. The AICPA has an online directory of its members who are Accredited in Business Valuation (ABV) credential holders which can be found at www.aicpa.org. The list is organized by state. The directory includes only the name, firm affiliation, and city of each ABV credential holder.

American Society of Appraisers: The American Society of Appraisers has an online directory of its accredited members. The web address is www.appraisers.org. Within the ASA there are three certification types: accredited members (AM); accredited senior appraiser (ASA) and Fellows of ASA (FASA). An accredited member does not have to be a certified public accountant but must have a college degree. Minimally, there is a day long exam. The applicant must also pass an ethics examination. The American Society of Appraisers is the only organization which has a separate ethics examination. To become an accredited member the expert must submit two valuation reports. There is also an experience requirement: the individual must have two years full-time or equivalent work. An accredited senior appraiser must have three years full time or equivalent experience. A Fellow of the ASA must meet the same requirements as an accredited senior appraiser and also will be voted into the ASA College of Fellows.

Institute for Business Appraisers: The third organization providing for accreditation of business appraisers is the Institute for Business Appraisers (IBA). It offers programs of interest to members whose business valuation activities are less than full time or whose practice includes valuation of small to mid-size businesses. The IBA has an online directory of its members at http://www.go-iba.org/directory.asp. Within the IBA there are four certification types: certified business appraisers (CBA); Master Certified Business Appraiser (MCBA); Fellows of the IBA (FIBA); and Business Valuator Accredited for Litigation (BVAL). A certified business appraiser does not need to be a certified public accountant. The prerequisite is four years of college or its equivalent. There is a 3.5 hour proctored examination to become a certified business appraiser (CBA). Similar to the American Society of Appraisers, to become a certified business appraiser, an individual must submit two business appraiser reports showing professional competence. Unlike the American Society of Appraisers or the American Institute of Certified Public Accountants there is no experience requirement to become a certified business appraiser with the IBA. To become a Master Certified Business Appraiser, the individual must also have 10 years' practice experience or received credit for published writing or lecturing. The appraiser must also have four work

product references from other CBAs. Fellow of the IBA have the same requirements as an MCBA and are voted into the IBA College of Fellows.
The IBA has Rules of Professional Conduct. The preamble states, "A member of the Institute of Business Appraisers (IBA) assumes an obligation beyond any imposed by law. By accepting membership, the individual recognizes a responsibility to the public, to clients, intended third party users of his/her reports and to colleagues. The individual member agrees to be bound by the contents of the following Institute of Business Appraisers pronouncements, in addition to any rules set forth, herein." The IBA also has Business Appraisal standards.

National Association of Certified Valuation Analysts: The fourth organization that provides accreditation for business appraisers is the National Associated of Certified Valuation Analysts (NACVA). Family lawyers may encounter two types of appraisers certified by NACVA: Accredited Valuation Analyst (AVA) and Certified Valuation Analyst (CVA). The NACVA web page address is www.nacva.com. They have an online directory of members. To gain the AVA credential, an appraiser must have a business degree and must take a 30 to 50 hour, take home examination which includes one case study. To become a Certified Valuation Analyst an individual must be a CPA.
The examination is a half day proctored exam which includes a case study. There is no requirement to submit actual reports to become a CVA.

The above organizations have attempted to make business valuation practice more consistent and to this end the organizations have a joint Business Valuation Glossary Committee, which has prepared the first draft of a jointly approved glossary for business valuation terms.

Other experts who may perform business valuations in divorce cases include Chartered Financial
Analysts awarded by the association for Investment management and research. Generally, such experts tend to value larger, publicly held companies.

A lawyer reviewing an expert's curriculum vitae may see certain abbreviations which indicate the expert's professional background. The following chart summarizes these accreditations.

AIBA	Accredited by the Institute for Business Appraisers (IBA)
AM	Accredited Member of the American Society of Appraisers (ASA)
ASA	Accredited Senior Appraiser of the American Society of Appraisers (ASA)
AVA	Accredited Valuation Analyst of the National Associated of Certified Valuation Analysts (NACVA)
BVAL	Business Valuation Accredited for Litigation (Institute for Business Appraisers - IBA)
CBA	Certified Business Appraisal of the Institute of Business Appraisers (IBA)
CBI	Certified Business Intermediary of the International Business Broker's Association (IBBA)
CFA	Chartered Financial Analyst of the Association for Investment Management and Research
CPA/ABV	Certified Public Accountant Accredited in Business Valuations of the AICPA
CVA	Certified Valuation Analyst of the National Association of Certified Valuation Analysts (NACVA)
FASA	Fellow of the American Society of Appraisers (ASA)
FCBI	Fellow Certified Business Intermediary of the International Business Brokers Association (IBBA)
FIBA	Fellow of the Institute for Business Appraisers (IBA)
MCBA	Master Certified Business Appraiser (Institute for Business Appraisers - IBA)

C. Uniform Standards of Professional Appraisal Practice and Business Valuation Standards of ASA and Other Organizations

1. Importance of USPAP Generally

The American Standards Board of the Appraisal Foundation promulgated the Uniform Standards of Professional Appraisal Practice (USPAP). These standards apply to any appraiser including an appraisal of real estate, personal property, intangible assets and business interests. Shannon Pratt in his treatise, VALUING SMALL BUSINESSES & PROFESSIONAL PRACTICES (1998) states: "The fact that these standards are reaching a position of general acceptance is evidenced by the frequent references to USPAP in both judicial and in professional literature." An updated version of the USPAP is published annually, generally in November. To order an interactive copy see: https://commerce.appraisalfoundation.org/. There is a charge of $30.

Standards 9 and 10 of the USPAP address business valuations.

The American Society of Appraisers mandates compliance with USPAP for appraisals prepared by its members. The Institute for Business Appraisers generally endorses USPAP but compliance is not mandatory for its members. Additionally, USPAP is not binding on members of AICPA or NACVA.

The ASA has also issued "Principles of Appraisal Practice and Code of Ethics." This Code is designed to provide guidance to appraisers generally and to provide a structure for regulating conduct of members of the ASA through disciplinary actions. These standards apply to both business valuations and other types of valuations and are general in nature.

2. Business Valuation Standards promulgated by the ASA Business Valuation Committee

While USPAP addresses ethical issues and generally addresses the process of business valuation, the American Society of Appraisers recognized that the USPAP did not comprehensively outline the factors that should be considered in a business appraisal. Accordingly, the American Society of Appraisers Business Valuation Committee developed business valuation standards that every member must follow in a business valuation.

Currently, there are eight Standards. Additionally, there is one Statement on Business Valuation Standards and one Advisory Opinion. The Business Valuation Standards differ from USPAP and Revenue Ruling 59-60 (discussed below) in terms of required specificity of the various steps of the business valuation process. The standards represent the minimal criteria that must be present in a business valuation. Every appraiser who is a member of the ASA must adhere to the various standards. Additionally, because these standards are generic in treatment of generally accepted valuation theory and practice, a business appraiser who is not a member of the ASA may find it hard to justify reasons that the standards should be ignored. In the unlikely event that an ASA appraiser has good cause to depart from the Standards, the appraiser must state the specific reasons for the departure in the report.

An example of the general nature of the ASA standards is the requirement that an income approach to value must be considered and must include an assessment of future benefits that are discounted. The standards include a section that contains a long list of definitions often used in business appraisals (Section VIII). The standards also include a "statement" which provides a specific outline of the guideline company approach to business valuation (discussed below).

3. Other Standards

The National Association of Certified Valuation Analysts has also published professional standards. These may be used to cross-examine a certified valuation analyst. If the expert is an accountant, there are also professional standards promulgated by the American Institute of Certified Public Accountants if engaged after that date. The AICPA has general standards for consulting practice, which includes business valuations. Effective January 1, 2008, the AICPA has now issued standards specifically addressing business valuation. The lawyer in a business valuation case should become aware of the appropriate professional standards for the expert retained by each side in any business valuation case.

D. Learned Business Valuation Treatises

There are several articles, studies, and books prepared on the subject of business valuation. Some are relied upon more than others by the valuation community, though one is not necessarily authoritatively better than another. Three of the better known books are Shannon Pratt's VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, (4th Ed. 2000) (Valuing a Business); VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES (2d Ed. 1988) and THE LAWYER'S BUSINESS VALUATION HANDBOOK (American Bar Assn. 2000).

E. **Important Internal Revenue Service Revenue Rulings**

1. **Revenue Ruling 59-60**

Revenue Rule 59-60 is the best known and most often used administrative ruling in the area of business valuation. The purpose of the revenue ruling is to give a general outline and review of 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. Although it was written over 40 years ago, it is cited by many family law decisions in many states.

Revenue Ruling 59-60 provides a definition for "Fair Market Value" which is: "…the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having knowledge of relevant facts." The ruling provides a solid basis for valuation. The business appraiser should consider it as the ruling itemizes and explains eight relevant factors to be considered in valuing a closely held business. The eight factors outlined in Revenue Ruling 59-60 Section IV are:

1. The nature and history of the business since inception.
2. The economic outlook, in general, and the condition and outlook of the specific industry the subject company operates in.
3. The book value of the stock and the financial condition of the business.
4. The earnings capacity of the business.
5. The dividend-paying capacity of the business.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of stock and the size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

A similar issue is addressed in Revenue Ruling 59-60 relative to the loss of a key-person in a small business. In both contexts, an adjustment must be made by the valuator. On this subject, Revenue Ruling 59-60 states:

> The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

2. **<u>Other Revenue Rulings</u>**

Other rulings that the IRS has issued that directly affects the valuation of an interest in a business which an associate should know include:

1. **Revenue Ruling 68-609**: This revenue ruling addresses the “formula” method which was originally adopted in 1920 by an Appeals and Review Memorandum of the U.S. Treasury Department. In1920 the "formula” method was used to estimate the value of the goodwill that breweries and distilleries lost because of the Prohibition. Since then, this method has been widely used in valuations including valuations in divorce cases. In 1968, the Internal Revenue Service addressed this method in Revenue Ruling 68-609 and ruled that “….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 therefore available.” The application of this Revenue Ruling is discussed below in Section

2. **Revenue Ruling 77-287**: Revenue Ruling 77-287 discusses the value of restricted stock studies in determining marketability discounts. This ruling is significant in part because Revenue Ruling 59-60 failed to address marketability discounts, this issue was addressed in a later revenue ruling. While this ruling specifically relates to restricted stock (discussed below) in determining marketability discounts, the rule specifically indicates that it amplifies Revenue Rule 59-60 and commonly is considered in conjunction with Revenue Ruling 59-60. Revenue Ruling 77-287 discusses the value of restricted stock studies in determining marketability discounts.

3. **Revenue Ruling 93-12**: Revenue Ruling 93-12 allows application of minority interest discounts to partial transfers even when a family owns overall control of a closely held business.

The appraiser must understand what they are valuing. It is important to know whether the appraiser is valuing a controlling interest or a minority interest in a closely-held corporation. While in simplest terms a controlling interest is generally defined as one in which a shareholder has more than a 50 percent interest in a company, it is important to understand that control is not an all or nothing proposition. A shareholder may have the prerogatives of control despite not having a controlling interest in a company. Such prerogatives of control may include the ability to appoint management, ability to determine management compensation and perqs, ability to set policy of a business, etc.

For example, the husband could have a 25% interest in a company and his father could have a 50% interest in a company. Separately considered, the husband has a minority interest, but the collective interest of the husband and his father is greater than 50% (a controlling interest). In Revenue Ruling 93-112 this issue was raised. A donor transferred corporate shares to each of his children. The question was whether the fact that the family retained control should be considered in valuing each transferred interest for estate and gift tax purposes under the Internal Revenue Code. The revenue ruling holds that if the donor transfers shares of the corporation to his children, the factor of corporate control in the family is not considered in valuing each of the transferred interest.

Assume a divorce valuation case in which the wife has a 25% interest in a corporation and the husband has a 50% interest. Furthermore, it appears clear the husband will be awarded the entire marital interest in the corporation. The issue may be whether the appraiser is valuing a 75% interest or two separate interests (i.e., a 25% interest and a 50% interest). Since the majority approach of case law has held that the court should consider imminent tax consequences when those tax consequences are not considered speculative, it is suggested the valuator should appraise the interest of husband and wife collectively. It is further suggested that the valuator should consider these interests separately only if stock will continue to be held by each party individually. If the distribution of stock in a business is not clear (the determination of which party will be awarded the stock in a marital corporation), then the appraiser may consider completing two valuations — one based upon valuing each holding individually and one valuing the marital interest of the stock as a block.

