BLUE SKY OR BOOK VALUE? COMPLEX ISSUES IN BUSINESS VALUATION

AUTHORS:

J. KENNETH HUFF, JR., CPA/ABV, CVA
4412 Spicewood Springs Rd.
Suite 104
Austin, Texas 78759
(512) 345-9485 (Telephone)
(512) 345-2236 (Telefax)

RICHARD R. ORSINGER
ATTORNEY AT LAW
1616 Tower Life Building
San Antonio, Texas 78205
(210) 225-5567 (Telephone)
(210) 267-7777 (Telefax)

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by

Ken Huff
Certified Public Accountant
Accredited in Business Valuation
Certified Valuation Analyst
Private Investigator

Richard R. Orsinger
Attorney at Law
Board Certified in
Family Law and Civil Appellate Law
Texas Board of Legal Specialization

I. INTRODUCTION. This article discusses issues that can arise in valuing a business in a Texas divorce. The first part of the article discusses basic business valuation methods. These are the methodologies that should be considered as establishing the admissibility of expert opinion under *Daubert* and *Gammill*. The article then focuses troublesome issues that can arise in a Texas divorce, including tax attributes, personal goodwill, post-divorce labor, covenants not to compete, buy-sell provisions, discounts and premiums, qualifications and *Daubert* reliability, mixed character ownership interests and using standards for qualifications of experts and the reliability of their methodology as a way of dealing with appraisal advocates.

II. GENERAL PRINCIPLES OF BUSINESS VALUATION IN DIVORCE. [The author of this Section is J. Kenneth Huff.]

A. COMMON ELEMENTS.

1. A community interest in a closely held business is usually not divided in kind, therefore, a value must be assigned to the interest, in order to divide the parties' community estate. Even a separate property business may need to be valued if there is a *Jensen* reimbursement claim. *See Jensen v. Jensen*, 665 S.W.2d 107 (Tex. 1984). The *Jensen* reimbursement claim arises when the business is the separate property of a spouse and the owner/spouse improves the business by failing to reasonably compensate the community estate for time, toil and effort.

2. The closely held business or professional practice is generally not going to be sold. The owner/spouse will continue to own and operate the business or professional practice. Where the value to the owner of continued ownership is different from what the business interest can be sold for, the Fair Market Value does not represent economic realities. Generally, the difference is attributable to post divorce earnings which are not divisible community property.

3. Generally, there is no willing seller or willing buyer of an interest in a closely held business, therefore, a hypothetical buyer must be assumed. This assumption is consistent with the definition of Fair Market Value.

4. The closely held business is generally not traded on any public exchange where value can be readily determined. In addition, it may be difficult to locate guideline companies or comparable sales transactions necessary when using a market method of valuation. Guideline companies are publicly traded companies which have characteristics similar to the subject business. In using the Guideline Company Method, value is determined by applying a value multiple derived from the guideline company to the subject company such as a price to earnings multiple. Comparable sales transactions represent data derived from the actual sale of a similar company and applied to a subject company.

B. STANDARDS OF VALUE (DEFINITIONS OF VALUE). Standard of Value is defined as the identification of the type of value being utilized in a specific engagement: e.g. fair market value, fair value, investment value. INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS.

1. Fair Market Value. This is the most common definition of value.

a. Revenue Ruling 59-60. Revenue Ruling 59-60 defines Fair Market Value as:

> ...the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.

This definition assumes a hypothetical arm's length sale without regard to a specific buyer or seller.

b. Standard for Divorce Cases in Texas. The Texas Supreme Court has defined Fair Market Value as: "...the amount that a willing buyer, who desires to buy, but is under no obligation to buy would pay to a willing seller, who desires to sell, but is under no obligation to sell." *City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex. 1972); *Wendlandt v. Wendlandt*, 569 S.W.2d 323, 325 (Tex. Civ. App--Houston [1st Dist.] 1980, no writ); *Morgan v. Morgan*, 657 S.W.2d 484 (Tex. App--Houston [1st Dist.] 1983, writ dism'd). This definition is essentially the same as the definition given in Revenue Ruling 59-60.

2. Investment Value. The value of a business to a specific owner or prospective owner. This definition of value is sometimes used interchangeably with Intrinsic Value defined below.

3. Fair Value. The definition of Fair Value differs from state to state, however, most valuation experts agree Fair Value is calculated on a control basis without regard to discounts for marketability or minority interest.

a. Texas Corporation Act. The Uniform Business Corporation Act defines Fair Value - "with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."

b. Intrinsic Value. The definition of Intrinsic Value is the true, inherent and essential value, independent of accident, place, or person, which value is the same everywhere and to everyone.

c. Transaction Value. The price at which an actual transaction occurred.

C. PREMISE OF VALUE. "An assumption as to the set of actual or hypothetical transactional circumstances applicable to the subject valuation." Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, p. 23 (3rd ed. 1996).

1. Liquidation Value. Liquidation value is premised on the idea that the assets of the business will be sold. In other words, the business does not have any intangible or going concern value.

2. Going Concern Value. Going concern value is premised on the assumption that a business will continue to operate consistent with its intended business purpose as opposed to liquidation.

D. DETERMINING RATES FOR DISCOUNTING OR CAPITALIZING (INCOME, EARNINGS OR CASH FLOW).

1. Discount Rate. Discount rate is defined as a rate of return used to convert a monetary sum payable or receivable in the future into present value. The discount rate is also equal to the cost of capital or the required rate of return. AMERICAN SOCIETY OF APPRAISERS BUSINESS VALUATION STANDARDS, January 1995, p. 18.

2. Capitalization Rate. Capitalization rate is defined as any multiple or divisor used to convert income into value. AMERICAN SOCIETY OF APPRAISERS BUSINESS VALUATION STANDARDS, January 1995, p. 16. The capitalization rate is usually derived from the discount rate by subtracting company growth.

3. Build-Up Method (Ibbotson Data). The build-up method is the most common method of calculating the discount rate. Most valuation experts obtain the data necessary for determining the discount rate from the book, STOCKS, BONDS, BILLS AND INFLATION: VALUATION EDITION 2001 YEARBOOK, Ibbotson Associates. The build-up method consists of the following general steps:

a. Risk-Free Rate. The risk free rate of return is the return an investor could obtain from a low-risk guaranteed investment, such as U.S. Treasury Notes. Generally, the risk free rate is the current rate of a thirty-year Treasury bond with twenty years to maturity. The reason for using twenty-year rather than thirty-year bonds is because Ibbotson Associates publishes equity risk premium data related to twenty-year Treasury bond maturities, but no such equity risk premium data are available for thirty-year maturities.

b. Plus: The Equity Risk Premium. The extra return earned by an average equity investor in excess of the return on long-term Treasury securities.

c. Plus: The Risk Premium for Size. The additional return from the smallest public companies.

d. Plus: Specific Company Risk and Other Risk Factors. This represents the additional adjustment attributable to such factors as the subject company's industry, financial risk and any other specific risk of the subject company.

e. Net Cash Flow Discount Rate. The total of items a. through e. equals the net cash flow discount rate.

f. Capitalization rate. Capitalization rate is calculated by subtracting the subject company's average growth rate from item e.

4. Other Methods for Determining Discount Rate. Other methods for determining discount rates are available but are rarely used and are beyond the scope of this article.

E. VALUATION METHODS

1. Book Value/Adjusted Net Assets.

a. Book Value. Book value is accounting terminology representing the capitalized cost of an asset less accumulated depreciation, depletion or amortization as it appears on the books of account of the enterprise. With respect to the enterprise, book value represents the difference between net assets and total liabilities as they appear on the company's balance sheet. The term book value does not represent the value of any items on the company's balance sheet.

b. The Adjusted Net Assets Method of Valuation. The Adjusted Net Assets Method of valuation is the method in which a company's assets and liabilities are adjusted to appraised or Fair Market Value in order the determine the value of the company's equity. The Adjusted Net Assets Method is commonly used if any of the following situations exist: the company has no established earnings history; a volatile earnings history; the continuation of the company as a going concern is questionable; or, the company's goodwill is personal in nature. The Adjusted Net Assets Method is generally used in the valuation of a controlling interest. If this method is used to value a minority interest, generally a discount for lack of marketability and minority interest would be applied. Shannon P. Pratt, BUSINESS VALUATION BODY OF KNOWLEDGE: EXAM REVIEW AND PROFESSIONAL REFERENCE, p. 87 (1998). Going concern value may be included in this method if the company is expected to continue operating and there exists intangible assets such as patient files, staff and procedures in place and an established patient or client base.

