Business Valuations: Effective Presentation of Complex Issues

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Advanced Family Law Course 2021
August 2 - 5, 2021
San Antonio, Texas

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by

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I. INTRODUCTION. This Article makes suggestions on how to explain business valuation concepts in simple terms. Sample text boxes and PowerPoint slides are included in the Article to show how you can explain business valuation ("B.V.") concepts in simple terms. A companion PowerPoint slideshow has more examples.

II. STANDARDS OF VALUE. In Shannon P. Pratt, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 22-30 (3d ed. 2008), Pratt recognizes seven measures of value: (i) fair market value, (ii) fair value, (iii) investment value, (vi) intrinsic or fundamental value, (iv) going-concern value, (vi) liquidation value, (vii) book value, and (viii) sentimental value. In business valuation parlance, these are called "standards of value." *See also* James R. Hitchner, FINANCIAL VALUATION: APPLICATIONS AND MODELS (2d ed. Wiley 2006) pp. 3-6. Texas law recognizes "sentimental value" in some instances. Each of these standards will be discussed below, followed by an analysis of the "inputs" to be considered in estimating fair market value. The remainder of the article examines issues that arise in divorce valuations, including separating personal goodwill from enterprise goodwill.

III. DEFINITIONS OF VALUE. Here are the commonly-used legal, tax, accounting, and business valuation definitions of value. An important thing to remember about fair market value, and the willing buyer/willing seller formulation of it, is that the willing buyer and willing seller cannot be made particular, meaning that "the hypothetical persons are not specific individuals or entities." *Estate of Simplot v. Commissioner of Internal Revenue*, 249 F.3d 1191, 1195 (9th Cir. 2001).

A. DEFINITIONS OF VALUE IN TEXAS LAW. Texas statutes and cases give varying definitions "value," depending on the circumstances.

1. Value. The term "value" under Texas law embraces different measures of value, not just "market value" or "fair market value." In one case involving the value stock of a closely-held business, the jury charge told the jury to find "the value of his stock in Vector Industries . . . without specific reference to market value, book value, or some other measure of value . . ." *Vector Indus., Inc. v. Dupree*, 793 S.W.2d 97, 103 (Tex. App.--Dallas 1990, no writ). The appellate court held that the jury issue "refers to value generally, without specific reference to market value, book value, or some other measure of value. Therefore, all testimony as to value became relevant for the purpose of answering this question." *Id.* at 103.

2. Market Value (Condemnation Cases). In *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 182 (Tex. 2001), (land condemnation case), the Texas Supreme Court defined "market value" (leaving off the "fair") in this way:

> Market value is "the price the property will bring when offered for sale by one who desires to sell, but is not obliged to sell, and is bought by one who desires to buy, but is under no necessity of buying."

In *State v. Windham*, 837 S.W.2d 73, 77 (Tex. 1992) (a land condemnation case), the Supreme Court said:

> Market value is "the price which the property would bring when it is offered for sale by one who desires, but is not obligated to sell, and is bought by one who is under no necessity of buying it." *Carpenter*, 89 S.W.2d at 202. In deciding market value the jury is permitted to consider all of the uses to which the property is reasonably adaptable and for which it is, or in all reasonable probability will become, available within the foreseeable future.

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977) (a land condemnation case), the Court quoted the definition from *City of Austin v. Cannizzo*. 267 S.W.2d 808 (1954): "the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it . . . ."

In *City of Pearland v. Alexander*, 483 S.W.2d 244, 247 (Tex. 1972) (a land condemnation case), the Supreme Court emphasized the willing buyer/willing seller aspect of market value, saying:

> The jury is instructed that the term market value is the price the property will bring when offered for sale by one who desires to sell, but is not obliged to sell, and is bought by one who desires to buy, but is under no necessity of buying.

The Court went on to say:

> The willing-seller willing-buyer test of market value is to be applied and those factors are to be considered which would reasonably be given weight in negotiations between a seller and a buyer. *City of Austin v. Cannizzo*, *Supra*.
>
> In *Texas Electric Service Co. v. Campbell*, 161 Tex. 77, 336 S.W.2d 742 (1960), we ruled evidence based on possibilities rather than reasonable probabilities to be incompetent, citing *State v. Carpenter*, *Supra*, that 'evidence should be excluded relating to remote, speculate, and conjectural uses, as well as injuries, which are not reflected in the present market value of the property.' This is but saying, as in *Cannizzo*, that the question of the competency of evidence bearing on the issue of market value at the time of the taking rests on those factors of reasonable weight in the factual determination of what a willing seller would sell for and what a willing buyer would pay.