IV. DISCOVERY ISSUES IN BUSINESS VALUATION CASES AND PROTECTIVE ORDERS

A. Introduction

In many matrimonial cases, the parties' real battle is often not the trial of the case, but involves the discovery process in which the rights of third persons, who also have an interest in the business, have to be balanced against the need for discovery by a divorce litigant. In the business valuation context, a spouse often has interest in a closely held corporation. The corporation is a separate legal entity and will often claim that discovery requests are unduly onerous and that the non-business owning spouse should not need copies of the actual documents upon which the financial statements of the business will be based.

V. THE VALUATION PROCESS

A. General Steps in the Valuation Process

The process of performing a business valuation is broken down into five general steps: defining the assignment; gathering the data; analyzing the data and performing the valuation analysis; using various methodologies to arrive at a conclusion of value (including applying discounts or premiums where applicable); and writing the valuation report.

As the process begins, it is important that the attorney understand or at least be familiar with relevant valuation terminology. An appendix provides a comprehensive list of the most common terms used by business appraisers and their definitions. These terms have been obtained from a variety of sources including the ASA and other recognized appraisal publications.

B. Defining the Assignment

Standard of Value -- Fair Market Value Versus Investment Value: In valuing a business, the appraiser must define what "standard of value" the appraiser will use. While few cases specifically discuss the standard of value in divorce cases it appears that case law gives lip-service to the term "fair market value." Very simply put, "fair market value" is the amount at which a business interest would change hands between a hypothetical willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts. (See, for example 26 CFR 20.2031-3 and Revenue Ruling 59-60). In the definition of fair market value, the hypothetical willing buyer should not have special motivations that are not characteristic of a typical buyer. Clearly, fair market value may differ from the value the business has to a particular buyer or investor. Such a value has been termed a "synergistic value," an "investment value," or a "strategic value," but these terms are synonymous. There are a number of reasons that synergistic value ma be greater than fair market value of a given business. Take the example of a manufacturing plant that has outdated equipment but which sells well known product at a profit. Another larger business may have access manufacturing capacity within the same industry. The larger business may make an offer to purchase, based upon the fact that the company is a particularly good "fit." The value to this particular buyer may differ from what otherwise might be determined to be the fair market value of the business. Other reasons for a synergistic value could include a personal relationship between the owners of two businesses.

Nature of Business Interest Being Appraised: The appraiser must also understand what they are valuing. Is it important to know whether the appraiser is valuing a controlling interest or a minority interest in a closely held corporation. While in simplest terms a controlling interest is generally defined as one in which a shareholder has more than a 50 percent interest in a company, it is important to understand that control is not an all or nothing proposition. A shareholder may have the prerogatives of control despite not having a controlling interest in a company. Such prerogatives of control may include the ability to appoint management, ability to determine management compensation and perqs, ability to set policy of a business, etc.

For example, the husband could have a 25% interest in a company and his father could have a 50% interest in a company. Separately considered the husband has a minority interest, but the collective interest of the husband and his father is greater than 50% (a controlling interest). In Revenue Ruling 93-112 this issue was raised. A donor transferred corporate shares to each of his children. The question was whether the fact that the family retained control should be considered in valuing each transferred interest for estate and gift tax purposes under the Internal Revenue Code. The revenue ruling holds that if the donor transfers shares of the corporation to his children, the factor of corporate control in the family is not considered in valuing each of the transferred interest.

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Because the majority approach is that the court should consider imminent tax consequences when those tax consequences are not considered speculative, [*See, In Re the Marriage of Olson*, 223 Ill.App.3d 636, 585 N.E.2d 1082, 160 Ill.Dec. 60 (2d Dist. 1992)] it is suggested the valuator should appraise the interest of husband and wife collectively. It is further suggested that the valuator should consider these interests separately only if stock will continue to be held by each party individually. If the distribution of stock in a business is not clear (the determination of which party will be awarded the

stock in a marital corporation), then the appraiser may consider completing two valuations — one based upon valuing each holding individually and one valuing the marital interest of the stock as a block.

C. Gathering Data

Once the appraiser and lawyer have a clear understanding of the interest that is to be valued, the next step is to begin the process of gathering the data. The information needed will involve requesting standard information that is common to all business valuation engagements and also information that is unique to the specific company being valued and its industry. Normally, the business appraiser will provide the attorney with a document and information request which the attorney can incorporate into a notice to produce.

We have included with our materials a sample production request relating to a business interest. The general information requested will include:

— Financial statements for the last five years, as well as interim financial statements if the valuation is to be performed as of an interim date.
— Detailed general ledgers and /or cash disbursement journals.
— Income tax returns for the same five year period.
— Articles of incorporation or partnership agreement or operating agreement, depending on the type of entity being valued.
— Listing of shareholders, partners or members and ownership percentages.
— Aging of accounts receivable.
— Listing of investments.
— Detailed list of all inventory adjusted to fair market value.
— Detailed list of property and equipment with depreciation lapse schedules including any and all appraisals indicating their fair market value.
— A request for copies of insurance policies might also assist in this process.
— Details of loans and other significant accounts payable.

Other items typically requested are based on information obtained from the company's balance sheet. If the appraiser is looking at possibly using an asset based valuation approach, the information detailed above may become crucial in the analysis. Even if the valuator considers an approach other than an asset based valuation, these items may be important in determining if the company has any non-operating assets and liabilities on its books, or whether the company has any excess working capital or working capital deficiencies.

Non-financial documents will normally also be requested to provide the appraiser with additional knowledge about the company, including its corporate structure, obligations and various business agreements. These documents would include items such as: shareholder agreements, organizational charts, business plans, forecasts or projections, marketing materials, previous valuations, union agreements, stock transactions, insurance policies, information on litigation, and real estate and equipment appraisals.

A valuator may be useful in various aspects of a divorce case. For example, information obtained for purposes of normalizing the companies earnings may also be of use in determining the business-owner spouse's true economic income. Some of this information may be obtained through an on-site visit and the appraiser's discussion with management. If opposing counsel prohibits the appraiser from meeting with management personnel or refuses to provide information, the attorney will need to pursue other means, such as depositions or detailed interrogatories. Most states limit the number of interrogatories that may be asked without leave of the court or written stipulation of the parties. Because interrogatories directed to a party are limited in most states, it is necessary for counsel representing the non-business owning spouse to seek leave of court to propound additional interrogatories if the responding party objects.

D. Initial Financial Analysis and On-Site Visit

It is necessary for the associate to work with the valuator to secure, review, and analyze as much historical financial and operational information as possible. This type of information acts as a building block for the valuator in gathering additional data, research and in applying appropriate valuation methodology in the final preparation of the report. A thorough review of this information can point to the true historical performance of the company, trends in the operating

business and identify other issues for valuation analysis. In addition, this analysis will prepare the appraiser for one of the most important parts of the appraisal, the site visit.

One of the first steps in the analysis by the appraiser is to prepare what are called “common size financial statements.” In this format the balance sheet is presented with each asset line item reported as a percentage of total assets and each liability and equity item reported as a percentage of their total. The income statement is also presented in a similar fashion with each category of income and expense reported as a percentage of net sales. This simple analysis highlights the relationship of the various account balances to one another and is also useful in spotting trends over the years. It also helps identify unusual or non-recurring items and identifying differences from industry norms.

The appraiser should also look for trends in the company's annual sales growth, annual net income growth, gross margins and operating expenses. A tool used in performing this analysis is financial ratios. The computation of financial ratios is useful in comparing the subject company to other companies or industry statistics. A summary of the common ratios used by the appraiser are summarized in an Appendix. Identification of the trends of a business enables the appraiser to make further inquiries of management about the effect of those trends on future operations during the site visit.

A site visit is a key element of the appraisal process that cannot be ignored if the valuation is to be complete. During the site visit, the appraiser attempts to accomplish the following objectives:

- Tour the facilities and observe the operation of the business.
- Interview key management personnel to discuss the industry, the subject company's operations, and its outlook for the future.
- Present to management questions raised during the preliminary analysis phase of the valuation, review trends displayed during the analysis, and get management's feedback on those trends.
- Follow up on any missing information from the original request list.

Shannon P. Pratt, when discussing the relative importance of site visits/management interviews in his book, VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES (2d ed. 1998) states:

> [F]or valuations subject to contrarian review (which most are), courts are becoming quite sensitive to the importance of site visits and management interviews. Many clients and attorneys dismiss or downplay the importance of a site visit and/or don't want to incur the interruption or the cost of the analyst's time for it. We prefer to make site visits and conduct management interviews. In our experience — as well as in many court cases -- the site visit not only helps the analyst get a better perspective, it makes a difference in the analyst's credibility in the eyes of the court.

In addition to simply interviewing management, a tour of the company's facilities is also essential when valuing a business. The tour of the physical plant provides the appraiser with information that cannot be gleaned simply by looking at financial statements and other related financial information. The tour should provide the analyst with a better idea of the company's operations from a physical viewpoint. It permits an evaluation of the plant's physical adequacy and allows the appraiser to observe the efficiency of the location as well as the layout and condition of the facilities.

Dr. Pratt also addresses cases where the intended user of the report is unfamiliar with the business or has never seen the facilities in question. He indicates:

> If the analyst will need to communicate some description of the operations, facilities, or both to someone lacking the opportunity to visit the facilities, such as a judge in a court case, it may be desirable to take a set of pictures while on tour.

It is widely accepted in the valuation profession that a site visit/management interview is a very important part of the valuation process, and is, in fact, imperative if an appraiser is to perform a complete analysis of the operations of the company being appraised.

E. Completing the Financial Analysis and Normalizing the Earnings Stream

Once the site visit is complete, the appraiser should be in a position to complete the financial analysis. Based on the documents received, discussions with management and the site visit, the appraiser determines what, if any, adjustments need to be made to the original financial statements provided. This process is known as “normalizing” the financial statements. Normalizing is a process of adjusting the financial information to take into account the following items:

- Non-recurring items such as sales of fixed assets, lawsuit settlements, and casualty losses.
- Non-operating items such as depreciation and related expenses for non-business real estate or personal property and investment income or expenses.
- Owner's discretionary expenses such as personal automobiles, insurance policies, travel, and other personal “perks.”
- Related party transactions which do not reflect market rates, such as leasing space from a building owned by the shareholder at above market rates.
- Compensation which does not reflect market rates.

By adjusting for these types of items, the appraiser portrays the business operations as they should be expected to look, under normal conditions as on an ongoing basis, to a prospective buyer of the business. The appraiser must identify what is being valued because the adjustments that the appraiser might consider could be different depending on whether a control or minority interest is being valued.

If the appraiser is valuing a controlling interest in a closely held corporation, the issue of reasonable compensation must be addressed. The key is the ability to distinguish between how much in dollar amounts is taken by the business owner as “reasonable compensation” and what portion is the return on capital. In other words, given the services that an owner provides, the appraiser examines what is the reasonable amount that the business would expect to pay outside personnel to perform similar services.

Overcompensating the owner of a business will reduce the profitability of a business. By normalizing the owner's income, the appraiser may lower the owner's salary, which increases the profitability of the business, which in term increases the amount of the valuation. While this is a standard technique of business valuators in non-divorce cases, this presents problems with “double dipping” issues in that the owner's income (without a normalization adjustment) is counted once as income for the purpose of either child support or maintenance and a second time for the purpose of determining the value of the business. See, e.g., Gunnar J. Gitlin, "Business Valuation in Divorce - What is Double-Dipping and How is it Quantified?, *American Journal of Family Law.*

Despite the double dipping argument, the rationale for normalizing the owner's income is that the critical issue in these cases is the earnings stream of the business excluding the earning capacity of the business owning spouse. Thus, the valuator must assume the replacement of the business owing spouse with another person who would assume the duties of the business owning spouse. If this hypothetical person would normally receive a lesser amount of compensation from the business without a loss in business earnings, then there is a sound argument that the appraiser should normalize the business owner's income.

In analyzing the reasonable compensation issue, the lawyer should work with the appraiser to obtain factors the court may consider, such as:

- The appraiser must develop a full understanding of the operating entity. This includes the size of the company and the historical as well as the future growth plans of the company.

- The appraiser must consider the make up of the management team. Determine who is included in officers' compensation and how much are they paid. The valuator should obtain a complete history of the various compensation levels.

- What are the job descriptions of the applicable officer(s).

- What is the strength of the management team/officer group? Obtain the background of each member of the management team or officer group including their education, experience, time commitment (are they employed on a full-time or part-time basis), skills (what specialized skills do the individuals bring to the table). How many hours do the individuals spend at their jobs, and how successful has the individual been at his/her particular job?

- How deep/diversified is the management, i.e., is management distributed among a number of managers? Is management succession in place? What is the length of time have various managers been at their positions? What are the local employment conditions, especially regarding the ability to find and replace management personnel?

- What is the performance of the company before considering officers' compensation and how does it compare with the industry that they are in?