2. Income Methods and Definition.

a. Definition. The income approach represents a set of procedures in which an appraiser derives an estimate of value for an income producing property by converting its anticipated benefits into property value. This conversion can be accomplished in two ways. Annual income expectancy can be capitalized at a market-driven capitalization rate or at a capitalization rate that reflects a specified income pattern, return on investment and change in the value of the investment. Alternatively, the annual cash flows for the holding period and the reversion can be discounted at a specified yield rate. APPRAISAL INSTITUTE, DICTIONARY OF REAL ESTATE APPRAISAL, p. 178 (3rd ed). There are two primary approaches to estimate value based on the income methods, capitalization of a single period of normalized earnings or cash flow and discounting future earnings or cash flow. These methods are discussed below.

b. Capitalization Method. This method is defined as the conversion of income, earnings or cash flow into value. AMERICAN SOCIETY OF APPRAISERS BUSINESS VALUATION STANDARDS, January 1995, p. 15. The formula for applying the Capitalization Method is cash flow (or net earnings) divided by the capitalization rate equals estimated value. GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Volume 1, Chapter 5, p. 5-2 identifies the steps in applying this method as follows:

(a) Obtain financial statements for a representative period of time (usually at least five years).

(b) Adjust the financial statements for GAAP errors and for normalization adjustments.

(c) Recompute federal and state tax liabilities on the normalized pretax income determined in Step (b).

(d) If the benefit stream to be capitalized is cash flow, adjust the net earnings in Step (c) to arrive at gross or net cash flow.

(e) Determine the capitalization rate.

(f) Determine the period of operations that should be capitalized.

(g) Estimate the operating value of the company by dividing the net earnings in Step (c) or the cash flow in Step (d) by the capitalization rate obtained in Step (e).

The Capitalization Method can be used for valuations of either control or minority interest. Adjustments to financial statements will dictate which type of interest is valued. The adjustments necessary to normalize the benefit stream should be consistent with the interest valued. If a minority interest is valued, adjustments would not be made to items which cannot be controlled with a minority ownership interest, such as owners' compensation.

The Capitalization Method should be considered when the following circumstances exist GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Volume 1, Chapter 2, p. 2-42:

(a) Earnings capacity contributes significantly to the company's worth.

(b) Enough reliable data is available to reasonably estimate expected normal earnings.

(c) Current earnings levels are expected to approximate future earnings.

(d) Earnings for the subject company are significantly positive.

(e) Expected growth rates are modest and predictable.

(f) Owner benefits can be reasonably estimated.

(g) The company has significant intangible asset value.

(h) Earnings are considered a better indicator of value than net cash flow.

c. Discounted Future Returns Method. This method is based on the premise that a financial investment is worth the sum of all future benefits it will provide to the owner, each discounted to a present value at a discount rate that reflects the time value of money and the degree of risk (uncertainty) of receiving the benefits in the amounts expected. Shannon P. Pratt, BUSINESS VALUATION BODY OF KNOWLEDGE: EXAM REVIEW AND PROFESSIONAL REFERENCE, p. 105 (1998). The steps in estimating value pursuant to this method are listed as follows GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Volume 1, Chapter 5, p. 5-42:

(a) Obtain a financial forecast.

(b) Adjust the financial forecast for any GAAP errors or normalization adjustments.

(c) Recompute federal and state taxes if adjustments were made in Step (b).

(d) If net cash flow is the benefit stream to be discounted, additional adjustments should be made to arrive at forecasted net cash flow for each year.

(e) Determine the discount rate.

(f) Estimate the operating value of the company during the terminal year.

(g) Estimate the current operating value of the company by discounting back all future operations (including the terminal value of the company in Step (f) to present value using the present value conversion factors for the discount rate determined in Step (e).

The Discounted Future Returns Method can be used for valuations of both control and minority interest depending on the nature of adjustments to the financial forecast as discussed above under the Capitalization Method.

The Discounted Future Returns Method should be considered when the following circumstances exist GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Chapter 2, p. 2-43:

(a) Earnings/cash flow potential contributes significantly to the company's worth.

(b) Current cash flow levels are expected to differ significantly from future cash flows.

(c) The company's future cash flows can be reasonably estimated.

(d) The company's net cash flow in the terminal year is expected to be significantly positive.

(e) The company's total net cash flow during the forecast period is not expected to be significantly negative.

(f) If valuing a controlling interest, owners' benefits can be reasonably estimated.

(g) The company is a start-up business.

(h) The company is a potential acquisition.

d. Market Approach. Under this approach, the value of a business is based on comparable business sales transactions, guideline companies or prior transactions.

(1) The Guideline Company Method. This method estimates value by comparing guideline companies valuation multiples to the subject company. Revenue Ruling 59-60 strongly advocates the Guideline Company Method. Guideline companies should be similar to the subject company. The term "similar" allows for wide latitude in the selection of guideline companies. The object is to find companies that experience similar risk characteristics such as markets served, type of products, geographical territory and size and comparability of financial history. Shannon P. Pratt, BUSINESS VALUATION BODY OF KNOWLEDGE: EXAM REVIEW AND PROFESSIONAL REFERENCE, p. 128 (1998).

(2) Based on Multiples. The Guideline Company Method is based on valuation multiples derived from guideline companies applied to the subject company, such as price to earnings.

(3) Comparable Sales/Prior Transactions Methods. These methods are based on comparison of the subject company to sales of comparable companies or prior transactions within the subject company. The Comparable Sales Method is similar to the application of the Guideline Company Method since appropriate multiples are applied in estimating value. Value is estimated based on the Prior Transactions Method by examining sales transactions relating to the subject company. These transactions may provide some of the best evidence of value provided they are at-arms-length transactions within a reasonable proximity in time to the valuation date.

(4) When to Consider. The market approach should be considered when the following circumstances exist. GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Chapter 2, p. 2-43:

- There is an adequate number of guideline companies and/or transactions to determine a value multiple.
- If guideline companies will be used, there is adequate data on the guideline companies to allow the consultant to make appropriate analyses and adjustments.
- The valuation is for federal income tax purposes.
- The company being valued is considering a public offering.

e. Discounts and Premiums. After the operational value of the business has been estimated, the next step in the valuation process is to determine whether premiums (which increase value) or discounts (which decrease value) should be applied.

(1) Factors to Consider. Premiums and discounts are determined based on the following factors:

- The characteristics of manner in which the estimated value was determined. Methods to arrive at the estimate of value generally will yield a value relating to a specific type of interest, controlling or minority, and to whether the value derived is a marketable or non-marketable value. For example, an estimate of value utilizing Ibbotson data yields a marketable minority interest value. Therefore, discounts or premiums should be consistent with the manner in which the estimate of value was derived.
- The appropriate standard of value required for the particular valuation. For example, if Fair Value is the appropriate standard, discounts for lack of marketability and minority interest should not be applied.
- Ownership characteristics of the subject interest being valued should correlate to the valuation approaches and methods. For example, the valuation approach might yield a marketable control value when the interest valued is a non-marketable minority interest. Therefore, an adjustment must be made to reconcile the valuation approach to the interest being valued.

(2) Lack of marketability. Marketability represents the ability to quickly convert the business interest into cash. For example, actively traded public stocks can be sold and converted into cash in three business days or less.

The determination of a lack of marketability discount should be based on empirical data supporting the amount of discount applied. There are numerous studies quantifying various levels of marketability discounts based on private placements of restricted shares of public stocks and private transactions compared with subsequent initial public offerings.

GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Volume 2, p. 8-27 lists a number of these studies and the average discount from each study.

In addition to studies quantifying marketability discounts, the following factors should be considered. Shannon P. Pratt, BUSINESS VALUATION BODY OF KNOWLEDGE: EXAM REVIEW AND PROFESSIONAL REFERENCE, p. 161 (1998):

- The greater the dividend or withdrawal amount, the less the discount for lack of marketability.
- Put rights can greatly reduce or even eliminate a discount for lack of marketability.
- The wider the pool of realistic potential buyers, the less the discount for lack of marketability.
- As the size of the block of stock increases, the discount for lack of marketability decreases.
- Restrictions on the transfer of stock tend to increase the lack of marketability discount.