3. Fair Market Value (Local Government Code). Tex. Atty. Gen. Op. DM-441 (May 20, 1997) considered the meaning of "fair market value" for purposes of government entities swapping land pursuant to the Local Government Code. The AG Opinion states:

> The term "fair market value" is not defined for purposes of section 272.001 and we define it according to its common usage. Gov't Code § 311.011 (Code Construction Act). "Fair market value" is generally defined as the price that a willing buyer, who desires to buy, but is under no obligation to buy, would pay to a willing seller, who desires to sell, but is under no obligation to sell. *City of Pearland v. Alexander*, 483 S.W.2d 244, 247 (Tex. 1972); *Atterbury v. Brison*, 871 S.W.2d 824, 828 (Tex. App.--Texarkana 1994, writ denied). We also note that the measure of damages in an eminent domain proceeding where an entire tract or parcel of land is condemned is "local market value." Prop. Code § 21.042(b). Cases construing this provision indicate that "market value" means a fixed, ascertainable sum. *Melton v. State*, 395 S.W.2d 426, 429 (Tex. Civ. App.--Tyler 1965, writ ref'd, n.r.e.) ("Market value should be based upon reasonable cash value."); *Houston v. Charpoit*, 292 S.W.2d 677, 680-81 (Tex. Civ. App.--Galveston 1956, writ ref'd n.r.e.) (market value may be determined on basis of credit transaction, rather than on cash price of land).

Tex. Atty. Gen. Op. DM-441, *4 (May 20, 1997).

4. Market Value (Texas Tax Code). The Texas Tax Code defines "market value" in this way:

> "Market value" means the price at which a property would transfer for cash or its equivalent under prevailing market conditions if:
>
> > (A) exposed for sale in the open market with a reasonable time for the seller to find a purchaser;
> >
> > (B) both the seller and the purchaser know of all the uses and purposes to which the property is adapted and for which it is capable of being used and of the enforceable restrictions on its use; and
> >
> > (C) both the seller and purchaser seek to maximize their gains and neither is in a position to take advantage of the exigencies of the other.

Tex. Tax. Code § 1.04(7). The Austin Court of Appeals noted that "[t]his statutory definition, first enacted in 1979, accords with the traditional definition applied by Texas courts that market value means the price property would bring when offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it." *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724, 727 (Tex. App.–Austin 1997, writ denied).

Under the Texas Tax Code, real property must be appraised at market value as determined by generally accepted appraisal methods or techniques. See Tex. Tax Code § 23.01. A business's inventory, however, must be appraised at the price for which it would sell as a unit to a purchaser who would continue the business. *See Id.* § 23.12.

5. Market Value (Leased Equipment). The *City of Harlingen v. Estate of Sharboneau* definition of market value was applied to the value of leased equipment contributed to a partnership in *Brogan, Ltd. v. Brogan*, 2007 WL 2962996, *6 (Tex. App.--Amarillo 2007, pet. denied) (mem. op.).

B. FEDERAL TAX DEFINITION OF FAIR MARKET VALUE. Treasury Regulation 20.2031-1(b) defines "fair market value" in this way:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.

Treasury Reg. 20.2031-1(b) goes on to say:

> The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Id.

In *United States v. Cartwright*, 411 U.S. 546, 550-51, 93 S.Ct. 1713, 1716-17, 36 L.Ed.2d 528 (1973), the U.S. Supreme Court said:

> In implementing 26 U.S.C. § 2031, the general principle of the Treasury Regulations is that the value of property is to be determined by its fair market value at the time of the decedent's death. 'The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.' Treas. Reg. § 20.2031-1(b). The willing buyer-willing seller test of fair market value is nearly as old as the federal income, estate, and gifts taxes themselves, and is not challenged here.FN7 Under this test, it is clear that if the decedent had owned ordinary corporate stock listed on an exchange, its 'value' for estate tax purposes would be the price the estate could have obtained if it had sold the stock on the valuation date, that price being, under Treas. Reg. § 20.2031-2(b), the mean between the highest and lowest quoted selling prices on that day.