- What is typical compensation; how are officers compensated (e.g. salary versus bonus); what are the typical perks in the company's specific industry, etc.?

- What are the typical responsibilities for officers in that specific industry? In some industries the officers / management team perform many functions.

Once the appraiser fully understands the composition of the owner's officer/management team, the appraiser reviews the various databases and surveys which publish officers' compensation material. Some of sources include:

1. Robert Morris Associates, *Annual Statement Studies* (obtains information from bank loan applications).
2. Financial Research Associates, *Financial Studies of the Small Business*.
3. Dun & Bradstreet, *Industry Norms and Key Business Ratios.*
4. Surveys performed by specific industry associations, such as: National Tooling & Machine Association, *Executive Compensation Report* and compensation surveys for the medical profession by the AMA and MGMA, etc.

Caution is required when using this data. The appraiser must not blindly apply the percentages provided from the various studies even when the compensation information is given as the mean, median or broken down by quartiles as to the subject company's sales. The appraiser must consider the information about the officer/management team as discussed above and use common sense. The appraiser should consider whether he could reasonably expect to hire the applicable number of outside personnel for that amount of compensation considering the local employment conditions.

After all adjustments have been made, the appraiser must recomputed the income taxes based on the normalized income.

VII. BUSINESS VALUATION APPROACHES

A. General Introduction to Business Valuation Approaches

Business valuation treatises, such as this one, are used both by the general practitioner and the divorce "specialist." A general practitioner will not frequently have cases with complex business valuation issues, but the general practitioner will have such cases from time to time. There is an analogy here.

The general practitioner, from time to time, will also represent a plaintiff in a personal injury suit, a suit involving medical issues. How does the general practitioner prepare to settle or try the case? A general practitioner will usually rely on the advice and explanations which are received from the client's physician, or the health care professional who is retained for the case. The general practitioner does not attempt to develop comprehensive medical knowledge. On the other hand, a lawyer who "specializes" in cases where people are injured, will have a comprehensive knowledge of medicine.

To this point, we have dealt with general concepts of evaluation. Next, however, are the more complex matters dealing with the approaches and methods of valuing a business and the application of premiums and discounts drafted. These are intended for the general practitioner who needs to develop an expertise in a particular area of evaluation, and as a review for the "specialist." After, the more advanced discussion of business valuation topics, we will address the approaches taken by various states and how the case law applies these approaches and methods.

There have been volumes written on the topic of business valuation approaches, premiums and discounts. This book will provide the lawyer with an overview of the major approaches to valuation in divorce cases and highlight the key concepts.

The appraiser considers the use of three approaches in valuing a closely held business: the income approach, the market approach and the asset based or cost approach. Within each of these three approaches, the appraiser may use a number of different “methods” in determining the value of the business. The particular approach and method used by the appraiser depends on the facts and circumstances of the business interest being valued. The business appraiser must consider each approach and determine which approach or approaches are most appropriate.

The three business valuations approaches are:

The Income Approach: Using an income approach the business is valued on the basis of the income stream the business generates.

The Market Approach: Using a market approach, the business iv valued based upon referenced to other transactions -- in real estate referred to as comparable sales.

The Asset Based Approach: Using an asset based approach, a business is valued on the basis of its assets and liabilities.

As sub-topics of these overall approaches are certain methods used in valuing a business: these may be summarized as follows:

Income Approach Methods:

Discounting: Under the discounting method, each increment of the projected economic income of an investment is discounted back to a present value rate of return known s a discount rate.

Capitalizing: Under the capitalizing method, a single period's economic income is divided by a rate of return known as a capitalization rate.

Market Approach Methods:

Publicly Traded Guideline Company Method: In this method valuation the valuator finds publicly traded companies which are comparable. The valuator examines the multiples from the prices and financial data of the guideline companies and applies these multiples to the financial data of the business being appraised.

Comparative Transaction Method (Mergers and Acquisition Method): In this valuation method the appraiser finds companies that have been sold which are comparable. The valuator examines the multiples from the prices and financial data of such companies and applies these to the business being appraised.

Past Transactions Method: This method of valuation is often significant in divorce valuations because it uses any past transactions of the companies own stock. Similarly, “buy-sell agreements” are often considered by the divorce courts in fixing the value of a business — especially when they are negotiated when a divorce is not contemplated.

Rules of Thumb: Rules of thumb are not a business valuation method. Nevertheless, rules of thumb may have their origin in market transactions and therefore rules of thumb are generally considered under the rubric of a market approach.

Asset Based Method:

Adjusted Net Asset Value Method: Under this method of valuation, the company's assets and liabilities are adjusted to their current fair market value. Under this method the valuator in a divorce valuation is generally valuing the business on the basis of a going concern value. Occasionally, a business will be in the process of liquidation and, if so, the valuator will adjust the assets and liabilities to their fair market value (not as a going concern) but based upon the premise that the business will be liquidated.

Hybrid Method - Excess Earnings Method: The excess earnings method has often been used in divorce cases. This valuation method has components of an asset based approach as well as an income approach. This method might be classified under an asset based approach because the appraiser will added the values of the tangible and intangible assets.

On the other hand, it also has features of an income approach because using this method the valuator will consider the income stream of the business in determining the intangible value of the business and the evaluator will apply a capitalization rate to the excess earnings of the business. Therefore, it is more properly considered as a hybrid method.

B. Income Approach

The income *approach* is probably the most widely used approach in business valuation. It is also the approach which may present the most problems for the court in differentiating between enterprise and personal goodwill. Under the income approach, the value of the business is based on the company's earnings, or the future earnings that the business is expected to produce. The company's earnings stream or future benefits is converted to a present value. This is done by either capitalizing the current benefits using an appropriate capitalization rate, or by discounting the future benefits using an appropriate discount rate. The capitalization of earnings method derives the company's value by looking at a *single period* of normalized earnings stream. The discounted future earnings method is derived by looking at the company's normalized earnings stream to be received over a number of years *in the future*. Using an income approach, there is a direct relationship between the amount of earnings or benefits the company will generate and its value.

The two primary *methods* used under the income approach are the discounted future earnings method and the capitalization of earnings method. Theoretically, both methods should produce identical results. Practically, the results will often differ due to the assumptions that are made in applying each method. Each method assumes that the company is a going concern and that earnings are expected to exist in the future.

A. Capitalized Returns Method Compared to Discounted Economic Income Method

In the capitalization method, since the appraiser is converting only a single number (a measure of income for a period) to a present value. The appraiser has determined that historical returns of the business are indicative of future results and that the company's growth rate is stable and predictable. In the discounting method, the appraiser concludes that past results do not necessarily indicate future results and anticipates that the company will report earnings that vary significantly from year to year. Therefore, using the discount method the appraiser anticipates that the company has specific future earnings expectations, such as that the company is expected to grow rapidly in the near term with growth slowing and leveling off in the future.

Under both methods, the appraiser needs to determine a normalized earnings stream. Usually, this is a cash flow earnings stream but there can be other types of earnings streams. The key is identifying the earning stream that the appraiser is using and matching the appropriate capitalization or discount rate for that particular income stream. For example, the appraiser does not apply the same discount rate to net cash flow and net income. There usually must be an adjustment to the capitalization or discount rate to reflect the type of earnings stream that the appraiser is using.

Even though the income approach is widely accepted by business valuators, it may present problems in divorce valuations. The lawyer handling a business valuation case needs to understand that the appraisal using an income approach results in a single value for the business which may include elements of personal goodwill. In looking at the future earnings stream of the company, the appraiser might assume that the continuing personal efforts of the business owning spouse is a significant contributing factor in determining the future growth of the company — the future earnings stream of the company. Since doing so would be contrary to Illinois case law, discussed below, the appraiser must make certain that the future earnings stream of the business does not take into consideration the earning potential and personal efforts of the business owning spouse following the divorce.

Whenever the capitalization of earnings method is used, it is simply assumed that the expected state of affairs will continue indefinitely. While the capitalization of earnings method derives the company's value by looking at a single period of normalized earnings stream, long term, sustainable growth may still be built into an appraiser's calculations using the capitalization method. In addition, the single period of normalized earnings stream used by the appraiser may already take into consideration earning potential of the spouse who owns the business. Thus, use of the capitalization of earnings method, is no indication that personal goodwill cannot be built into the overall value of the business.

2. Determination of Capitalization/Discount Rate

The lawyer should conceptually understand the impact of the discount or capitalized rate on value. The discount or capitalization rate will be expressed as a percentage. As the rate goes up, the value of the business goes down. A relatively small difference in the discount rate or capitalization rate chosen, can have a significant impact on value. Accordingly, it is important for the lawyer handling a business valuation case to understand how the discount or capitalization rate is selected based upon the two approaches that the appraiser will generally use.

a. **Build-up Approach and Modified Capital Asset Pricing Model (CAPM) Generally**

In the capitalization method, the appraiser divides next year's estimate of economic benefits (which could be based upon the immediate prior year, a simple average of prior years, a weighted average of prior years, etc.) by a capitalization rate. This capitalization rate equals the discount rate less the appraiser's estimate of any long-term sustainable growth of the company. Since a company's capitalization rate is derived from its discount rate, the appraiser must determine the discount rate before determining the capitalization rate. In developing a discount rate, appraisers generally use either the “build-up” approach and the “modified capital asset pricing model” (CAPM).

b. **The Build-up Approach**

The most common approach appraisers use to determine the discount rate for closely held businesses is the build-up approach. The build-up approach is based on the concept that the rate of return an investor would require to invest in a particular company is determined by increasing the risk free rate by an amount sufficient to compensate for all the identifiable risk factors associated with that company. The appraiser simply adds these various percentage amounts together to determine the discount rate. The following summarizes the discount rate components under the build-up approach:

1. **Risk Free Rate of Return**: The appraiser determines the risk-free rate of return as of the valuation date. This is the rate of return that an investor could obtain from a relatively risk-free investment. It is generally accepted that an appraiser can use the rate on a long term U.S. Treasury bond, such as the 20 year U.S. Treasury bond yield.

2. **Equity Risk Premium**: The appraiser adds to the risk free rate an equity risk premium. The equity risk premium represents the additional return an investor would require based on the perceived risk of ownership in a publicly traded company as compared to the return on U.S. Treasury bonds. The addition of the risk free rate and the equity risk premium produces an average market return for a large publicly traded company. Since closely held companies being valued in divorce cases are much smaller than large publicly traded companies further adjustments must be made.

3. **Size Premium**: The valuator next adds a risk premium for size. This assumes that an investor requires an additional return for investing in small companies rather than large ones because of the additional risk. The Ibbotson Yearbook measures the difference between the return required on small company stocks and large company stocks. It should be noted, however, that what Ibbotson considers a small company is still significantly larger than most closely held companies the family lawyer encounters.

4. **Investment Specific Risk**: Finally, the appraiser adds an additional premium for the return an investor would require to account for particular risks associated with the company being valued. This specific company risk number will generally be a positive number assuming greater risk for the companies set forth in step 3 above. Some factors the appraiser considers in developing this premium include the depth of company management, the companies competitive position, and a number of other subjective factors. The specific company risk premium is the most subjective factor used in the build-up approach.

Component	**General Source**	**Amount**
Risk Free Rate	Often 20 year T Bond Rate as available as of the effective date of the valuation.	2.70% (keep in mind the inverse relationship between this and all these components and value. This number has been substantially higher in the relatively recent past. Figure as of April 1, 2013).

Equity Risk Premium	Data available based on S&P 500 stock returns over income yields on applicable U.S. Treasury instrument rate. See: Ibbotson SBBI Yearbook.	6.14%
Industry Risk Premium	See Historical Industry Risk for specific SIC Code as reported per same source.	3.66%
Impact of Size Effect on Risk	Size premium based on historical return of small cap stocks (decile 10b market cap below $206.8M) in excess of CAPM, as reported by 2012 Ibbotson SBBI Yearbook	6.10%
Specific Company Risk Premium	Matter of judgment for appraiser. "There is no widely accepted model or set of formulas to convert the results of these analyses into an exact quantified effect on the discount rate."	3.00%
Total Discount Rate		21.6%

Source for Chart as Adapted and Updated: See Exhibit 9-2, *Valuing a Business*, 4th Edition, p. 163.

c. **Modified Capital Asset Pricing Model**

The formula under what is called the "Modified Capital Asset Pricing Model" (CAPM) is very similar to the build-up approach except that it considers "beta." Beta simply measures the variance between stock price of a single company and a broad index of stocks, such as the S&P 500. If a company, or industry group, has a beta less than 1.0 it indicates that the returns of that group tend to go up less than the market when the market goes up and tend to go down less than the market when the market goes down. If a company's beta is greater than 1.0, its returns would tend to go up more than the market when the market is up and down more than the market when the market goes down. Securities with betas greater than 1.0 are characterized as aggressive securities and are more risky than the market as a whole. Thus, beta can be characterized as a sort of volatility index. The formula for modified CAPM considers beta as well as the same factors in the build-up approach: the risk free rate, an equity risk premium, a small company risk premium and a specific company risk adjustment. *Valuing a Business* states, "a 'modified CAPM,' which includes adjustments for size and specific company risks, is generally accepted.