(3) Minority Interest Discounts and Control Premiums. The minority interest discount represents the reduction from the prorata share of the value of the entire business to reflect the absence of control. Control premiums reflect the additional value inherent in the controlling interest. A control premium is usually necessary when the valuation method yields a minority interest value when the valuation is of a controlling interest.

(4) Other Discounts. May be considered such as key man and blockage discounts. The key man discount relates to the loss of a key person who has been intimately involved in the operation of the business. This risk factor can be considered in determining the discount or capitalization rate instead of a line item discount. The blockage discount applies to blocks of publicly traded stock large enough to affect the normal trading volume of the stock. To sell this volume of stock may require a discount.

f. Adjustments to Financial Statements. Adjustments to the financial statements of the business being valued generally take two forms: GAAP adjustments and normalization adjustments.

GAAP adjustments relate to adjusting the financial statements for items which are not recorded pursuant to generally accepted accounting principals. As reflected in the GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Volume 1, Chapter 4, p. 4-20, GAAP adjustments provide the valuation consultant with a consistent, reasonable starting point for the valuation.

Normalization adjustments are unique to business valuation engagements. Different adjustments apply to the interest being valued. In valuing a minority interest, adjustments should not be applied if no authority exists to affect such changes. For example, a holder of a minority interest has no authority to change existing owner compensation since only a controlling interest has this authority. These adjustments provide the valuation consultant insight into:

- What prior operations might have looked like under normal conditions and on a consistent basis with guideline companies, or
- What a prospective buyer might reasonably be expected to obtain from the company in the future, using history as a guide. GUIDE TO BUSINESS VALUATIONS, Practitioners Publishing Company, Volume 1, Chapter 4, p. 4-20.

III. QUALIFICATIONS OF BUSINESS VALUATION EXPERTS. [The author of this Section is Richard R. Orsinger.]

A. GENERAL RULE ON QUALIFICATIONS. The following text, taken from Chapter 3-2 of the State Bar of Texas Family Law Section's EXPERT WITNESS MANUAL, discusses the general rule regarding qualifications of expert witnesses in Texas courts. *See* http://www.expert-witness-manual.com.

Under TEX. R. EVID. 702, a person may testify as an expert only if (s)he has knowledge, skill, experience, training or education that would assist the trier of fact in deciding an issue in the case. *Broders v. Heise*, 924 S.W.2d 148, 149 (Tex. 1996). This involves the expert's "qualifications." The party offering the testimony bears the burden to prove that the witness is qualified under Rule 702. *Broders v. Heise*, 924 S.W.2d 148, 151 (Tex. 1996). The decision of whether an expert witness is qualified to testify is within the trial court's discretion, and will be reviewed on appeal only if the ruling is an abuse of discretion, meaning that the trial court acted without reference to any guiding rules or principles. *Broders v. Heise*, 924 S.W.2d 148, 151 (Tex. 1996).

Whether an expert is qualified to testify under Rule 702 involves two factors: (1) whether the expert has knowledge, skill, etc.; and (2) whether that expertise will assist the trier of fact to decide an issue in the case.

Courts sometimes evaluate the first prong, of adequate knowledge , skill, etc., by asking whether the expert possesses knowledge and skill not possessed by people generally. *Broders v. Heise*, 924 S.W.2d 148, 153 (Tex. 1996). *See Duckett v. State*, 797 S.W.2d 906, 914 (Tex. Crim. App. 1990) ("The use of expert testimony must be limited to situations in which the issues are beyond that of an average juror"); John F. Sutton, Jr., *Article VII: Opinions and Expert Testimony*, 30 HOUS. L.REV. 797, 818 (1993) [Westlaw cite 30 HOULR 797].

The second prong, assisting the trier of fact, requires that the witness's expertise go to the very matter on which the expert is to give an opinion. *Broders v. Heise*, 924 S.W.2d 148, 153 (Tex. 1996), citing *Christopherson v. Allied Signal Corp.,* 939 F.2d 1106, 1112-1113 (5th Cir.), *cert. denied*, 503 U.S. 912, 112 S. Ct. 1280, 117 L.Ed.2d 506 (1992). The test then for qualifications is whether the expert has knowledge, skill, experience, training or education regarding the specific issue before the court which would qualify the expert to give an opinion on the particular subject. *Broders v. Heise*, 924 S.W.2d 148, 153 (Tex. 1996). Stated differently, the offering party must demonstrate that the witness possesses "special knowledge as to the very matter on which he proposes to given an opinion." *Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713, 718 (Tex. 1998). *See United Blood Services v. Longoria*, 938 S.W.2d 29 (Tex. 1997); Linda Addison, *Recent Developments in Qualifications of Expert Witnesses*, 61 TEX. B.J. 41 (Jan. 1998) [Westlaw cite: 61 TXBJ 41].

B. QUALIFICATIONS OF BUSINESS EVALUATORS, IN PARTICULAR. [The author received assistance in preparing this section on qualifications of business evaluators from Patrice L. Ferguson, of Ferguson, Camp & Poll, Houston, Texas. Ms. Ferguson is both an attorney and a CPA, and has a forensic and accounting practice in Houston.]

1. Business Evaluators: Licensing and Professional Organizations. Business evaluators are not licensed or accredited by the State. Most business evaluators belong to one or more of four associations that offer education and accreditation in business appraisal. These are the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA).

a. AICPA. The American Institute of Certified Public Accountants (AICPA) is the national professional organization for all CPAs. Membership is voluntary. In 1997 the AICPA instituted a professional designation for CPAs who have met experience, education and testing requirements for business valuation. That designation is ABV–Accredited in Business Valuation. See: <http://www.aicpa.org/members/div/mcs/abv.htm>.

b. American Society of Appraisers. The American Society of Appraisers (ASA) was formed in 1936 and is an appraisal certifying organization representing all major disciplines of appraisal specialists, including those who specialize in business valuation. In order to ensure that professional appraisers adhere to high technical and ethical standards in performing valuation projects, ASA has prepared a comprehensive set of *Principles of Appraisal Practice and Code of Ethics* for its members. These principles are appropriate for business valuation specialists as well as appraisers for other valuation disciplines within the ASA membership. Among topics addressed by the principles are the following major issues:

Objectivity

Obligations to the client

Obligations to other appraisers

Guidance on the application of various methods and practices

Unethical and unprofessional practices.

Guidance on the appraisal report.

Beyond the preceding general standards, the Business Valuation Committee of the ASA has adopted standards that relate specifically to business valuation engagements. These standards currently include eight Business Valuations Standards, Definitions, a Statement of Business Valuation Standards, and one Advisory Opinion.

The ASA follows mainstream business valuation methods for appraising businesses. See <http://www.appraisers.org>.

c. Institute of Business Appraisers. The Institute of Business Appraisers (IBA) consists of persons who engage in the valuation of mid-sized to smaller businesses. Members include CPAs, business brokers, attorneys, economists, college professors and estate appraisers. Formed in 1978, the IBA has over 3,000 members, half of whom are CPAs. The IBA awards

Professional Certifications, including: CBA, Certified Business Appraiser; AIBA, Accredited by IBA; BVAL, Business Valuation Accredited for Litigation.

d. National Association of Certified Valuation Analysts. The NACVA is an organization of some 4,500 CPAs and other valuation professionals who engage in business valuation, litigation support and other types of valuation services. The NACVA was formed in 1991. The NACVA offers three designations: Certified Valuation Analyst (CVA); Accredited Valuation Analyst (AVA); and Government Valuation Analyst (GVA). Approximately 3,500 members have obtained one of these designations. A CVA must be a licensed CPA and a member of the local CPA society or of the AICPA. An AVA must have a business degree and experience in business valuation. A GVA must be currently employed by a government agency and performing valuation work. See <http://www.nacva.com>.

e. The International Business Brokers Association. The International Business Brokers Association (IBBA) has established authoritative principles for conducting business brokerage activities. The IBBA Standards provide a minimum standard of methodology for business brokers when dealing with customers, clients, and other business brokers. In addition to six standards a glossary is included in the standards for terms that are unique to the business brokerage industry.