C. ACCOUNTING DEFINITION OF FAIR MARKET VALUE. The accounting profession has adopted the term "fair value" as the equivalent to the legal "fair market value." The current definition and description of "fair value" is set out by the Financial Accounting Standards Board, in Accounting Standards Codification 820.

Fair Value is defined: Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distress sale) between market participants at the measurement date under current market conditions. 820-10.35-54G, p. 225 (May 2011).

Additional considerations have been established by the FASB regarding determining fair value:

> A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. (ASC 820-10-35-31 p.201) (May 2011). The exit price objective applies for all assets and liabilities measured at fair value.

Fair value measurements of non-financial assets assumes the highest and best use by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible.... FASB ASC Topic 820-10-35-10A (May 2011).

> Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same--to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability). FASB ASC 820-10-05-1B (May 2011) <http://asc.fasb.org/imageRoot/00/7534500.pdf>.

> Fair value measures should consider the utility of the asset or liability being measured and specific attributes to the asset or liability. FASB ASC Topic 820 Implementation Guidance, p. 5 (10-20-2009).

> Transaction costs should be excluded from all fair value measurements. FASB ASC Topic 820 Implementation Guidance, p. 5 (10-20-2009).

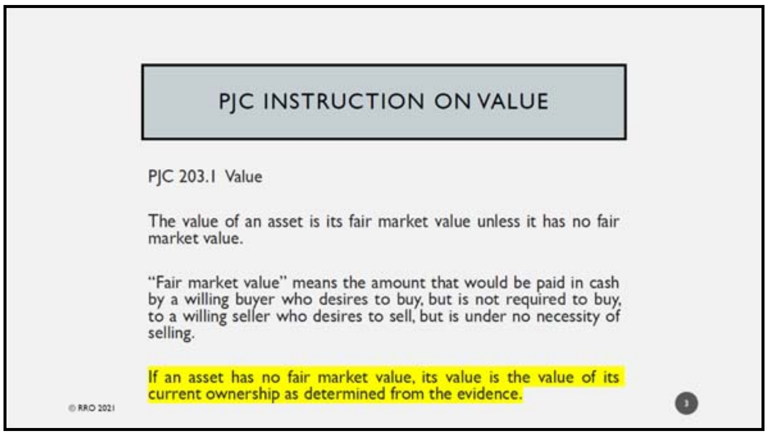
FASB has issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, which "defines fair value, [and] establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) . . . ." It represents the latest authoritative statement about determining fair value for purposes of financial statements. The document can be found at <http://www.fasb.org/pdf/fas157.pdf> (7-12-2021).

D. BUSINESS VALUATION DEFINITION OF FAIR MARKET VALUE. The most-frequently cited source of the business valuator's definition of "fair market value" comes from Revenue Ruling 59-60, which took its definition from Treasury Regulations for estate and gift taxes. The Revenue Ruling 59-60 definition of "fair market value" is:

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

Rev. Rul. 59-60, § 2.02. Rev. Rul. 59-60 goes on to add: "Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property." *Id.*

E. PATTERN JURY CHARGES. The State Bar of Texas' PATTERN JURY CHARGES (FAMILY & PROBATE) PJC 203.1 defines value for purposes of divorce. A PowerPoint slide with this definition is the best one to use for a judge and especially for a jury.



IV. APPROACHES TO ESTIMATING FAIR MARKET VALUE. There are three main approaches to determining the value of an asset:

> Texas courts have recognized three general approaches to determining market value: (1) the market data (or comparable sales) approach; (2) the cost approach; and (3) the income (or income-capitalization) approach. *See Religious of the Sacred Heart v. City of Houston*, 836 S.W.2d 606, 615–16 (Tex. 1992); *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977). In addition, when circumstances dictate, the Texas Supreme Court has not hesitated to recognize alternative methods of valuation. *See Missouri–Kansas–Texas R.R. v. City of Dallas*, 623 S.W.2d 296, 299–301 (Tex. 1981). These approaches are not different definitions of market value; they are simply different ways of arriving at an estimate of what a willing buyer would pay a willing seller.

Travis Cent. Appraisal Dist. v. FM Properties Operating Co., 947 S.W.2d 724, 730 (Tex. App.–Austin 1997, writ denied). "These approaches are not different definitions of market value; they are simply different ways of arriving at an estimate of what a willing buyer would pay a willing seller." *Id.* at 730.