While beta is readily available for publicly traded companies, the appraiser must estimate it for privately held companies. Doing so is a laborious task which is not required when using the build-up approach. It is done by referring to proxy companies which are must be substantially similar to the company being appraised. Generally, Capital Asset Pricing Model should not be used by the appraiser of a closely held business unless the company is a candidate to go public or a candidate for acquisition by a public company. See e.g., *Estate of Klauss v. Commissioner*, T.C. Memo 2000-191 (June 27, 2000). The essential problem with use of the CAPM model to value a closely held corporation is that the beta to be applied must be estimated from comparable publicly traded companies and often there are not comparable public companies when valuing a relatively very small closely held business.

Under both the build-up approach and CAPM approach the discount rate derived is generally assumed to be a rate to be applied to a net cash flow earnings stream. If the earnings stream being used is one other than net cash flow, the discount rate needs to be adjusted further.

d. **Determination of the Capitalization Rate from the Discount Rate**

Once the appraiser has calculated the discount rate, to determine the capitalization rate, the valuator simply subtracts the company's long-term growth rate from the discount rate. The capitalization rate which results from this calculation should appropriately be applied to the following year's income or earnings stream. Thus, if the appraiser is using the current year's earnings stream or an average of prior years' earnings, an adjustment to the capitalization rate is needed. The appraiser does

this by dividing the capitalization rate by one (1) plus the long-term growth rate. This calculation lowers the capitalization rate thereby increasing the value of the business.

e. **Growing Acceptance of Discounted Economic Income Approach to Valuing Business Interests**

Pratt's *Valuing Small Businesses & Professional Practices* treatise discusses using the discounted economic income method at page 248. The heading under this section is, "Growth Acceptance of the Discounted Economic Income Method." It states in significant part:

> Some analysts are reluctant to use the discounted economic income method in marital dissolution matters because they are afraid that it impounds the results of future efforts of the operating spouse (which are not marital property) into the present value of the business. If this is a potential issue, the analyst should be careful when using the discounted economic income method to reflect only cash flows that would reasonably be expected from running the business with an employed, nonowner manager. This procedure would not reflect the potential contribution of extra efforts or special talents of the owner/manager.

In the chapter on Marital Dissolution, Pratt states, "The trend in many family law courts is to emphasize income approach methods more than asset -based methods of valuation." It also states:

> However, recent family law court cases have indicated that the courts are turning more frequently to other valuation methods. This is because these other methods (such as the discounted cash flow method) have achieved wide acceptance in the valuation community at large.

3. **Debt Inclusive Method (Valuing Company's Equity) vs. Debt Free Method (Valuing Company's Total Invested Capital)**

The above analysis assumes the appraiser is valuing only the company's equity (e.g., the stock of a corporation). This is known as the debt inclusive method or direct equity method. In many privately owned businesses, unlike their publicly traded counterparts, debt is kept to a minimum because the debt of the business is limited by the private finances of the company's principal owner(s). However, as privately owned businesses grow, at some point in their development, they begin to resemble their publicly traded counterparts and will often take on more debt.

Alternatively, the expert could value the total invested capital (both the equity and the interest bearing debt). This is known as the total invested capital or debt free method. In a controlling equity valuation, the appraiser examines the capitalization structure of companies in its industry. This is because only a controlling owner has the ability to change the company's capital structure. By valuing a company's invested capital, the appraiser considers the effects of debt on the company's valuation.

The following example illustrates why it is important for the valuator to consider assessing the total invested capital of a business. Assume there are two companies, company "A" and company "E". Each company has $100 cash as its only asset and each company earns $25. Company A's capital structure consists of $50 in interest bearing debt and $50 in equity capital while company E's structure consists of $100 in equity capital (i.e., there is no interest bearing debt). Company A's return on the money invested (equity) is 50% ($25/$50) while company E's return on equity is 25% ($25/$100). If the two companies were publicly traded, company A would have a greater value than company E. In the real world, company E would likely be forced to eventually modify its capital structure to conform to that of other companies in the same industry. While any investor should be interested in a company's return on equity, it should be kept in mind that only a controlling investor has the ability to alter the subject company's capital structure. Therefore, when valuing a closely held company under the fair market value standard of value, the appraiser should consider the company's capital structure, notwithstanding the fact that no change in the existing business is likely to occur as a result of a divorce — when there is a valuation of a controlling interest.

If the appraiser is using the total invested capital method of valuation, a rate of return associated with investing in both the equity and the debt capital of the business must be determined. There is an averaging of each of these components of the business' capitalization. This average is not a simple average. Instead, the discount rate is the weighted average of the cost of each of the components in the business' capital structure. This is called the weighted average cost of capital ("WACC").

In order to develop a discount rate under WACC, the appraiser needs to determine the cost of equity capital, the cost of debt capital, the proportion of equity in the capital structure and the proportion of debt in the capital structure.

First, the appraiser determines that the cost of the company's debt which is usually based on the current interest rates on the company's current interest bearing debt. The debt cost is than adjusted for taxes.

Next, the appraiser determines the weight to be applied to the debt and equity (the proportion of debt and equity in the capital structure of the business.) The weights that are applied to the cost of debt and the cost of equity are based on whether or not the appraiser is valuing a controlling interest or minority interest. When appraising a minority interest where the buyer cannot control the capital structure of the company, a WACC based on the company's actual weight of debt and equity is used. If the appraiser is valuing a controlling interest where the potential buyer would also have control over the capital structure, the appraiser may use WACC based on the debt and equity cost and weights of capital that are typical in the industry — that is a hypothetical capital structure discussed above.

Third, the appraiser determines the cost of equity capital. Typically, this is the discount rate that the appraiser has calculated previously for the return to the equity holder. After applying the respective weights to the costs of debt and the cost of equity, the appraiser finally adds the weighted cost of equity and debt together for the determination of the WACC. The WACC must be applied to an earnings stream that has been adjusted for the cost of the debt. For example, interest expense is added back to determine the net cash flow to invested capital. The appraiser looks to determine the earnings stream that is available to both the debt holders and equity holders (the total invested capital of the business).

Using the WACC method, once the appraiser determines the value for the total invested capital of the company (which includes the company's interest bearing debt), the appraiser then subtracts out the amount of this debt to arrive at the value of the equity of the company.

B. Market approach

1. Introduction

A “market approach” is a general way of determining a value of a business interest using one or more methods that compare the company to similar business interests that have been sold. Market transactions in businesses, business ownership interests or securities can provide objective data for developing value measures to apply in business valuations. Such value measures are frequently derived from "guideline companies.” Guideline companies are companies that provide a reasonable basis for comparison to the relative investment characteristics of the company being valued.

Transactions entered into in a free and open market can provide the clearest indication of what value the market places on a particular type of business. However, the key to using this method is the ability to obtain financial data for companies which are comparable to the company being valued. The key is comparability, because, unfortunately, businesses are not interchangeable assets.

2. **Past Transactions Method**:

First, the appraiser examines transactions involving the stock of the company being valued. However, it is important to review these type of transactions carefully to determine if they were an arms-length transaction, as opposed to simply a transfer of shares to related or friendly parties. The next place to look for transactions is the market place which consists of both publicly traded companies as well as private transactions. An advantage to looking to the market place to value a business is that doing so appears to measure the business more objectively without considering the involvement of the business owing spouse.

Case Law Re Evidence of Prior Sale of Stock in Determining Value: *In Re Marriage of Grunsten*, 304 Ill.App.3d 12 (1st Dist. 1999), ruled that the trial court erred by not giving sufficient weight in a 1994 hearing to the price at which the husband bought half the business in 1989. A critical issue of fact upon which the appellate court in *Grunsten* reversed the trial court was the price which the husband paid previously for a half interest in the business. In April 1989 the husband bought the other man's share from his widow, with a cash payment of $245,246 plus a consultant's salary of approximately $46,000 per year for three years to the widow and a $25,000 contribution for a "college scholarship" for the decedent's daughter. The agreed upon valuation date in the divorce case was December 31, 1993. The husband's expert placed the

value of the business at $418,954. The wife's expert placed the value at $1,043,771. The trial court found a value of $558,677.

On appeal the wife argued that the trial court's valuation of the business was wrong because it was below the valuation the husband paid the widow four years earlier. The evidence showed that the financial health of the business had greatly improved since the buyout. The appellate court agreed "that the trial court failed to give the [prior] sale sufficient consideration in assessing the value of [the business]. Had the court done so, it would have been evident that [the husband's] expert valuation was grossly inaccurate." The appellate court, instead of remanding, found the value of the business to be $816,240, a figure the review court concluded was "a most conservative valuation of GSP suggested by the record, taking into account the experts' valuations, the Simonek transaction and the company's sustained growth since 1989." In arriving at this figure, the appellate court determined that the consultation agreement was part of the consideration for the purchase because there was no evidence that the widow had any consulting skills and the husband conceded that she rarely visited the corporation. The appellate court also included in the payout to the scholarship fund as part of the purchase price.

A case which held that a past transaction of the subject company's stock was not entitled to significant weight because it was not an arms length transaction is *Silker v. Silker*, 593 N.W.2d 830, (1999). In Silker, the husband and his brother each owned 47.5 percent share of the stock in a family business. They executed a shareholder's agreement which provided that if either brother decided to leave the business and they were unable to agree on a division of assets, the initiating shareholder must name a price per share, allowing the other brother to either buy from or sell from him at that price. In 1990, the husband set a price on his shares at $950,000 and his brother sold his interest in the company for this amount. In divorce proceedings eight years later, the trial court rejected the wife's expert's valuation of the business at $943,000 and accepted the husband's valuation of $300,000 based upon the rationale that the belief that the husband had to pay a premium in order to buy out his brother's share of the business. On appeal the wife argued that the trial court erred in failing to follow Revenue Ruling 59-60 which states that sales of closely held businesses are indicative of fair market value unless they are forced, distressed or not at arms length. The appellate court ruled against the wife's argument noting that transaction was not at “arms length” because the husband was buying out his brother. The court held that it was not unreasonable for the trial court to decide that the husband set an inflated price in order to ensure that his brother would sell the stock to him. Additionally, the husband's experts each testified that the buyout was not indicative of the fair market value of the business.

Various tax court decisions have concluded that in determining the value of closely held stock, actual sales made in reasonable amounts at arm's length in the normal course of business, within a reasonable time before or after the date, are the best criterion of market value. *Fitts' Estate v. Commissioner of Internal Revenue*, 237 F.2d 729 (8th Cir. 1956). The *Fitts* court held that the sale of stock occurring more than three years before the valuation date were not indicative of the value as of the valuation date.

1) Was the transaction at arms length;
2) How comparable was the size of the block of stock that was sold as compared to the size of the block being valued;
3) Did the seller know the relevant facts surrounding the value of the stock.

3. **Guideline Publicly Traded Company Method**:

There is an enormous storehouse of reliable data from the transactions in publicly traded companies. In VALUING A BUSINESS, Pratt states:

> The size requirements for a public offering and public trading are far less than many people think. Many closely held companies that might be thought of as small actually are large enough to go public if they so desired. However, it is not necessary for a company to be eligible to go public in order to use valuation guidance from the public market.

In searching for guideline companies to compare with the company being valued, the lawyer handling a family law case should try to determine from the owners or management who are their direct competitors. There are also a number of sources that compile names and data regarding companies. Whatever sources are used to identify potential guideline companies, the appraiser must use both quantitative and qualitative analysis in the selection. Revenue Rule 59-60, which favors the use of the guideline company method, states:

> In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained.

Determining whether or not a particular public company should be considered as most comparable depends upon a number of factors including capital structure, credit status, depth of management personnel experience, the nature of competition and the maturity of the business. *See*, *Talichet v. Commissioner*, 33 T.C.M. 1133 (1974). One of the significant factors the appraiser will examine in finding a comparable company is size. Larger companies tend to operate differently than smaller privately held companies and as a result do not necessarily make good guideline companies. In many valuations the company is so unique that it is difficult to find a set of guideline companies. Revenue Ruling 59-60 states that companies may be in the same “or similar” industries. This phrase gives the valuator latitude to exercise reasonable judgment in selecting companies from related industries if guideline companies cannot be found in the company's industry group. There are a number of tax court cases in which the court has either accepted or rejected the use of comparable companies. These cases may be of some relevance for valuations in divorce cases.