IV. DAUBERT RELIABILITY AND RELEVANCY OF BUSINESS VALUATION EXPERTS. [The author of this Section is Richard R. Orsinger.]

A. GENERAL REQUIREMENTS UNDER DAUBERT, KUHMO, ROBINSON, GAMMILL CASES. In the case of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 113 S. Ct. 2786, 125 L.Ed.2d 469 (1993), the U.S. Supreme Court held that FRE 702 overturned earlier case law requiring that expert scientific testimony must be based upon principles which have "general acceptance" in the field to which they belong. *See Frye v. U.S.*, 293 F. 1013 (D.C. Cir. 1923) (establishing the "general acceptance" test for scientific expert testimony). Under Rule 702, the expert's opinion must be based on "scientific knowledge," which requires that it be derived by the scientific method, meaning the formulation of hypotheses which are verified by experimentation or observation. The Court used the word "reliability" to describe this necessary quality. The Court also indicated that relevance required that the expert's data and methodology be sufficiently connected to the issue in the case to warrant admission of the expert's evidence.

In *Kumho Tire Co. v. Carmichael*, 526 U.S.137, 11 S. Ct. 1167, 143 L.Ed.2d 238 (1999) (ruling below: 131 F.3d 1433 (11th Cir. 1997)), the Supreme Court said that the reliability and relevancy principles of *Daubert* apply to all experts, not just scientists, and where objection is made the court must determine whether the evidence has "a reliable basis in the knowledge and experience of [the relevant] discipline." The trial court has broad discretion in determining how to test the expert's reliability. *Id.*

The Texas Supreme Court adopted the *Daubert* analysis for TRE 702, requiring that the expert's underlying scientific technique or principle be reliable and relevant. *E.I. du Pont de Nemours v. Robinson*, 923 S.W.2d 549 (Tex. 1995). The Texas Supreme Court listed factors for the trial court to consider regarding reliability: (1) the extent to which the theory has been or can be tested; (2) the extent to which the technique relies upon the subjective interpretation of the expert; (3) whether the theory has been subjected to peer review and/or publication; (4) the technique's potential rate of error; (5) whether the underlying theory or technique has been generally accepted as valid by the relevant scientific community; and (6) the non-judicial uses which have been made of the theory or technique. *Robinson*, 923 S.W.2d at 557. *See America West Airline Inc. v. Tope*, 935 S.W.2d 908 (Tex. App.--El Paso 1996, no writ) (somewhat unorthodox methods of mental health worker in arriving at DSM-III-R diagnosis did not meet the admissibility requirements of *Robinson*). The burden is on the party offering the evidence to establish the reliability underlying such scientific evidence. *Robinson* at 557.

In *Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713 (Tex. 1998), the Texas Supreme Court announced that the reliability and relevance requirements of *Robinson* apply to all types of expert testimony, whether or not it is based on science. In *Gammill* a unanimous Supreme Court said:

> We conclude that whether an expert's testimony is based on "scientific, technical or other specialized knowledge," *Daubert* and Rule 702 demand that the district court evaluate the methods, analysis, and principles relied upon in reaching the opinion. The court should ensure that the opinion comports with applicable professional standards outside the courtroom and that it "will have a reliable basis in the knowledge and experience of [the] discipline." [FN47]
>
> We agree with the Fifth, Sixth, Ninth, and Eleventh Circuits that Rule 702's fundamental requirements of reliability and relevance are

> applicable to all expert testimony offered under that rule. Nothing in the language of the rule suggests that opinions based on scientific knowledge should be treated any differently than opinions based on technical or other specialized knowledge. It would be an odd rule of evidence that insisted that some expert opinions be reliable but not others. All expert testimony should be shown to be reliable before it is admitted. [FN48]

Gammill, 972 S.W.2d at 725-26.

After noting that the reliability and relevancy criteria listed in *Daubert* may not apply to experts in particular fields, the Texas Supreme Court noted that nonetheless there are reliability criteria of some kind that must be applied.

The Court said:

> [E]ven if the specific factors set out in *Daubert* for assessing the reliability and relevance of scientific testimony do not fit other expert testimony, the court is not relieved of its responsibility to evaluate the reliability of the testimony in determining its admissibility.

Gammill, 972 S.W.2d at 724.

Daubert and *Robinson* contain a relevancy requirement, to be applied to expert evidence, that was explained in *Gammill v. Jack Williams*, 972 S.W.2d 713, 720 (Tex.1998), in the following way:

> The requirement that the proposed testimony be relevant incorporates traditional relevancy analysis under Rules 401 and 402 of the Texas Rules of Civil Evidence. To be relevant, the proposed testimony must be "sufficiently tied to the facts of the case that it will aid the jury in resolving a factual dispute." Evidence that has no relationship to any of the issues in the case is irrelevant and does not satisfy Rule 702's requirement that the testimony be of assistance to the jury. It is thus inadmissible under Rule 702 as well as under Rules 401 and 402.

Some courts and commentators call this connection the "fit" between the evidence and the issues involved in the case.

B. *DAUBERT* APPLIED TO ECONOMISTS. The *Daubert* reliability concept has been applied to economists.

In *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000), the court of appeals applied the *Daubert* reliability standard to the testimony of an economist in an anti-trust case, and ruled the testimony inadmissible because not all relevant circumstances were incorporated into the expert's economic model, and the model failed to account for market events that did not relate to any anticompetitive conduct.

In *In re Valley-Vulcan Mold Co.*, 237 B.R. 322 (6th Cir. 1999), the Court of Appeals applied *Kuhmo* and affirmed the admission of the opinion of a financial expert on the solvency of a company in connection with an effort to recover fraudulent conveyances. The witness, who was national director of a valuation services group, had degrees from prestigious universities, and had experience in determining the solvency of companies.

In *Liu v. Korean Air Lines Co., Ltd.*, 1993 WL 478343 (S.D.N.Y. 1993), the trial court applied *Daubert* standards and partially admitted and partially rejected a professional economist's testimony. The court permitted testimony on: the future growth of Taiwan's economy and its effect on employment in the shipping industry; the concept of the lost value of household services (but not the value of them, since the expert's value was based in US and not Taiwanese figures); the decedent's statistical work life expectancy; the projected spread of growth of decedent's income over 10 years. The court rejected testimony on: the likelihood of the decedent being promoted on any particular dates; the assumption of an 8% annual increase in the decedent's earnings; lost fringe benefits (because the expert did not support with evidence his assumption that fringe benefits equalled 19.95% of salary).

Other cases applying the *Daubert* reliability concept to economists are discussed in Androgue & Ratliff, *Kicking the Tires After Kuhmo: the Bottom Line on Admiting Financial Expert Testimony*, 37 HOUS. L. REV. 431, 454-464 (2000).

C. *DAUBERT* APPLIED TO ACCOUNTANTS. The *Daubert* reliability concept has been applied to accountants. In *G.T. Laboratories, Inc. v. The Cooper Companies, Inc.*, No. 92-C-6647 (W.D. Ill. Sept. 24, 1998) [1998 WL 704302], an accountant's testimony was excluded because it was based on non-standard methodology and the expert did not show that the methodology had been tested or subjected to peer review or had had an error rate determined. In *S.E.C. v. Lipson*, 46 F. Supp.2d 758 (N.D. Ill. 1999), a CPA's opinion that a company's internal financial reports were not reliable was excluded because the expert's opinions were not based on the methods and principles of

accountancy. These cases and others are discussed in Androgue & Ratliff, *Kicking the Tires After Kuhmo: the Bottom Line on Admiting Financial Expert Testimony*, 37 HOUS. L. REV. 431, 454-464 (2000).

In *TUF Racing Products v. American Suzuki Motor*, 223 F.3d 585 (3rd Cir. 2000), the court of appeals upheld the admission of a CPA's opinion on lost profits under *Daubert* standards. It was permissible for the CPA to testify to the discounted present value of lost future earnings based upon information provided by the plaintiff and assumptions given by counsel.