Since the appraiser uses market information from the sale of minority interests when using the guideline publicly traded company method, the indicated value that one is realizing is a marketable, minority indicated value. Therefore, in valuing an interest in a closely held company for a divorce valuation, a premium might be added if the appraiser is valuing a controlling interest. On the other hand, the appraiser must also discount the guideline publicly traded indicated value due to the lack of marketability of the closely held business interest. These premiums and discounts are discussed below.

3. Private Transactions — The Comparative Transaction Method

In addition to using publicly traded companies, private transactions may also be analyzed to determine the value of a company. There are various databases which the appraiser may review in order to find comparable companies which are not publicly traded. This may be called the comparative transaction method. The significant difference between the use of the market for guideline companies and the use of private transactions for guideline companies is that the guideline publicly traded companies involve minority interest transactions of fully marketable securities. Generally, private transactions provide data about transfers of controlling interests and the transfers may include the entire capital structure of the business — not just the equity of the business.

Using a market approach based upon private transactions, experts often rely upon market valuation multiples, such as pricing/earnings ratios or price/sales ratios, from sales of comparable businesses or practices that included a covenant not to compete or an employment agreement. This overstates the value of the business or practice without the participation or restrictions on the business owner. The expert avoids this problem by subtracting from the total consideration paid in the comparable transaction, the value of the covenant not to compete or the employment agreement and recomputes the valuation multiples without those agreements. This may be difficult to obtain from some of the databases available.

4. Rules of Thumb and Multiple of Discretionary Earnings “Method”

Often parties in divorce cases will have heard of rules of thumb applicable to a particular industry. If rules of thumb in a particular industry are widely disseminated and referenced in the industry, they should not be completely ignored. On the other hand, rules of thumb or industry methods should only be used as a starting point in the valuation process or as what is known as a “sanity check” in the appraisal process. The value that the appraiser develops using the rule of thumb should be tested against other methods and accepted only if clearly supported by these other methods.

A rule of thumb measure of valuing a small business often involves what may be called the multiple of discretionary earnings “method.” Because the multiple of discretionary earnings is more of a rule of thumb than an approved method of valuing business, an appraiser valuing a closely held business should never use this method only. A factor which makes this method a viable tool for business appraisers is that considerable data on multiples of the sale price to discretionary earnings have been collected in the last several years. This method may be useful in divorce valuations because discretionary earnings exclude the owner's total compensation for those services that could be provided by a sole owner/manager. Discretionary earnings are defined as earnings prior to taxes, interest, noncash charges, all aspects of compensation to one owner and nonoperating and non-recurring items. The earnings are typically multiplied by a pricing multiple of discretionary earnings.

VALUING SMALL BUSINESSES & PROFESSIONAL PRACTICES discusses the standard of value the multiple of discretionary earnings method produces. It states:

> Consequently, if the multiple of discretionary earnings method is used in a valuation performed for divorce purposes, the analyst should try to check the comparative transactions used. This check is performed in order to attempt to determine the extent to which, if any, the multiple may reflect a covenant (or other personal services or restraints) that the court may consider nonmarital property.

As is addressed below, the value of a covenant not to compete is similar in nature to the value of personal goodwill of a business. Certain databases indicate whether or not a covenant not to compete was included and also indicate how much of the purchase price was allocated to the covenant not to compete.

C. THE COST APPROACH

An “asset based approach” is a general way of determining a value indication of a business' assets or equity interest using one or more methods based directly upon the value of the assets of the business less liabilities.

The theoretical basis for this approach is the “principle of substitution.” The premise is that a potential buyer of a business would not pay more than the amount necessary to replace each of the business assets owned by the entity with ones of equal utility, less any liabilities to which the entity is obligated.

The problem with the cost approach to valuing many businesses is that the value of a business interest is not due the value of the underlying assets of the business themselves but is dependent upon the value of the earnings stream that is expected to be derived from the business assets. Thus, when looking at this approach it is usually more appropriate for valuing businesses such as holding companies or investment companies, real estate partnerships, and start-up companies. This approach is also used when there is an insufficient earnings stream of the business or when liquidation of the business may be contemplated. This approach is not appropriate for entities that are profitable operating companies with intangible assets that are not contemplating liquidation.

It is easy to confuse the cost approach of valuing a business with the book value of a business. in VALUING A BUSINESS states, “Under any standard of value, the true economic value of a business enterprise equals the company's accounting book value only by coincidence. ... From a valuation perspective, the terms book value or net book value are merely accounting jargon.” One of the reason that these concepts are confusing is the fact that one off the asset based methods is sometimes referred to as the adjusted book value method. Such a method involves the discrete revaluation of the company's individual assets and liabilities. It may be called the net asset value method, the adjusted net asset value method, the asset build-up method, the asset accumulation method or the adjusted book value method.

1. Net Asset Value Method

Under the net asset value method, the company's assets and liabilities are individually adjusted to their fair market value in order to determine the company's equity value. In analyzing the balance sheet, all necessary adjustments to account for missing assets and liabilities must be determined. For example, if the company maintains its books and records on a cash basis of accounting, the appraiser must calculate and record the trade receivables and payables. Although this discussion has focused on the tangible assets of a company, it is also important to recognize and identify intangible assets. Any goodwill on the balance sheet from a prior acquisition should be eliminated. However, other intangible assets such as patents, copyrights, customer lists, computer software, going concern value, goodwill, and bargain leases should be valued. While the valuator will normally identify and value contingent liabilities, such as pending litigation, environmental concerns, etc., the valuator should not speculate on the potential impact of such contingencies unless they can be reasonably quantified.

After the assets and liabilities are recorded on the balance sheet, the appraiser must value each of the assets. Items such as cash or marketable securities may be valued by researching published closing prices as of the date of the valuation. However, unless qualified, the business appraiser should not act as a real estate or machinery and equipment appraiser. The

business appraiser usually requests a real estate appraiser (MAI) to perform a complete valuation of all of the company's real estate holdings. There are also appraisers who are specially trained and certified to value the fair market value of machinery and equipment. Accounts receivable must also be analyzed. The appraiser should look at the company's aging of accounts receivable. Based on the aging taken in conjunction with a review of the historical collection results and discussions with management, the appraiser adjusts the balance of the accounts receivable to the estimated fair market value.

In valuing the intangible assets of the business (including but not limited to goodwill), the methods that can be used are the discrete method (valuing each asset of the business individually) and the collective method. In the discrete method, each of the individual intangible assets (or individual category of intangible assets) of the business or professional practice is separately identified and valued. In valuing intangibles collectively, the aggregate intangible value of the business or professional practice, from whatever source, is analyzed and quantified. The discrete method of valuation is much more costly to perform. It will value items separately, such as a trained and assembled workforce in place, a trade name, client records, a favorable lease-hold interest, etc.

An issue often raised is how should individual assets be appraised. This is usually dictated by the premise of value that is selected. The premise of values that is typically considered in valuing individual assets includes fair market value (in continued use or as part of a going concern) or, occasionally, orderly liquidation value.

Under the premise of "fair market value in continued use," it is assumed the assets are sold as a mass assemblage and as part of an income producing company where the business earnings support the value. The American Society of Appraisers ("ASA") define "orderly liquidation value" as the gross amount expressed in terms of money which could be typically realized from a sale, as of a specific date, given a reasonable period of time to find a purchaser(s), with the seller being compelled to sell on an as is-where is basis. It is assumed that the assets are to be sold piece meal, not as part of a mass assemblage.

2. Excess Earnings Method

Under the cost approach, there is a method referred to as either the "capitalized excess earnings method," the "excess earnings method," the "treasury method," or the "formula approach" which is discussed briefly above in Section 3(e)(2) regarding Revenue Rule 68-609. This method was designed as a procedure to determine the fair market value of a company's intangible assets by capitalizing all earnings beyond a fair return on its tangibles assets. The Revenue Ruling which sets forth the steps in the excess earnings method is attached as an appendix. While the steps appear straight-forward the naive use and the overuse of this method has been criticized by the I.R.S. as well as various learned treatises. See, e.g., VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES, p. 422. The ruling itself states that, "[T]he "formula" approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefore available." This method is sometimes referred to as the "method of last resort."

Appraisers often use the excess earnings method in divorce valuations. VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES states:

> The reader should keep in mind the fact that the excess earnings method originally was created for the purpose of valuing assets, not for the purpose of valuing the company as a whole. Consequently, perhaps the most appropriate application of the excess earnings method is for the purpose of allocating total value between tangible and intangible assets. Examples of this include:
>
> > Divorce cases, in jurisdictions where personal goodwill value is considered a personal rather than a marital asset and therefore needs to be separated from the value of the business or practice.

Although use of the excess earnings method is not encouraged, the following is a brief summary of the procedures for this method:

1. Estimate a normalized level of earnings: The appraiser first estimates a normalized earnings of the business. Often, the measure of normalized earnings of the business is net cash flow.

2. Determination of Total Return on the Tangible Assets: The appraiser first estimates the fair market value of each identified asset of the company. It is because the valuation is based in significant part on valuing identified assets that this method may be considered an asset based method of valuation. Next, the valuator determines the reasonable rate of return to be applied to the net tangible assets. A significant problem with this valuation method is that there is no objective means to establishing this rate of return. Different types of assets have different risks. For example, cash has very little risk and has a rate close to the risk free rate. Clearly, inventory and machinery and equipment is riskier and requires a higher rate of return, but there is little empirical data which the appraiser can use to support the rate of return on assets on then cash. After identifying a fair rate of return on each set of assets, the dollar amount of the total return on all the tangible assets is calculated by adding the rate of returns for each asset or group of assets. Some appraisers merely determine the weighted average rate of return and apply the rate to the total tangible assets. In effect, this is the first capitalization rate that the appraiser must determine when using this method.

3. Determination of Excess Earnings of Business (Earnings Attributable to Intangible Assets): The appraiser next takes the dollar amount calculated as the total return on the tangible assets in step one and subtracts it from the company's normalized earnings stream. The result of this is the calculation of the "excess earnings" amount — the earnings attributable to the intangible assets of the company.

4. Determination of Capitalization Rate to Apply to Excess Earnings: Next, the appraiser must determine the appropriate capitalization rate to applied to the "excess earnings." This is the second capitalization rate that the appraiser must use when using this method. Problems may occur here. This rate applies to the intangible assets of the company. The intangible assets of a company are the riskiest and thus should yield the highest rate of return. This rate should generally be higher than the capitalization rate computed under the income approach for the equity of the company because the rate of return computed under the income approach relates to the entire company — including the tangible assets of the company. While there is empirical data supporting the use of the capitalization rates under an income approach there is no such data supporting the use of essentially two separate capitalization rates under the excess earnings method (one rate applied under step 2 and the second rate applied under step 4).

5. Determination of Intangible Value of Business: The appraiser next calculates the intangible value of the business by dividing the excess earnings by the capitalization rate developed for the excess earnings.

6. Determination of Value of Business by Adding Tangible and Intangible Assets: Finally, the appraiser determines the value of the company by adding together the fair market value of the company's net tangible assets determined in step one and the value of the intangibles assets of the company as calculated in the previous step.

Example of Simplified Calculations Using Excess Earnings Method

1. Normalized earnings of Business (often net cash flow). $100,000

2. Estimated net tangible assets of $300,000 x required return of 15% ($300,000 x 15%).$45,000

3. Excess Earnings. $55,000

4. Cap rate applied to excess earnings. 25%

5. Value of intangible assets $220,000
(Results of step three divided by step four)

6. Total value of business $520,000
(Results of step 5 plus value of net tangible assets).

Interestingly, the most common error in using the excess earnings method as pointed out in VALUING SMALL BUSINESSES & PROFESSIONAL PRACTICES is the failure to allow for owner's salary:

> Nevertheless, valuations are often performed using the capitalized excess earnings method without including a reasonable allowance for the compensation to the business owners for the service they performed. This error results in an overstatement of the true economic income of the company. This in turn leads to an overstatement of the value of the subject business.

There are a number of other problems that may be presented if the appraiser blindly follows the language in Revenue Rule 68-609 which refers to using a five year period. Often, the use of a simple average earnings for such a five year period would conflict with the dictates of Revenue Rule 59-60 which indicates that, "... Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power." This author has reviewed a number of divorce valuations in which the business has had an upward trend in income. If an evaluator who is faced with such a trend merely takes a five year average, it will conflict with the dictates of Revenue Rule 59-60 and understate the value of the business. Rather than using a simple average, it may be more appropriate for the evaluator to use a weighted average earnings approach. Under such an approach, the evaluator would determine the average earnings as follows:

2000:	$500,000	x 3	= $1,500,000
1999:	$400,000	x 2	= $ 800,000
1998:	$300,000	x 1	= $ 300,000
		6	$2,600,000

Thus, the valuator would divide the total of $2.6 million by six to determine the average earnings of $433,333.

Another mistake that is often made by valuators in using the excess earnings method is the failure to properly determine the net tangible asset base. Occasionally appraisers will rely upon the book value of the net tangible assets of the business. This valuation method will require in essence two appraisals: the appraiser will have to have the tangible assets of the business appraised in order to determine their current value. The required valuation of the tangible assets of the business is both an advantage and a disadvantage in using this method. Because the valuation must include a determination of the value of the tangible assets of the business, the method is helpful in distinguishing the tangible and the intangible assets of the business. The lawyer handling a business valuation case should bear in mind that the intangible assets of the business are not necessarily equal in value to the goodwill of the business. There can be other components to the intangible value of the business, such as the value of patents, etc. Nevertheless, usually the intangible value of a business will consist of goodwill.

States such as Illinois require the appraiser to distinguish personal versus enterprise goodwill. By being able to separate out the intangible asset base of the business, the appraiser can then attempt to clearly differentiate personal versus enterprise goodwill. The same approach could be used if the appraiser used an income approach as well as an adjusted net asset approach in valuing a business.

Perhaps the biggest problem in using the excess earnings method is that the appraiser will have little guidance in determining what are in essence two capitalization rates. The problems in determining the first capitalization rate (the estimated rate of return on the tangible assets of the business) have been discussed above. Using any income approach the use of one capitalization rate involves a significant subjective element of the appraisal process. The subjective nature of this process is compounded because the appraiser must determine a second capitalization rate to apply to excess earnings. In using an income approach, there are models which are relatively objective in nature that the appraiser can use in determining the capitalization rate. While there are certain subjective elements that the appraiser would use following such an income approach (such as the rate of risk for the company being valued), there is nothing comparable for the appraiser to refer to in developing the capitalization rate applicable to excess earnings. It is for this reason it has been written, "The excess earnings [method] should not be used in the valuation of professional practices, because it is antiquated and conceptually flawed. Rather a capitalized earnings approach should be used. (See R. Victor Hass, Jr., "Valuation of Professional Practices" VALUATION STRATEGIES IN DIVORCE, Robert D. Feder Ed., ___). Pratt states, "It is this lack of empirically supported basis for the capitalization rate applied to excess earnings that many appraisers consider to be the weakest link in the excess earnings method." THE LAWYER'S BUSINESS VALUATION HANDBOOK, p. 184. Because of the vagaries in the process of determining what are essentially two capitalization rates, the appraiser should perform a reasonableness check (also known in the industry as a sanity check) in order to determine if the overall capitalization rate that is implied is within the same ballpark as the capitalization rate that would be obtained using a conventionally -- such as

by using the build-up method. In the above example the estimated normalized earnings of the business were $100,000 and the value of the entity was $520,000, then the implied overall capitalization rate would be 19.2% ($100,000/$520,000).

Negative Goodwill: Often it is assumed that virtually any business must have goodwill. For the purpose of the excess earnings method goodwill is based upon the company's economic income over and above a reasonable rate of return on the company's net tangible assets. It is quite possible that a company can have an economic income of less than what would be a reasonable rate of return on the net tangible assets of the company. If so, the company may be considered to have negative goodwill. Assume there is only one owner of a small business. A business may have negative goodwill if the business owner earns a lesser income by way of salary and profits from the business than he or she could earn if he were not running the business but were an employee performing the same or similar functions.

VIII. **DISCOUNTS AND PREMIUMS**

In divorce valuations, the biggest issue often is not the value of the business itself, but the amount of discounts or premiums applied to determine the value of the marital interest in a closely-held business. The two biggest issues are generally minority/control and lack of marketability. Often with the minority interest discount as well as a lack of a marketability discount over half of the value of a business is "lost." While the average business valuation report in a divorce case may be 20 to 30 pages in length, the loss of value of much or most of the value of the business enterprise is often explained by the business appraiser in a few paragraphs with a passing reference to certain studies. Many appraisers use essentially rules of a safe harbor in determining discounts or premiums, such as a rule of thumb that a marketability discount should be approximately 35% less than the preliminary indication of value or that the control premium should be approximately 40% more than this preliminary indication of value.
Accordingly, a lawyer handling a business valuation case should be aware of how these discounts (and premiums) are determined.

Other discounts that often occur in business valuations include key person discounts, voting versus non-voting share discounts, portfolio discounts, blockage discounts, trapped in capital gains discounts, litigation risk discounts and environmental risk discounts. Similar to the key person discount is a concept in which personal goodwill is differentiated from enterprise goodwill in order to not include the future earnings stream which depends upon the personal involvement of the business owning spouse. We will focus upon the issues that are usually significant in divorce valuations: control premiums, minority interest discounts, lack of marketability discounts, key person discounts and the manner in which the courts handle goodwill in divorce valuations.

Before applying any discount or premium, the appraiser must carefully look at the methodology used as well as what type of value they are trying to determine. For example, if the appraiser uses the income approach, the assumptions used in developing the earnings stream determine whether or not the indicated value is a minority or controlling value. If in developing this earnings stream, the appraiser makes all of the modifications that a controlling shareholder would be able to make, then the indicated value would result in a control value. On the other hand, if these adjustments were not considered, the earnings stream and ultimate indicated value represents a minority value.

The same analysis applies under each approach used by the appraiser. Under the market approach, the comparative data that the appraiser uses determines the type of preliminary value. For example, if the appraiser uses data from merger and acquisition data, the resulting value usually represents a control value. If the appraiser uses multiples from publicly traded companies' minority shares, the resulting value usually represents a minority interest value. Under the cost approach, the indicated or preliminary value is usually a control value.

Example of Relationship Between Nature of Ownership Interest and Applicability of Valuation Discounts:

Type of Ownership Interest	Example of Type of Interest	Applicable Valuation Discount	Illustrative Impact of Reduction in Value	Illustrative Percentage Discount

Marketable, controlling.	100% ownership of business offered for sale	No discounts.	$10 per share	None
Nonmarketable, controlling.	**Less than 100% (controlling) ownership of business**	Discount for **illiquidity**.	$9 per share	10%
Marketable, noncontrolling.	Registered stock of publicly traded company.	Discount for **lack of control** (minority int.)	$6.30 per share	30%
Nonmarketable, noncontrolling.	**Minority shares of stock in closely held business**.	Discount for lack of marketability	$3.78 per share	40%

See, Shannon Pratt, VALUING A BUSINESS, (4th ed. 2000) at 372.

A. **Control Premiums and Minority Discounts**

A control premium is defined as the additional consideration an investor would pay over a marketable, minority equity value (publicly traded stock prices) in order to own a controlling interest in the common stock of a company. Appraisers often use two terms as synonyms: discounts for lack of control and minority interest discounts. Because it is possible that a discount for lack of control may be applied even where a party has a 50% interest in a company or greater, the term discount for lack of control is more encompassing. An excellent basic primer on minority interest discounts in family law cases is, “Valuation of Minority Interests in Closely Held Companies: What Family Lawyer's Should Known,” by John D. Emory, Jr., *American Journal of Family Law*, Vol 14, 120-122 (2000). Emory states:

> The radical difference between values of controlling and minority interests in a closely held company was laid bare over a century ago when one judge stated, “There are 51 shares ... that are worth $250,000. There are 49 shares that are not worth a ----.” (See *Humphrys v. Winous Co.*, 133 N.E.2d 780, 783 (Ohio Sup. Ct. 1956) quoting from John H. Doyle, speech before Ohio State Bar Association, July 1893).

If the valuator is appraising a control value and the indicated or preliminary value determined is a minority value, a control premium is applied to the indicated value. Conversely, if the appraiser is valuing a minority interest and the preliminary value is a control value, than a minority discount must be applied to the preliminary value. The same analysis applies in determining whether to apply a lack of a marketability discount.

In determining the extent of a discount or premium, the degree of attributes of a controlling shareholder as compared to a minority shareholder must be understood. The controlling shareholder has certain prerogatives of control such that they can set corporate policy, appoint management, determine compensation for management, determine perqs of management, acquire or liquidate corporate assets, declare and pay dividends, etc. Interested buyers are usually willing to pay a premium for these rights. Minority stock interests in a closely-held business are usually worth much less than the proportionate share of the business to which it attaches. In other words, the pieces of the pie added together probably will not equal the value of the whole pie, as the whole pie is worth more than its individual pieces.

There are many factors in determining the level of the discount or premium. The degree of control that the shareholder possesses to perform some of the items mentioned above is important. The prerogatives of control the minority shareholder possesses must also be considered. Sometimes, the degree of control is dictated by such factors as contractual restrictions, industry or governmental regulations, state laws, distribution of the ownership of the company, size of the company, depth of management or the size of the block of stock that is being valued. A simplified chart showing the degrees of control could be summarized as follows:

- 100% Control.
- Slightly Less than 100% Control: Minority interest may be a nuisance.
- Less than 80% control: Cannot consolidate financial statements for tax purposes.

- Two-Third Interest: About one-third of the states require more than a 50% (plus one share) vote to approve certain major corporation actions (see chart below). This may be known as super-majority. The various states' statutory positions on this issue will have an affect on the degree of control.
- 50% Interest: This interest is neither a control nor minority position. Such a shareholder has the power prevent actions but generally does not have the authority to control action of the company.
- Swing Vote - Minority block: This depends upon the distribution of the stock. The relationship between the persons owning other stock may have a value on the swing vote.

Majority Versus Super-majority Voting Requirements: The chart below shows that about one-third of the states require more than a 50% plus one share vote in order to approve major corporation actions such as selling the business or merging with another business. In these states, it is this authors experience that many appraisers overlook the value of having a two-thirds interest in a corporation. Even in states that do not have super-majority statutory requirements, such a majority may still be required according to the articles of incorporation or bylaws. This may have a significant impact upon the degree of control of a spouse in divorce proceedings.
There may be a reason to apply a discount for lack of control even if the valuation is of more than a minority interest. This would not be termed a “minority interest discount” but a lack of a control discount. There are no studies to help quantify such a discount for lack of complete control.

Similarly, a minority interest that involves some elements of control may be entitled to less than full minority status depending upon the elements of control. A typical situation in which a party may have a minority interest but has some elements of control involves a corporation where three persons are equal shareholders. Neither person is in a control position relative to the others. It stands to reason that the appraiser should apply a substantially lower minority interest discount as compared to a valuation involving a one-third shareholder or a two-thirds shareholder.

Once the economic implications associated with the rights are identified, the appraiser then determines the appropriate magnitude of a control premium or a minority interest discount in the valuation process.

1. **Studies of Control Premiums and Minority Interest Discounts**: A number of studies have attempted to examine the range of premiums buyers would be willing to pay for a controlling interest in a company. Control premium studies generally compare the public market trading prices before the announcement of a merger or acquisition to the merger or acquisition price. The percentage of the acquisition price over the previous minority trading price is considered to be the control premium. The percentage of the acquisition price below the acquisition price at which the minority stock had been trading is termed the minority discount. It is important to note, however, that acquisition prices often reflect elements of strategic or synergistic value, and therefore the premiums paid may reflect some elements over and above the value of the elements of control. If this is correct, then the market data would overstate the amount of any minority interest discount. VALUING A BUSINESS, by Shannon Pratt addresses this issue and states: “The inclusion of acquisition price premiums in excess of stand-alone control premiums may taint the commonly used control premium data sources, but analysts should realize that these data sources are still the best empirical evidence generally available to quantify the control premiums.”

On the other hand, it is arguable that in public companies, the controlling stockholders are not in a position to exploit the prerogatives of control to the same extent as in private companies. Using this argument, it could be urged that the market data should not understate the amount of any minority interest discount.

A. **Mergerstat Review Studies**: One source of data on control premiums has been presented in *Mergerstat Review* compiled by Houlihan, Lokey, Howard & Zukin (“HLHZ”). This study provides historical summaries of the average and medium premiums paid for control and certain non-control blocks of common shares. These premiums are measured in percentages as the difference between the acquisition price and the price of the freely traded public shares five days before the announcement of the acquisition. For example, the average premium for 1995 was 44.7%, while the median was 35%. Over the last 10 years the median premium paid ranged from 29% to 35% and averaged 31.4%. The Mergerstat Review premium studies are indicated according the applicable industry and the amounts often vary significantly, depending upon the applicable industry. As a result, the appraiser's report should give reference not only to the averages in the studies but the averages in the applicable industry provided there are sufficient number of transactions in a given industry.