D. *DAUBERT* APPLIED TO OTHER FINANCIAL EXPERTS. In *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513 (Del. 1999), the Delaware Supreme Court held that *Daubert* and *Kumho Tire* apply to valuation experts testifying in appraisal proceedings regarding corporate stock. The court upheld the lower court's decision to reject an expert's capital market approach to valuation, and both sides' experts' discounted cash flow approach to valuation. How *Daubert* standards might be applied to valuation experts is further discussed in Androgue & Ratliff, *Kicking the Tires After Kuhmo: the Bottom Line on Admiting Financial Expert Testimony*, 37 HOUS. L. REV. 431, 454-464 (2000).

In *Callahan v. A.E.V. Inc*., 182 F.3d 237 (3rd Cir. 1999), the court of appeals indicated that *Daubert* applied to lost profit testimony in an antitrust case and ruled that the testimony of two financial experts was admissible.

United States v. Whitehead, 176 F.3d 1030 (8th Cir. 1999), the appellate court upheld the admissibility of an FBI agent's opinions explaining the criminality of a check kiting scheme. *Accord*, *United States v. Yoon*, 128 F.3d 515, 527-28 (7th Cir. 1997) (also involving a check-kiting scheme).

E. STANDARDS OF RELIABILITY FOR BUSINESS VALUATION. The IRS, in Rev. Rul. 59-60, said that business valuation "is not an exact science." The business valuation field has general principles that are widely-acknowledged, but business valuation involves many subjective decisions that are not subject to precise measurement. Additionally, there is no "peer reviewed" publishing industry in business valuation, in contrast to scientific fields.

1. Sources of Authority on Business Valuation. Sources of authority for business valuation include the IRS, the Appraisal Standards Board, the AICPA's Business Valuation Committee, and the other business valuation organizations mentioned above. The non-governmental organizations publish materials, conduct educational classes, conduct testing, and award special designations for business evaluation. There are some privately published books and journals that many consider authoritative. For example, Shannon Pratt's books on business valuation are highly respected. And there are court decisions involving valuation issues–mostly estate tax litigation. However, case law usually is fact-specific and not very helpful in articulating business valuation standards.

2. IRS Standards on Business Valuation. For purposes of business valuation methods, the main authoritative statements by the Internal Revenue Service are revenue rulings. However, private letter rulings (PLRs) which, although not public, do present the IRS' position on substantive tax issues. There are some PLRs that relate to business valuation, and many business evaluators consider PLRs. Remember, these are IRS positions.

The most important source of authority on valuing closely held businesses, from the IRS or from any other source, is Rev. Rul. 59-60 (1959-1 C.B. 237), which provides guidance regarding the valuation of stock of closely held corporations for estate and gift tax purposes. In RR 59-60, the IRS reviewed in general the approach, methods, and factors to be considered in valuing shares of closely held corporate stock for estate and gift tax purposes. RR 59-60 was modified by Rev. Rul. 65-193. The provisions of Rev. Rul. 59-60, as modified, were extended to the valuation of corporate securities for income and other tax purposes by Rev. Rul. 68-609, 1968-2 C.B. 327. Rev. Rul 93-12 deals with attributions. There are others, as well.

The IRS has issued other Rev. Rulings on valuing business interests that are considered authoritative. For example, Rev. Rul. 77-287 deals with the valuation, for Federal tax purposes, of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities laws. RR 77-287 is on-line at:
<http://www.minval.com/irsrevrule77287_mineral.htm>.

3. The Appraisal Standards Board & USPAP. The Appraisal Standards Board (ASB) is a subdivision of the Appraisal Foundation. The Appraisal Foundation was established pursuant to congressional authority to be a source of appraisal standards and appraiser qualifications. The Appraisal Foundation promulgates appraisal standards through the Appraisal Standards Board (ASB) and qualifications through the Appraiser Qualifications Board (AQB). The Appraisal Standards Board has issued valuation standards, called USPAP. See <http://www.appraisalfoundation.org>.

a. What Is USPAP? USPAP is the Uniform Standards of Professional Appraisal Practice, issued by the Appraisal Standards Board. USPAP has been adopted

by various federal and state agencies. Much of USPAP applies to valuing real estate. However, Standards 9 & 10 apply to business appraisals. See: <http://www.appraisalfoundation.org/uspap2000/toc.htm>.

The ASB says this about USPAP:

> The Uniform Standards of Professional Appraisal Practice [were] adopted by the Appraisal Standards Board of the Foundation on January 30, 1989 and [are] recognized throughout the United States as the generally accepted standards of professional appraisal practice.

<http://www.appraisalfoundation.org/overviw.htm>.

Although USPAP is widely-recognized, and some state laws require that appraisals be done in conformity with USPAP, USPAP is not universally acknowledged. For example, the American Institute of Certified Public Accountants and the IRS have not adopted USPAP.

b. USPAP Not a Standard of Admissibility of Opinions on Value. There are no Texas cases considering USPAP as a standard for admissibility of expert valuation evidence. Courts of other states have held that USPAP is not a rule of evidence.

Connecticut has adopted executive department regulations requiring that real property appraisals be performed according to USPAP. Conn. Comm. of Consumer Protection Reg. 20-504-2. One Connecticut judge rejected a claim that an appraisal report was inadmissible for violating USPAP, saying that the purpose of the Connecticut legislative scheme and related regulations was to provide for the licensing and certification of appraisers, and "not to impose threshold standards for the admissibility, or content of, an appraisal . . . ." *Connecticut Housing Finance Authority v. Moniz*, CV-950553406S (Conn. Super. Ct. Hartford Nov. 10, 1997) (unreported) [1997 Conn. Super. LEXIS 3027]. Several Minnesota courts have arrived at the same opinion, rejecting challenges to admissibility based upon a violation of USPAP, saying for example that "USPAP standards are not Rules of Evidence. Rules of Evidence govern the admissibility of evidence at trial." *Ferche Acquisitions, Inc. v. County of Benton*, C5-94-513 and CX-95-274 (Minn. Tax Ct. Sept. 21, 1995) [1995 Minn. Tax LEXIS 62]. *See Huisken Meat Center, Inc. v. County of Murray*, C4-95-87 *3 (Minn. Tax Ct. June 3, 1996) [1996 Minn. Tax LEXIS 34] (failing to adhere to USPAP goes to the credibility, not the admissibility of evidence"); *Small Building Redevelopment Corp. v. County of Hennepin*, TC-19147 (Minn. Tax Ct. April 12, 1995) ("failing to adhere to USPAP goes to the credibility, not the admissibility, of the evidence") [1995 Minn. Tax LEXIS 19]. The Mississippi Supreme Court rejected an attack on an appraisal by an expert who owned nearby land, saying that the USPAP preamble and Rule 2-3 "do not render incompetent an appraiser with interests in nearby land or in the subject property being appraised. The emphasis of USPAP is on disclosure of any material interest which the appraiser may have." *Broadhead v. Bonita Lakes Mall, Ltd.*, 702 So.2d 92, 98 (Miss. 1997).

It thus appears that failure to comply with USPAP is at best just one factor to consider on admissibility. A variation from USPAP in how much disclosure is contained in a written report is not very important from a reliability standpoint. However, a variation from the valuation methodology in USPAP is important to the question of whether the evaluator's methodology is reliable.

4. Generally Accepted Business Valuation Methods. For publicly-traded stock, market reports reflect what price shares are selling for–this is the value you use, subject to some adjustment.

For valuing a privately-held business, the starting point is the historical, existing financial records, including books of account, financial statements, and tax returns. Financial reports and tax returns are designed for purposes other than establishing value, so the rules for preparing these documents are different from the generally-accepted methods for valuing business interests. As noted by the Texas Supreme Court in *Bendalin v. Delgado*, 406 S.W.2d 897, 900-901 (Tex. 1966):

> Book value is entitled to little, if any, weight in determining the value of corporate stock, and many other factors must be taken into consideration.

Additionally, there may be questions about the accuracy of a business's books of account, financial statements, and tax returns.

Some businesses are valued based on Fair Market Value of assets and liabilities. Others are valued based on capitalized income. Others are based on cash flow. These methods are discussed in the first part of this article. Deviations from this methodology could make an expert's testimony subject to *Daubert* attack.