The averages for the past five years may be summaries as follows:

Year	Median	Average
1995	29.2%	44.7%
1996	27.3%	36.6%
1997	27.5%	35.7%
1998	30.1%	40.7%
1999	34.6%	43.3%

While the averages and medians as shown by this study are consistent, there is a very wide distribution of premiums. More than two-thirds of the median premiums reported in the 1990's were outside of the 20 to 40% range. 31% of these median premiums during the 1990's were 20% and less while 36% were more than 40%. Thus, the use of simple averages or medians of the mass of data does little to explain the use of a certain control premium (or a minority interest discount) in a given divorce case.

B. **HLHZ Control Premium Studies**: Another study, the HLHZ control premium study, also provides data on premiums paid in the cash purchase of control interests and value observed at various intervals before takeover. They looked at the premiums paid in relation to the market price one day, one week, one month and two months before takeover. The premiums are also categorized by size of company, industries of the target company, exchange of target company (NYSE, AMEX, etc.), date, and tender offer versus a leveraged buyout. The premiums in this study are slightly higher than Mergerstat Review's study.

Determining Minority Interest Discount from Control Premium: The impact of lack of control (minority discounts) can also be measured through the above studies. The appraiser can calculate the inverse of a control premium to determine the discount for lack of control (minority discounts). Thus, if the appraiser translates the Mergerstat control premiums for the last 10 years, the range of the implied minority discount is from 21.7% to 25.9%. The HLHZ study shows a higher discount.

C. **Criticisms of Applicability of Control Premium Studies' Averages to Divorce Cases**:

There are three significant criticisms of the control premiums' studies and the application of the averages of those studies to a given divorce case. Because the control premium studies often affect the appraisers' determination of the amount of a control premium or of a minority interest discount in a divorce case and because these premiums or discounts result in a significant effect upon the valuation of the spouse's interest in a divorce case, these criticisms are reviewed below.

Exclusion of Negative Premiums from Studies: It has been noted that not all transactions of controlling interests are at premium prices. Some recorded transactions occur at prices lower than the price that existed before the announcement. In other words, some control premiums are negative. Many appraisers overlook the fact that these negative premiums are excluded from these studies. This fact tends to exaggerate the reported averages based upon the studies.

References to Averages Versus Mediums: Another factor that results in misleading averages is reliance upon averages rather than median figures. Average figures tend to be higher than the median figures because average figures are usually distorted by a few very high premiums paid. Mercer states in QUANTIFYING MARKETABILITY DISCOUNTS:

> Many, if not most, appraisers sometimes ignore or gloss over these issues when considering the application of a control premium in the valuation of a closely held business. The result is a frequent tendency to overestimate the magnitude of control premiums applicable in many business valuations based upon the Mergerstat Review and HLHZ Control Premium studies.

Control Transactions May Consider Investment Value -- Not Fair Market Value:

The standard measure of value in divorce valuations is fair market value. However, many mergers and acquisitions are strategic in nature. Assume that a husband involved in a divorce owns a business that manufactures widgets. The plant owned by the husband's company is adequate but it is relatively expensive to produce widgets at the husband's plant. Assume also that another business has a state of the art plant in which they also manufacture certain types of widgets. This plant has significant excess capacity and can produce widgets more inexpensively than the husband's plant. Accordingly, the business that purchases the husband's plant does not value the business "as is" but instead considers the fact that they could make a great deal more money from the husband's business than the husband could. The purchase of the husband's business might be considered a "strategic," "investment," "acquisition," or "synergistic" value. However, the majority position in most states is that the appropriate measure of value in divorce cases is not strategic value but is fair market value.

Reviewing the transactions based upon the control premium studies, these transactions may include elements of value to a particular buyer instead of being based upon fair market value. Accordingly, some experts urge that the premiums based upon these studies should not be titled "control premiums" but should be called "acquisition premiums" in recognition of the fact that they reflect additional values compared to merely the element of control. Thus, acquisitions paid by financial buyers may be more representative of fair market value of control as compared to premiums paid by strategic buyers. As a result, most appraisers generally acknowledge that control premiums observed for public companies overstate the control premium that is included in the fair market value of a controlling interest as compared with a minority interest.

D. **Limited Partnership Discounts:** Another source of data for determining control premiums or minority interest discounts is limited partnership transactions. When these limited partnerships were formed in the 1960's and 1970's, no secondary market for resale of interests existed. However, more recently a market has developed for such limited partnership interests. The discounts at which the transactions take place relative to the underlying net asset values provides some indication of a minority interest discount. Nevertheless, there is a relatively small secondary market for limited partnership interests as compared to publicly traded stock and therefore the discounts shown may reflect the absence of the element of lack of marketability rather than that of only a minority interest.

2. **Impact of Other Factors - Minority Shareholder's Shareholder Oppression Suits**: The statute in each state relating to the rights of minority shareholders impacts the degree of control. In many states, the minority shareholder cannot bring suit to dissolve a corporation. However, in a growing number of states, including such states as California, New York, Delaware, Rhode Island, under certain circumstances, minority shareholders can bring suit to dissolve the corporation. The percentage of shares necessary to bring such suits varies from state to state. At least one family law case has mentioned the impact of such a statute as to whether to apply a minority interest discount.

In some cases, appellate courts have held that minority discounts should not apply because the state statute provides that the minority shareholder can force liquidation. For example, in the case of *Brenengen v. Brenengen,* 226 Wis.2d 562, 596 N.W.2d 501 (Wis. Ct. App. 1999), the Court of Appeals approved the trial court's decision not to adopt a minority discount for the husband's minority interest in the family partnership. The husband had a one-third interest in the partnership. The expert applied a twenty-five percent discount with the assumption that the husband could not force the partnership's dissolution to realize his share. The expert failed to recognize that under the state statute, the minority partner could force liquidation.

3. **Considering Control Premium by Adjusting the Company's Fundamentals**: Occasionally, rather than adjusting a minority value upward to estimate a control value (applying a control premium), the valuator simply adjusts cash flow upward to consider the cash flow that a control owner would realize instead of applying a control premium. Such adjustments include the elimination of excess compensation, liquidation of excess assets, etc. This process is often part of the "normalization." If the normalization process involves changes to the business that only an owner in a control position can make, generally the business is considered already valued on a "control basis" and accordingly the application of a control premium is not appropriate.

4. **Conclusion Re Control Premiums and Minority Interest Discounts**:
Virtually all appraisers agree that a spouse in a minority position lacks valuable prerogatives of control that are enjoyed by an owner in a control position. However, the differential in value between an individual with a minority interest compared to one who has a control interest is difficult to measure. Many of the studies ordinarily relied upon by experts overstate this difference due to various reasons.

B. **Lack of Marketability Discounts**

In valuing a closely-held businesses, the application of a discount for lack of marketability is often the single most significant adjustment to value, especially when valuing a minority interest. The concept of lack of marketability discounts refers to the liquidity of the interest in the company being appraised (i.e., the ease and speed at which it can be sold). A good working definition of marketability is where there is the ability to convert property to cash quickly, with minimum transaction and administrative costs, and with a high degree of certainty of receiving the expected amount of proceeds.

These discounts are sometimes called "illiquidity discounts." *See,* e.g., *Maggos v. Commissioner*, T.C. Memo 2000-127. The terms "lack of marketability discounts" and "illiquidity" are often considered to be synonymous. (However, as discussed below, it appears that there is a growing trend to use the term "illiquidity" discount when referring to a discount of a controlling interest in a corporation). An ownership interest in a business is worth significantly more if it is readily marketable because owners prefer to own liquid investments. The minority shareholder in a closely-held company does not have the same market access as a holder of an interest in a publicly traded company. The challenge to the business valuator of a privately held company then is to quantify the effect of lack of marketability in terms of its impact on the value of the company.

The effect of lack of marketability on the value of financial assets has been analyzed and commented on by many learned treatises and long been recognized by the courts. These studies can be broken down into two major groupings: those dealing with restricted stock and those dealing with initial public offerings.

1. **Restricted Stock Studies**

A "restricted stock" is also known as a "letter stock." Unregistered or restricted stock is issued under various circumstances.

-- **Closely-held Company's Sale of Unregistered Shares**: A closely-held company may sell unregistered shares of stock privately in order to raise capital.

— **Shares Issued When Company Acquired**: A company may use corporate stock to acquire other companies. When this is done the stock issued is often unregistered and is subject to restrictions on its sale.

— **Unregistered IPO Shares**: Often underwriters of an IPO request that some of the stock not be registered at the time of the public offering. The underwriters may be concerned that corporate insiders may sell their stock as soon as the company goes public and thus depress the stock's price. Occasionally, the shares are registered and are restricted from sale by a "lockout agreement" for a certain time period.

Restricted stock is identical to freely traded stock of a public company except it is restricted from trading on the open market for a certain period. The duration of the period of restriction varies but usually the restrictions lapse within 12 months (before April 29, 1997 there was a two year rather than one year holding period). Although the unregistered or restricted stock cannot be sold on the open market, it can be sold in private transactions. In 1990 the SEC eliminated the requirement that all restricted stock transactions must be registered with the SEC. The new rule allowed qualified institutional investors to more readily trade unregistered stock.

Since marketability is the only difference between restricted stock and freely traded stock, studies of such stocks are often used to measure the lack of a marketability discount to be applied when valuating a closely-held corporation. Because the short time period in which the restrictions on such stock expire, shares of closely-held stock are expected to require a higher marketability discount compared to the restricted stock of a publicly traded company. Studies of marketability discounts based upon restricted stock studies may be summarized as follows:

Study	**Average Discount**

SEC Overall Average (1966-69)	25.8%
SEC Nonreporting OTC (1966-69)	32.6% (both mean and median)
Milton Gelman (1968-70)	33%
Robert Trout (1968-72)	33.5%
J. Michael Maher (1968-73)	35.4%
Standard Research Consultants (1978-82)	45.0% (median)
Willamette Management Assoc (1981-84)	31.2%
William Silber (1981-88)	23.0%
FMV Opinions, Inc. (1979-92)	27.1%
Management Planning, Inc. (1980-96)	27.1%
Bruce Johnson (1/91-12/95)	20%
Columbia Financial Advisors (1/96-4/97)	21.0% (median 14.0%)
Columbia Financial Advisors (5/97 - 12/98)	13.0% (median 9.0%)
LiquiStat Study: 2005- 2006 (Published January-February 2007 Ed. Valuation Strategies)	32.8

At the outset, it should be noted that while the average discounts in the restricted stock studies are consistent, virtually all of the studies have a huge degree of variability with the highest discounts being more than 80 percent or 90 percent and with the smallest discounts actually representing a positive number, i.e., a premium. For this reason, it is inappropriate for any valuator to quote the averages as contained in either the restricted stock studies and urge their use to the subject company. Regarding the more recent LiquiStat Study, Pluris identified two weaknesses with prior restricted stock studies: (1) the lack of measurable parameters regarding the price discount (for example, was the observed price discount the result of company size or information asymmetry between the buyer and the seller?) and (2) the impossibility of establishing two distinct data sets, one completely liquid and one completely illiquid. Pluris reasoned that the observed price discounts from previous restricted stock studies were likely affected by factors unrelated to illiquidity: such as: (1) compensation for control and monitoring, (2) capital scarcity effects, and (3) information asymmetry effects. To overcome these perceived weaknesses, he analyzed the pricing of restricted stock in investor-to-investor trades-that is, transactions (1) not involving the issuer or an affiliate of the issuer and (2) not raising new capital for the issuer. According to Espen Robak of Pluris, clearly, the private placement process has facets, beyond just illiquidity, that affect discounts. See: the Discount for the Lack of Marketability: Update on Current Studies and Analysis of Current Controversies, by Reilly and Rotkowski.

Summary of Restricted Stock Studies: Since most divorce cases involve small companies and because the size of the company is a significant factor in valuations, it is noteworthy that the discounts for small public company restricted stocks were grouped in the 33% to 35% range. Since 1990, as the restrictions on these stocks has loosened, the discounts have been progressively lower. As a result, the current restricted stock transactions are becoming less and less useful in order to establish a benchmark for discounts for lack of marketability in divorce cases.

2. **Pre-Initial Public Offering (IPO) Studies**

Before the 1980's virtually all of the research directed at quantifying lack of marketability discounts was based upon the restricted stock studies. Generally, it was acknowledged that the lack of marketability discounts should be greater for closely-held companies compared to companies in which the ability to trade stock was limited for a certain time period. An excellent discussion of the Pre-IPO studies is contained in THE HANDBOOK OF ADVANCED BUSINESS

VALUATION, Robert F. Reilly and Robert P. Schweihs, editors (2000). Chapter 4 of the treatise addresses this subject at significant length. It states:

> However, one of the inherent weakness in using restricted securities as a benchmark is that the transferability restrictions generally lapse, or disappear, after a given period of time (historically, two years-subsequent to 1996, one year). In contrast, most closely held stocks have no meaningful prospects for liquidity (i.e., a "permanent restriction").

Nevertheless, before the initial public offering studies, there was no data to determine more specifically the difference between the value of stock in private transactions before going public relative to the market prices following the initial public offers. When a company goes public (makes an initial public offering), it is required to file a registration statement with the SEC. In addition to the financial statement information, it is required to disclose with the registration statement all transactions in the company's stock during the three years before the filing with the SEC. These details include the date of the transaction, the transaction price, and the number of shares. There are now two studies of such private transactions before an initial public offering.

Emory Pre-IPO Studies: John Emory directed a series of eight studies covering the years 1981 through 1997. These studies were discussed comprehensively in "*The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock (Eight in a Series) November 1995 through April 1997*" (BUSINESS VALUATION NEWS, December 1996 and 16 BUSINESS VALUATION REVIEW, No. 3. (September 1997). This series of studies contained a median discount of 44%.

Willamette Management Associates Pre-IPO Studies: Willamette Management Associates conducted a series of sixteen studies comparing private stock transactions to later public offerings. The studies covered the years 1975 through 1995. The median discount for private transaction Price/Earnings (P/E) multiples compared to public offering P/E multiples ranged from a low of 31.8% to a high of 73.1%. The conclusion to be drawn from the Willamette Management studies is that the discounts were higher than the average discounts presented in the restricted stock studies, those studies of companies which already had an established market. The average marketability discount determined from the studies ranged from 25% to 45%.

One criticism of the Willamette Management Associates studies is that they have **not** published the lists of stocks involved in each years study. It has been reported that Willamette has provided the underlying data to the courts and to the opposing experts under confidentiality agreements where there are disputes as to discounts for lack of marketability.

Valuation Advisors Pre-IPO Study: Recently Valuation Advisors conducted a study of companies that completed IPOs in 1999 using data from prospectuses. The average discount according to this study was approximately 49%. The study analyzed the transactions by length of time between the transaction and the initial public offering. As expected, the longer the holding period before the IPO, the greater the average discount. This study can be readily criticized, however, because it involved a higher proportion of "new economy" stocks at a time of a bull market for these securities.

Conclusion as to Pre-IPO Studies: The results of these studies are helpful in the determination of an appropriate marketability discount because the share prices analyzed reflected the buyer's ability to gain access to a public market within a readily foreseeable, well-defined period of time ranging from a few months to a few years. On the other hand, Mercer has pointed out that the pre-IPO studies likely measure more than only a discount for marketability and he correctly suggests that there are multiple enhancements experienced by a company going public which would include the new capital being raised which presents opportunities for future growth and the opportunity to pay down debt and improve the fundamentals of a company. Mercer opines, "Comparing pre-IPO discounts with marketability discounts is like comparing apples to oranges." *See,* Christopher Mercer, QUANTIFYING MARKETABILITY DISCOUNTS (1997) pp. 89-91.

Nevertheless, the marketability studies support the assumption that the fair market value of minority interests of closely-held companies should sell at significant discounts from their publicly traded counterparts. Minority shareholders in privately held companies do not enjoy as favorable an investment. Their shares have no immediate or predictable access to a public market, and the value of those shares suffers accordingly. Thus, the pre-IPO studies indicate the existence and general magnitude of marketability discounts but they should not be used as direct measures of such discounts without considering the potential impact of other factors involved in the IPO transactions.

3. **Mercer's Model**: Chris Mercer has developed what he calls the Qualitative Marketability Discount Model. This model is based upon the premise that the value of the nonmarketable minority interest is the present value of the benefits it will produce for its owner. Shannon Pratt in *Valuing Small Businesses and Professional Practices* states, “The model is totally sound, but the inputs require substantial subjective estimation. It is useful for identifying situations where the discount should be significantly above or below the averages shown by the restricted stock or pre-IPO studies. Christopher Mercer's book, QUANTIFYING MARKETABILITY DISCOUNTS (1997) is one of the leading treatises on the subject.

5. **Marketability Discount on Controlling Interests — n/k/a Illiquidity Discounts**

Although controlling shareholders can force registration to provide marketability, small closely held companies rarely, if ever, contemplate a public offering. Without market access, an investor's ability to control the timing of potential gains, to avoid losses and to minimize the opportunity costs associated with the inability to direct funds to a more promising investment is impaired. The challenge to the valuator of a private company then is to quantify the effect of illiquidity, in terms of its impact on the value of the company even when dealing with a control interest.

Although the studies discussed above did not address controlling interests, they do tell us that even a temporary lack of marketability can be largely negative. When one is valuing a controlling interest in a privately held going concern, the risk of being locked-in is present and should be recognized.

The case of *Estate of Woodbury G. Andrews*, 79 T.C. 938 (1982), states:

> [E]ven controlling shares in a non-public corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock.

Shannon Pratt, VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES, (3d. 1998) discusses application of lack of marketability discounts to divorce cases. It states:

> Similarly, in the marital dissolution situation, the spouse most actively involved in the small business usually gets the controlling interest in a business. And the nonoperating spouse usually gets much more liquid assets, such as cash, marketable securities, and real estate.
>
> A rational argument can be made that the same factors discussed above should be reflected in the value of the illiquid controlling ownership interest in the small business or professional practice for marital dissolution valuation purposes.

Christopher Mercer's position is that a marketability discount should not be applied when valuing a controlling interest. Mercer states, “In the context of this discussion, a controlling interest in enterprises is considered to be marketable, and a marketability discount is not used.” He acknowledges, however, that, “some appraisers, however, do apply a marketability discount, which may reflect the costs of brokerage or transaction costs, to control values. Christopher Mercer, QUANTIFYING MARKETABILITY DISCOUNTS, (1997) at pp. 15, 325-344. Mercer acknowledges that transaction costs could be considered as a rationale for a marketability discount but urges that for smaller business, those costs could range “up to 10% or more.” *Irreconcilable differences* at. 331.

Mercer's position against calling any such discount a marketability discount is that appraisers often get off track in applying a “marketability discount” to a controlling interest. Mercer cited the standard studies that are addressed above as those studies relate to the lack of marketability of minority interests in closely held businesses. Interestingly, Mercer's position on this issue notes that virtually all business owners are aware of the concept of something like a control premium. He then states, “How many business owners have you talked to who think that their controlling interest in a business is subject to some discount called a marketability discount?” I have never spoke with a business owner who would understand what that means. The alone exception may be, of course, the divorcing husband (or wife) who owns 100% of a business and who will benefit from a lower value!”

A lawyer handling a divorce valuation should understand that there is not a consensus on this issue but that a mistake many appraisers make is applying lack of marketability discount to a controlling interest in the same range as the valuator would apply such a discount to a minority position. It appears that there is a growing consensus away from the use of the term lack of marketability discount when valuing a controlling interest and toward the use of an illiquidity discount. The illiquidity discount is due to potential transaction related costs and other factors.

C. Other Entity Level Discounts -- Including Key Person Discounts

In addition to the discounts discussed above, there are other discounts that should be considered, such as a key person discount, potential discounts for trapped in capital gains, discounts for known or potential environmental liability, and discounts for pending litigation. These discounts are discounts applied to the entity, that is, **before** applying other discounts that apply to the particular party obtaining a divorce, such as the minority interest discounts and lack of marketability discounts. One of the most significant of these discounts applicable to divorce proceedings is a key person discount.

The ASA defines a key person as an individual whose contribution to a business is so significant that there is a certainty that present earnings levels would be adversely affected by the company losing that individual. This discount applies more to small service oriented businesses but can also have an impact on the value of larger businesses.

The key person discount is taken if the business valuator expects a reduction in the value of the subject company because of the loss of services of an individual who is actively involved and key to the company's operations. The person must play a significant role in the management of the company and possess talent or information that is not easily replaced or that requires a significant investment on the part of the company to replace that person.

In developing a key-person discount the valuator attempts to calculate the effect on earnings; research the replaceability of the key-person without material adverse effects on the company's profit level and determine the level of key-person life insurance that the company has. Assuming that the company is the beneficiary, key-person life insurance may be important if the amount of the death benefit is enough to help the company recover from a loss of a key-person.

The valuator must be careful not to double count with this discount, as the factors discussed above concerning the key-person discount may have already been taken into account in developing the discount rate used under the same income approach. If these factors were already taken into consideration in developing the discount rate, a separate key-person discount should not be taken.

The U.S. Tax Court has frequently recognized key person discounts. The amounts of discounts by the tax court have usually ranged from 10% to 25% of the value of the business before other adjustments. See, for example, *Estate of Milton Feldman*, T.C. Memo 1988-429 (25%) *Estate of Paul Mitchell*, T.C. Memo 1997-461. Therefore, even in a jurisdiction which does not, in itself, recognize the distinction between enterprise versus personal goodwill, the valuator may consider application of a key-person discount in an appropriate case.

D. Personal Goodwill Discounts

There are a number of states which mandate a distinction between enterprise versus personal goodwill, especially if the court is addressing a small, closely-held business — which may be a professional practice. This distinction has been given various names by the various court decisions. Personal goodwill may be called professional goodwill. Enterprise goodwill may also be referred to as practice goodwill. This discussion will use the terms personal and enterprise goodwill in making this distinction. Generally, states follow several approaches to the issue of personal goodwill.

The first approach distinguishes personal versus enterprise goodwill in valuation of all business interests and does not make an explicit distinction between whether the business is a professional business or is a non-professional business. Typical of states following this approach are Illinois, Indiana, Nebraska, and Virginia. The second approach is similar to the first approach but distinguishes between professional and nonprofessional goodwill. This is what some lawyers believe the law was in Illinois following *Zells* but before the *Talty* and *Schneider* decisions. Under each of these two approaches, case law generally does not allow the court to consider in the valuation an implied covenant not to compete. Illinois does not follow this second approach to valuing businesses in divorce cases. A third approach takes the position that value must be

established without dependence upon the net income of the professional but will allow consideration of continuity of practice, that is, the cases may assume that the owner will enter a covenant not to compete in valuing the subject business. A fourth approach states that professional goodwill is a marital asset subject to distribution in the divorce. This approach is the opposite of that followed in Illinois.
A 2010 book ideal for Illinois lawyers and valuators is BVR's Guide to Personal v. Enterprise Goodwill, 2010 Edition: (March 26, 2010) For a table of contents see the attached.

IX. **RECENT ILLINOIS CASE LAW AND BUSINESS VALUATION**:
Schneider: The most recent business valuation case (of the trilogy of key cases (*Zells*, *Talty* being the first two cases) addressed by the Illinois Supreme Court is *Schneider*. In an article after the publication of the *Schneider* appellate court decision the author had stated:

> The author predicts that the fact pattern presented in the Schneider case will be addressed in a third Illinois Supreme Court decision involving personal and enterprise goodwill. As a general matter in cases involving valuation of a professional practice, the authors agree that the fact that child support is awarded should not be dispositive as to whether there is an impermissible double-dip. Instead, the better argument in Schneider against considering personal goodwill was the fact that the wife sought and obtained a significantly disproportionate maintenance award. It would appear that this case would be a much better test case if the wife had only sought an equal distribution of marital property and had waived her right to maintenance. With this fact pattern it would appear clear that there could not be a double consideration of the greater income generating capacity of the business owning spouse.

As predicted the Illinois Supreme Court addressed for the third time the issue of personal and enterprise goodwill in its *Schneider* decision, 824 N.E.2d 177 (2005). Also as predicted, the Illinois Supreme Court determined that the fact that child support or maintenance was awarded was not dispositive as to whether there is a double-dip. The Supreme Court decision in *Schneider* essentially only reaffirmed that *Talty* remains good law. The opinion stated, "However, as this court made clear in *Talty*, the basis for our holding in *Zells* was not simply the fact that maintenance and support were awarded. Rather, the basis for our holding in *Zells* was the fact that personal goodwill "is already reflected in a number of the circumstances that must be considered by a judge in making an equitable division of property under the [Dissolution] Act." *Talty*, 166 Ill. 2d at 237." The court noted that in *Talty* there was no award or support or maintenance.
The Supreme Court decision then stated:

> In this case, as in *Talty*, the personal goodwill in Earl's dental practice was considered by the circuit court in assessing the criteria in section 503(d) and in deciding to award Jodi a disproportionate share of the marital assets. Any further consideration of that goodwill in valuing Earl's dental practice would amount to an impermissible double counting. Accordingly, we find that the appellate court erred in holding that personal goodwill should have been included in the valuation of Earl's dental practice. (Emphasis added.)

The Supreme Court emphasized that there is an impermissible double dipping to the extent there was a disproportionate property award. As suggested in the original chapter, "It would appear that this case would be a much better test case if the wife had only sought an equal distribution of marital property and had waived her right to maintenance. With this fact pattern it would appear clear that there could not be a double consideration of the greater income generating capacity of the business owning spouse."

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