V. CONSIDERING TAX ATTRIBUTES. [The author of this Section is Richard R. Orsinger.] Internal Revenue Code § 1041 excludes capital gain recognition of a transfer upon divorce, and gives the receiving spouse a carry-over basis in the asset. If that asset is

later sold for a gain, that gain will be taxed. Because the basis of many spouses' ownership interest in a closely held business is usually fairly low compared to time-of-divorce value, many lawyers want to consider the net after-tax value of the business interest in a divorce. However, there is Texas case law prohibiting trial courts from considering tax attributes of assets in making the property division.

In *Harris v. Holland*, 867 S.W.2d 86 (Tex. App.–Texarkana 1993, no writ), the court held that it was error for a divorce court to subtract potential capital gains tax liability while valuing a capital asset for purposes of divorce. The court relied upon two earlier cases, *Freeman v. Freeman*, 497 S.W.2d 97, 99 (Tex. Civ. App.--Houston [14th Dist.] 1973, no writ), and *Simpson v. Simpson*, 679 S.W.2d 39, 41 (Tex. App.-- Dallas 1984, no writ). In *Freeman* it was held to be improper for the divorce court to deduct the hypothetical tax liability that the husband would incur if a retirement plan were to be immediately liquidated. In *Simpson* it was error for the divorce court, in valuing retirement plans, to assume immediate liquidation of the two plans thus generating a projected tax liability calculated using the husband's income tax rate at the time of divorce. It can be argued that assuming immediate tax consequences in a tax-sheltered retirement account is not analogous to built-in capital gains tax associated with corporate stock, and that the same rule should not apply. It can also be argued that deferred tax liability, even on retirement accounts, should be considered, albeit discounted to present value from the projected date of retirement.

A number of courts of other states have also concluded that the tax implications of a future sale of property to a third party are too speculative to permit the divorce court to subtract this future tax liability from the present value of the asset–unless it could be ascertained that under the court's decree, such sale would actually occur. *See, e.g., In re Marriage of Goldstein*, 120 Ariz. 23, 583 P.2d 1343 (1978); *Levan v. Levan*, 545 So.2d 892 (Fla.App. 1989); Burkhart v. Burkhart, 169 Ind.App. 588, 349 N.E.2d 707 (1976); *Nemitz v. Nemitz*, 376 N.W.2d 243 (Minn.App. 1985); *In re Marriage of Beck*, 631 P.2d 282 (Mont. 1981); *Orgler v. Orgler*, 237 N.J. Super. 342, 568 A.2d 67 (1989); *Hovis v. Hovis*, 518 Pa. 137, 541 A.2d 1378 (1988); *Bettinger v. Bettinger*, 183 W. Va. 528, 396 S.E.2d 709 (1990). However, the Supreme Court of Massachusetts ruled that a trial court properly"imputed an estimated capital gains tax in order to assign a more accurate value to those assets." *Williams v. Massa*, 430 Mass. 619 (Mass. 2000).

The Second Circuit Court of Appeals, in *Eisenberg v. Commissioner*, 155 F.3d 50 (2nd Cir. 1998), has acknowledged the validity of adjusting for built-in capital gains tax when valuing C corporation stock. The Court distinguished earlier case law to the contrary, saying that at the time of those cases the General Utilities Doctrine permitted corporations to sell or distribute assets, or liquidate without incurring the built-in capital gains tax. The General Utilities Doctrine was abrogated in the Tax Reform Act of 1986. *See* Karen J. Damiano (CPA), *Eisenberg v. Commissioner: Court Allows Adjustment for Potential Built-In Capital Gains Tax*, WILLAMETTE MANAGEMENT ASSOCIATES INSIGHTS pp. 1-2 (Winter 1999). The Second Circuit commented:

> We believe it is common business practice and not mere speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the Corporation at issue in making a sound valuation of the property.
>
> * * *
>
> We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock.

The Court relied upon *Estate of Davis v. Commissioner*, Daily Tax Report (BNA) No. 126, at K-12, K-19 (T.C. June 30, 1998), in which the Tax Court found that an adjustment or discount attributable to potential built-in capital gains tax was appropriate.

The following article discusses the subject: Martin C. Van Acker, *Should Built-In Gains Tax Be Considered in Valuing Corporations?*, http://www.aaml.org/builtingains.htm [7-8-2001].

In *Obermer v. U.S.*, 238 F. Supp. 29, 34 (D.C. Haw. 1964), the court recognized unpaid capital gains on undistributed dividends as a proper factor to consider in valuing stock. *See* Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 440 (1997).

VI. PERSONAL GOODWILL AND POST-DIVORCE LABOR. [The author of this Section is Richard R. Orsinger.]

A. PERSONAL GOODWILL. In *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972), the Texas Supreme Court held that the goodwill of a sole practitioner doctor was not an asset to be valued or distributed upon divorce. The Court specifically said it was not addressing goodwill

of a business entity apart from the person of the individual member. *See Stephens v. Stephens*, 625 S.W.2d 428 (Tex. App.--Fort Worth 1981, no writ) (chiropractor-husband's professional goodwill not divisible). Subsequent Texas cases have suggested that where a professional business is conducted through an entity, be it a professional corporation, a professional association, or a partnership, any goodwill of the business entity which exists apart from the personal goodwill of the professionals involved can be a divisible asset upon divorce. Thus, in *Geesbreght v. Geesbreght*, 570 S.W.2d 427 (Tex. Civ. App.--Fort Worth 1978, writ dism'd), the court held that goodwill existed in the doctor-husband's medical corporation that was separate from the personal goodwill of the doctor, and which had a value for purposes of divorce. This same distinction has been recognized in other Texas cases: *Simpson v. Simpson*, 679 S.W.2d 39 (Tex. App.--Dallas 1984, no writ) (no goodwill of the entity, as distinguished from personal goodwill of the doctor-husband, existed in that particular case); *Finn v. Finn*, 638 S.W.2d 735 (Tex. App.--Dallas 1983, writ ref'd n.r.e.) (goodwill existed in lawyer-husband's law partnership separate and apart from the goodwill personal to him); *Trick v. Trick*, 587 S.W.2d 771 (Tex. Civ. App.--El Paso 1979, writ ref'd n.r.e.) (goodwill attributed to doctor-husband's professional association). In *Austin v. Austin*, 691 S.W.2d 290 (Tex. Civ. App.--Austin 1981, no writ), the court determined that goodwill reflected by a contract to purchase a professional practice was divisible upon divorce, since it had been converted into a contractual right. The rule is not limited just to members of the learned professions. In *Rathmell v. Morrison*, 732 S.W.2d 6 (Tex. App.--Houston [14th Dist.] 1987, no writ), the court recognized as nondivisible the personal goodwill of an insurance man.

Hirsch v. Hirsch, 770 S.W.2d 924 (Tex. App.--El Paso 1989, no writ), involved the valuation of a divorcing lawyer's professional corporation. The El Paso Court of Appeals mentioned *Nail*, *Geesbreght*, *Stephens*, and *Finn*, and went on to say that under these cases:

> it has become relatively clear that goodwill is not to be included or considered when placing a value on a professional corporation unless it can be determined first, that the goodwill exists independently of the personal ability of the professional person, and second, that if such goodwill does exist, it has a commercial value in which the community estate is entitled to share. *Finn*, 658 S.W.2d at 741. Where the entity is a one person professional corporation conducting business in that person's name, it would be difficult to get past the first prong of the test.

Id. at 927. At trial, Dr. Nini testified on behalf of the wife that the law practice had a present value of $ 444,774.00, which he determined by multiplying a five year average of the annual gross receipts of the corporation by one and a half. This supposedly took into account the tangible and intangible assets, including goodwill of the business, and the liabilities. No one asked Nini the value of the business without considering goodwill. The Jury question was:

> [F]ind from . . . the evidence . . . the present market value of . . . H. Thomas Hirsch & Associates, P.C.

The Court of Appeals considered the question faulty since it improperly allowed the jury to find that all of the corporate assets were acquired during marriage when there was at least some evidence to the contrary, and further because there were no instructions directing the jury to exclude goodwill from the value of the corporation. *Id.* at 927.

The issue of professional goodwill arose in the divorce case *Keith v. Keith*, 763 S.W.2d 950 (Tex. App.--Fort Worth 1989, no writ). The husband complained on appeal that the trial court improperly failed to find "whether any of the value of the partnership was professional good will attributable to him personally." *Id.* at 953. The Court of Appeals poured him out, on the grounds that he had *failed to request additional findings of fact* and conclusions of law regarding this value, and so *waived* his complaint at the lack of a finding.

In considering personal goodwill, the case of *Salinas v. Rafati*, 948 S.W.2d 286, 291 (Tex.1997), deserves some scrutiny. There the Supreme Court favorably cited *Nail* and held that the personal goodwill of the other partners is not an asset to consider in dividing up the spoils upon dissolution of a partnership. The key factor in that case was the fact that the partnership was terminating, as opposed to continuing in business. For this reason, the holding of *Salinas* does not directly apply to most divorces. However, *Salinas* confirmed the part of *Nail* and subsequent cases recognizing that even a professional practice *can* have non-personal goodwill that is divisible upon divorce.

B. POST-DIVORCE LABOR. The fruits of the post-divorce labors of an ex-spouse are his/her separate property. *Berry v. Berry*, 647 S.W.2d 945 (Tex. 1983). As a consequence, any component of value of a business attributable to a spouse's post-divorce labors must be excluded in arriving at a value for purposes of divorce. Thus, a business evaluator using an income approach must subtract the value of the spouse's

future labor from the income stream of the business, in determining present value of the business.

C. PATTERN JURY CHARGE INSTRUCTION. The current version of the State Bar of Texas Pattern Jury Charges -- Family Law (2000 ed.) handles the personal goodwill and post-divorce labor issues in the following way.
PJC 203.2:

> "Personal goodwill" is the goodwill that is attributable to an individual's skills, abilities, and reputation.
>
> In determining the value of *PARTY A*'s *medical practice,* you are not to include the value of personal goodwill or the value of time and labor to be expended after the divorce. However, you may consider the commercial goodwill, if any, of the *practice* that is separate and apart from personal goodwill.

This PJC instruction is more in line with the actual holding in *Nail v. Nail*, as opposed to the perhaps more expansive language of some subsequent opinions of various courts of appeals.

VII. COVENANTS NOT TO COMPETE. [The author of this Section is Richard R. Orsinger.] If the right to work after divorce is separate property, then funds received in exchange for a promise not to work after divorce would logically be separate property. Thus, payments received in exchange for a spouse's covenant not to compete after divorce should be the covenanting spouse's separate property.

Applying this concept to valuing a going business, it is argued by some that the part of a business' value that is attributable to the spouse's not competing with the business after divorce should be that spouse's separate property. In other words, the argument goes that in valuing the community's interest in a going business on divorce, the court should consider the value of the business as if the spouse were free to compete with it.

The Pattern Jury Charges Committee – Family Law, originally took a position on the covenant-not-to-compete issue. The original version of PJC 203.02 said:

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

The Committee relied on *Rathmell v. Morrison*, 732 S.W.2d 6, 18 (Tex. App.--Houston [14th Dist.] 1987, no writ).

A contrary argument was made regarding the role of the covenant not to compete in divorce valuations. In the January 1, 1989, edition of the Texas Academy of Family Law Specialists **Family Law Forum**, business evaluator Mike Hill made the following arguments:

> A covenant not to compete is inherent in the basic concept of willing buyer/willing seller that has been accepted throughout the courts of Texas in the definition of Fair Market Value. You cannot truly have a willing seller if they are not willing to sign a covenant not to compete and assist in the orderly transfer of the business from seller to buyer.
>
> * * *
>
> In summary, the concept that a covenant not to compete is directly tied to the future earnings of the spouse is incorrect. The covenant only protects the buyer from the business being destroyed by the seller. Asking a business appraiser to determine the value of a business without a covenant is like asking a real estate appraiser to appraise a home but to assume that the current owner is free to destroy the foundation upon which the home is built.

Another relevant consideration is the Texas Supreme Court's June 10, 1992 grant of writ of error in *Guzman v. Guzman*, 827 S.W.2d 445 (Tex. App.--Corpus Christi 1992), *writ denied as improvidently granted*, 843 S.W.2d 486 (Tex.1992), on the following point of error:

> The Court of Appeals erred in refusing to reverse the trial court's holding that the good will of the accounting practice of respondent was not property subject to division by the court for purposes of the divorce.

The Texas Supreme Court eventually withdrew its grant of writ, but in doing so the Court said:

> On procedural grounds, and without reference to the merits, we withdraw our order granting the application for writ of error as improvidently granted, and deny the application.

See *Guzman v. Guzman*, 843 S.W.2d 486 (Tex.1992).

The Supreme Court's handling of the *Guzman* case might suggest that at that time, at least, there was sentiment on the Texas Supreme Court to overturn *Nail*. In light of arguments such as those made by Mr. Hill, and considering that the articulation of the valuation factors in *Rathmell v. Morrison* have not been echoed in subsequent decisions, and in light of the peculiar history of the *Guzman* case, the PJC Committee decided to drop the portion of the instruction relating to "free to compete" that was based upon *Rathmell v. Morrison* and to fall back on the *holding* in *Nail v. Nail* as the most authoritative statement of the law on point.

VIII. BUY-SELL AGREEMENTS. [The author of this Section is Richard R. Orsinger.] Texas law is not entirely harmonious as to the effect of buy-sell restrictions on valuing closely held businesses upon divorce. One of the leading Texas cases is *Finn v. Finn*, 658 S.W.2d 735 (Tex. App.--Dallas 1983, writ ref'd n.r.e.) (en banc). There the court was confronted with buy-sell restrictions in a law partnership agreement. Under the buy-sell provisions, a partner withdrawing from the partnership was entitled to receive the amount in his/her capital account, his/her share of any undistributed earned income, and his/her proportionate interest in the firm's reserve account, less 10% of his/her proportionate share in accounts receivable for clients' disbursement. In other words, the buy-sell provisions of the partnership agreement precluded a departing partner from cashing in the value of his/her share of any partnership goodwill. The Court of Appeals found that the partnership had goodwill independent from the partners, but that the buy-sell restrictions precluded the community from having the advantage of such goodwill. It therefore had zero value for purposes of divorce.

In the case of *Keith v. Keith*, 763 S.W.2d 950 (Tex. App.--Fort Worth 1989, no writ), the court considered an argument that the value of a partnership interest on divorce should have been controlled by the buy-sell and liquidation provisions of the partnership agreement. The Court of Appeals said:

> Since the partnership is not being terminated, we do not find this provision of the agreement has any applicability to the matter before the trial court. Accordingly, the trial court did not err in failing to use the formula.

Id. at 953. The Forth Worth Court of Appeals went on to agree with Annette Stewart's concurring opinion in the *Finn* case, that a liquidation formula implemented upon death or withdrawal of a partner is not necessarily determinative of the value of a spouse's interest in the ongoing partnership at the time of divorce. The Court cited *In re Marriage of Slater*, 100 Cal. App.3d 241, 160 Cal. Rptr. 686, 688-89 (1979).

In the case of *Trick v. Trick*, 587 S.W.2d 771 (Tex. Civ. App.--El Paso 1979, writ ref'd n.r.e.), the jury valued the parties' shares of stock in the doctor/husband's professional association at $ 33.16 per share, despite the fact that a stock redemption agreement relating to the stock suggested a value of $ 17.86 per share. Although it is not clear from the Court of Appeals' Opinion, it appears that the Court of Appeals considered the jury verdict to be valid notwithstanding the lower value indicated by the stock redemption agreement. The redemption agreement applied only when a doctor left the group.

IX. DISCOUNTS AND PREMIUMS CLOSELY EXAMINED. [The author of this Section is Richard R. Orsinger.]

A. MARKETABILITY DISCOUNT. When no established market exists for an ownership interest in a closely held business, appraisers will apply a marketability discount. This discount reflects the owner's inability to quickly convert his/her interest into cash. Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 449 (1997). The discount should be considered no matter whether you are valuing a controlling interest or a minority interest. *Snyder v. Commissioner*, 93 T.C. 529 (1989); *Estate of Frank v. Commissioner*, 69 T.C.M. (CCH) 2255 (1995); Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 438 (1997). *See Estate of Bennett v. Commissioner*, 65 T.C.M. (CCH) 1816 (1993) (allowing a 15% discount for lack of marketability for a 100% ownership interest in a shopping center). The marketability discount is applied at the enterprise level, before any adjustments to value for partial interests. If there is a marketability problem peculiar to a minority interest in the business, that factor is included in the minority discount, not the marketability discount.

Even if there is a market for the ownership interest, sometimes an owner cannot liquidate his/her interest without the consent of other owners. This leads to what is called a "lock-in" or "lock-up" discount. Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 450 (1997). Such a discount was recognized for the owner of a minority partnership interest in *Harwood v. Commissioner*, 82 T.C. 239, 264 (1984). The appropriateness of this discount will be affected by the exact nature of the restriction on selling the interest in the business. Different degrees of restriction in

different situations can make it difficult to find comparables.

Business valuation guru Shannon Pratt offers three sources of empirical data as guidance for quantifying the discount for lack of marketability: 1) discounts on sales of restricted stock of publicly traded companies (i.e., letter stock); 2) discounts on sales of closely held company shares compared to subsequent public offerings of those shares; 3) cost of floating a public offering. Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, p. 239 (2nd ed. 1989).

Where a public market could be created for the interest, one way to measure the marketability discount is to determine the "cost of flotation," or the cost associated with the printing, underwriting, legal and accounting services, etc. necessary to take the stock public. Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 438-39 (1997), citing *First Trust Co. v. U.S.*, 3 A.F.T.R.2d 1726, 1739 (W.D. Mo. 1958). This approach is not appropriate in instances where the cost of flotation would approach or exceed the proceeds of the public offering, or where no market could be made. Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 439 (1997), citing *Estate of Reilly v. U.S.*, 88-2 U.S.T.C. 12, 782 (S.D. Ind. 1988) (criticizing use of flotation costs derived from 1971 SEC study); *Northern Trust Co. v. Commissioner*, 87 T.C. 349 (1986) (20% marketability discount). This approach would rarely be applicable held to a closely held business or professional practice.

When the entire business is being valued, the marketability discount should usually not reduce the value of the business below the value at which the assets of the business could be sold.

B. CONTROL PREMIUM. Sometimes a premium is applied when valuing a controlling interest in a business. *Estate of Chenowith v. Commissioner*, 88 T.C. 1577 (1987) (control premium added to 51% interest in corporation). The rationale for the premium is that the party controlling a business can determine salaries, distribution of profits, who is employed, and other factors that give value to ownership of the business.

On the other hand, in some situations the fact that there is a minority shareholder limits the majority owner's freedom of action and causes the price of the controlling interest to be reduced below its percentage share of total value. Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 440 (1997). Such a diminution of control rights should mitigate the offsetting minority discount. Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, p. 58 (2nd ed. 1989).

Shannon Pratt notes that "[w]hether an interest is a controlling or a minority interest is not necessarily a cut-and-dried distinction," but may instead be a matter of degree. Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, p. 55 (2nd ed. 1989).

The value of control depends on the owner's ability to exercise the rights typically associated with control, including: 1) electing directors and appointing management; 2) determining management's compensation and perquisites; 3) setting policy and determining the course of the business; 4) acquiring or liquidating assets; 5) selecting who to do business with; 6) making acquisitions; 7) liquidating, dissolving, selling out, or recapitalizing the business; 8) selling or acquiring treasury shares; 9) going public; 10) paying dividends; 11) amending the articles of incorporation and bylaws. Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, pp. 55-56 (2nd ed. 1989).

Factors that diminish control rights include: 1) cumulative voting; 2) contractual restrictions (i.e., restrictions imposed by a lender); 3) government regulations; 4) financial condition of the business; 5) rights of minority owners under statutes and case law; 6) whether control is composit. Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, pp. 57-58 (2nd ed. 1989). "Composit control" describes the situation where a minority interest gains control by allying with other minority owners to achieve voting control. *Id*., pp. 57-58.

C. MINORITY DISCOUNT. In most instances, if the partial interest being valued is a minority interest, there will be a discount due to lack of control, called a "minority discount." Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 443 (1997), citing *Righter v. U.S.*, 439 F.2d 1204 (Ct. Cl. 1971) (reviewing cases involving minority interest discounts). A Treasury Reg acknowledges that the degree of control represented by the block of stock to be valued is a relevant factor in valuing unlisted securities. Treasury Reg. 10.1031-2(f) (1992). Shannon Pratt calls the degree of control rights "[o]ne of the most important variables affecting value." Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, p. 55 (2nd ed. 1989). The rule is applied to various business interests, whether corporate, partnership or other. *See Harwood v. Commissioner*,

82 T.C. 239 (1984) (minority discount for partnership interest), *aff'd*,786 F.2d 1174 (9th Cir. 1986); *Moore v. Commissioner*, 62 T.C.M. (CCH) 1128 (1991) (same rules for discount apply to closely held corporations and partnerships; here 35% discount was applied to minority interest in family farming partnership).

The minority discount reflects the fact that a minority owner cannot control salaries, the distribution of profits, or other policies of the business. Although state statutes and case law provide minority owners with some rights, vindicating such rights through litigation can be a long, costly and wearing process, and may not outweigh the detriments of lack of control.

Lack of control, particularly over the ability to force distribution of profits, may make a minority interest unsellable, and therefore without any immediate value.

If comparable sales of other minority interests are available, then a market comparison approach can be used to value a minority interest. When comparable sales of minority interests are not available, it is necessary to value the business as a whole and to reduce the ownership share by an appropriate minority discount.

An issue can arise as to whether community property ownership of a controlling interest in a business is made up of two interests of one-half size, each of which should be discounted as a minority interest. This occurred in *Estate of Bright v. Commissioner*,658 F.2d 999, 1001 (5th Cir. 1981) (en banc), because the valuation was at death, and at the time of death either the surviving spouse or the estate could force partition of the community interest into two halves. The same concept could be applied in a divorce, were the court to divide a controlling interest into two minority interests, one owned by each spouse. However, where the controlling interest is going to be awarded to one spouse, no minority discount for community property ownership would be appropriate. Not that a similar issue can arise when a spouse's controlling interest is partly separate and partly community property. Should the community interest be valued without regard to the spouse's co-ownership of a separate property interest in the business?

One court excluded a minority discount when the business had been valued using the discounted cash flow method, on the grounds that a minority discount was inherently included in the valuation method. *Jung v. Commissioner*, 101 T.C. 412 (1993).

A question arises when an appraiser values a minority interest by considering sales of controlling interests, and vice-versa. It has been argued that controlling interests and minority interests are not comparable, and the value of one cannot be calculated from the other. Hood, Mylan & O'Sullivan, *Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 445 (1997).

Prior to 1993, the IRS took the position that minority discounts should not be recognized where minority interests capable of being aggregated into a controlling interest were owned by members of the same family. Rev. Rul. 81-253, 1981-2 C.B. 187, revoked by Rev. Rul. 92-12, 1992-1 C.B. 202; *see* Allen L. Feld, *The Implications of Minority Interests and Stock Restrictions in Valuing Closely-Held Shares*, 12 PA. L. REV. 934 (1974) (arguing that minority discounts should not be offered to members of the same family, since it results in tax avoidance). However, courts in taxcases recognized such discounts, even in a family situation. *Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981) (minority discount permitted for intrafamily gift); *Hicks v. U.S.*, 486 F.2d 325 (10th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974); *Estate of Heckscher*, 63 TC 485 (1975); *In re Allun*, 43 P-H Tax Ct. Mem. P74-284 (1974); *In re Bardahl*, 24 CCH Tax Ct. Mem. 841 (1965); *Kingery v. Dep't of Revenue*, 6 OTR 202 (Or. Tax Ct. 1975) [1975 Ore. Tax LEXIS 42]. Eventually the IRS relented and in Rev. Rul. 92-12, 1992-1 C.B. 202 the IRS abandoned its family attribution argument against minority discounts.

The IRS has argued a "swing vote" premium for an ownership interest that can be allied with different minority factions to achieve control. Tech. Adv. Mem. 94-36-005 (May 26, 1994). *See* Steven A. Horowitz & Alfred S. Scope, *I.R.S. or Minority Interest Discounts: It Don't Mean a Thing If It Still Got That Swing,* 73 TAXES 76 (Feb. 1995).