One Attorney General's Opinion made this statement about the method and factors to be considered in estimating the fair market value of property:

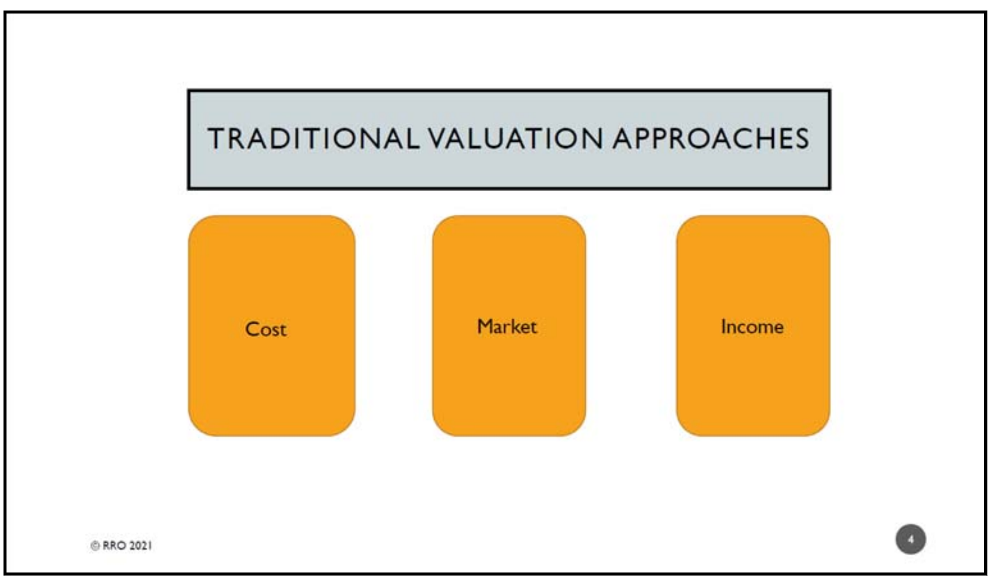
> The method used to calculate the fair market value of a particular property and the factors that must be considered in arriving at the fair market value of a particular piece of property are for a qualified appraiser to determine in accordance with accepted standards of appraisal; [FN8] they are not questions of law that are susceptible to the opinion process. [FN9]
>
> [FN8] See generally *Travis Cent. Appraisal Dist.*, 947 S.W.2d at 730 (listing three general approaches to determining market value and acknowledging alternatives); USPAP, supra note 5; Real Estate Valuation in Litigation, supra note 7; The Appraisal of Real Estate, supra note 3.
>
> [FN9] See, e.g., Attorney General Opinions DM-98(1992) at 3, H-56 (1973) at 3, M-187 (1968) at 3, O-2911 (1940) at 2.

Tex. Atty. Gen. Op. LO-98-082, p. 2 (September 28, 1998). The AG Opinion suggests that the methods and factors to consider in determining fair market value are not questions of law and cannot be promulgated by the Attorney General through the AG Opinion process. This view could be applied to the appellate opinions, as well as opinions of the U.S. Tax Court, on business valuation issues.

Texas Tax Code § 23.01(b) says this about determining market value:

> The market value of property shall be determined by the application of generally accepted appraisal methods and techniques. If the appraisal district determines the appraised value of a property using mass appraisal standards, the mass appraisal standards must comply with the Uniform Standards of Professional Appraisal Practice. The same or similar appraisal methods and techniques shall be used in appraising the same or similar kinds of property. However, each property shall be appraised based upon the individual characteristics that affect the property's market value, and all available evidence that is specific to the value of the property shall be taken into account in determining the property's market value.

The approaches to value could be explained using this PowerPoint slide:



A. MARKET APPROACH. Wikipedia gives a serviceable definition of the market approach to business valuation:

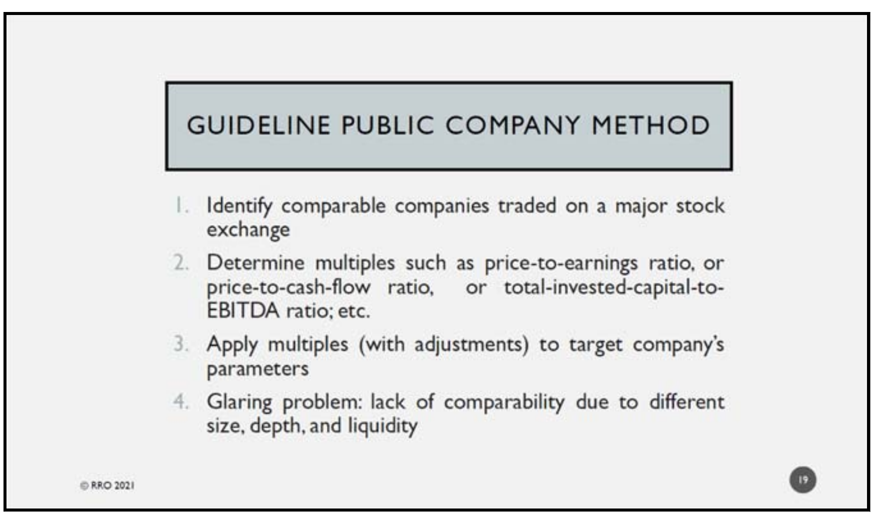
> The market approach to business valuation is rooted in the economic principle of competition: that in a free market the supply and demand forces will drive the price of business assets to a certain equilibrium. Buyers would not pay more for the business, and the sellers will not accept less, than the price of a comparable business enterprise. It is similar in many respects to the "comparable sales" method that is commonly used in real estate appraisal. The market price of the stocks of publicly traded companies engaged in the same or a similar line of business, whose shares are actively traded in a free and open market, can be a valid indicator of value when the transactions in which stocks are traded are sufficiently similar to permit meaningful comparison.

<http://en.wikipedia.org/wiki/Business_valuation#Market_approaches> [7-9-2021]. Roger G. Ibbotson, Professor Emeritus with the Yale School of Management, and historically an authoritative source of information regarding rates of return on investments and business valuation principles, said this:

> Implementation of the market approach using publicly traded companies typically relies on the use of financial ratios that compare the stock price of a company to its various accounting measures of fundamental data. Many ratios contain stock price or market value of equity and work well in the market approach to determining value:
>
> •Price to Earnings
> •Price to Cash Flow
> •Price to Shareholders' Equity

IBBOTSON SBBI 18 (2011 Valuation Yearbook).

Author Shannon Pratt recognizes two types of market approach: one involves guideline publicly traded companies and the other involves guideline merged and acquired companies. Shannon Pratt, VALUING A BUSINESS 950 (5th ed. 2008). Under the guideline publicly traded company method, the valuator develops "valuation multiples" based on the prices at which stock representing minority interests in comparable companies is trading. These multiples might be net sales, gross cash flow, net cash flow, net income before taxes, net income after taxes, etc. *Id.* at 265. There will usually be a significant difference in size between the guideline companies and the company being valued. Under the guideline merged and acquired company method, the valuator develops "valuation multiples" based on the transfers of controlling interests in publicly traded companies. The key to both of these approaches is the comparability of the guideline companies to the company being valued.



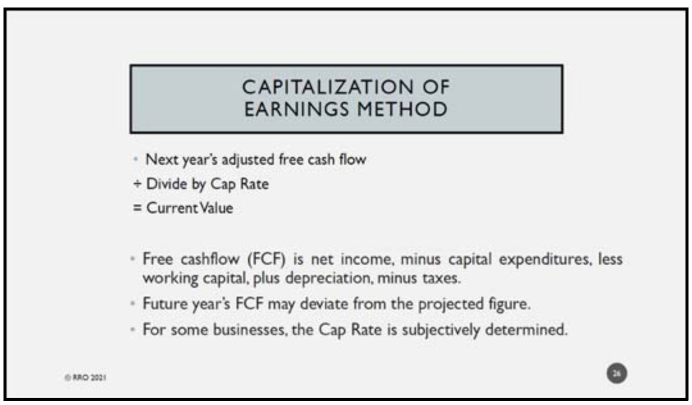
The Texas Supreme Court has said that, in real property condemnation cases, the market approach is preferred:

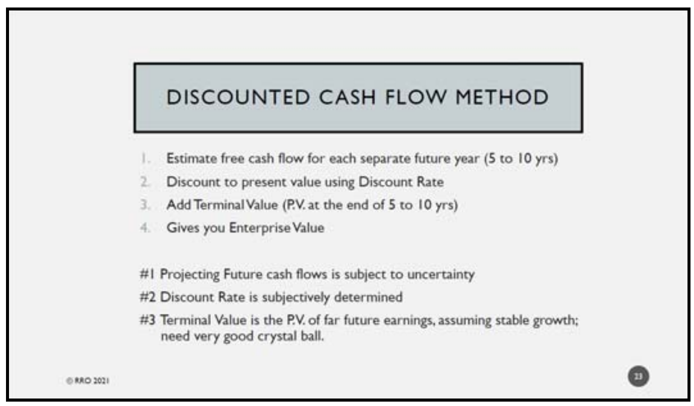
> Texas recognizes three approaches to determining the market value of condemned property: the comparable sales method, the cost method, and the income method. *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 182 (Tex. 2001). The comparable sales method is the favored approach, but when comparable sales figures are not available, courts will accept testimony based on the other two methods. *Id.* at 182–83. The cost approach looks to the cost of replacing the condemned property minus depreciation. *Id.* at 183 (citing *Religious of the Sacred Heart v. City of Houston*, 836 S.W.2d 606, 615–16 (Tex. 1992)). The income approach is appropriate when the property would be priced according to the rental income it generates. *Sharboneau*, 48 S.W.3d at 183 (citing *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977)). All three methods are designed to approximate the amount a willing buyer would pay a willing seller for the property. *Id.*

State v. Central Expressway Sign Associates, 302 S.W.3d 866, 871 (Tex. 2009). Of course, there is a great distinction between the market for real property and the market for closely-held businesses.

B. INCOME APPROACH. Ibbotson said this about the income approach:

> One of the most common business valuation methodologies is the income approach. Under the income approach, the analyst must first identify future cash flows to be generated by the asset being valued. Second is the identification of the appropriate rate to use in discounting the cash flows to present value. The discount rate, or cost of capital, should reflect the level of risk inherent in the cash flows being valued.
>
> IBBOTSON SBBI 13 (2011 Valuation Yearbook).





In *Polk County v. Tenneco, Inc.*, the Supreme Court said this about the income approach:

> The income approach to value, on the other hand, proceeds on the premise that a buyer of income-producing property is primarily interested in the income which his property will generate. In simple terms, the approach involves estimating the future income of the property and applying a capitalization rate to that income to determine market value. Comment, The Road to Uniformity in Real Estate Taxation: Valuation and Appeal, 124 U.Pa.L.Rev. 1418 (1976). The capitalization rate may be defined as the rate of interest investors would require as a return on their money before they would invest in the income-producing property, taking into account all the risks involved in that particular enterprise. Fisher, Capitalization Rates, 25 Nat'l Tax J. 263 (1972). See also Real Estate Appraisal Terminology 33, 34, 67 (1975). The income approach thus involves an estimate of two variables, future income and the capitalization rate, which are used to find the market value figure. The more precisely the variables are estimated, the more accurate the market value estimate will be. Conversely, if the variables used are inaccurate, then the resulting market value figure will also be incorrect.

Id. at 921.

In another case, the Supreme Court has stated that "the traditional income approach measures the value of property based on its known ability to produce income in its current state." *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 184 (Tex. 2001). In *Sharboneau*, the Supreme Court rejected using the income approach to valuing a tract of land purchased for development but which had not yet been subdivided and was not yet being marketed.

C. ASSET-BASED APPROACH. The asset-based approach to business valuation subtracts the business's liabilities from its assets to reach a net asset value. Shannon Pratt says:

B.V. Asset Approach

Assets
- Liabilities
= Value

"The asset-based approach focuses on the value of the enterprise's component assets, properties, and business units."

Shannon Pratt, VALUING A BUSINESS 64 (5th ed. 2008). The asset approach can be used with any of the premises of value: going-concern, value as an assemblage of assets, value as an orderly disposition, or value as a forced liquidation. *Id.* at 64, 47-48.

The court in *Estate of Dunn v. Comm'r*, 301 F.3d 339, 353 (5th Cir. 2002), said:

> By definition, the asset-based value of a corporation is grounded in the fair market value of its assets (a figure found by the Tax Court and not contested by the estate), which in turn is determined by applying the venerable willing buyer-willing seller test. . . . In other words, when one facet of the valuation process requires a sub-determination based on the value of the company's assets, that value must be tested in the same willing buyer/willing seller crucible as is the stock itself, which presupposes that the property being valued is in fact bought and sold.

Ibbotson notes that "[t]he asset-based approach to valuation is primarily used when appraising a holding company, family limited partnership, or entities in bankruptcy proceedings." IBBOTSON SBBI 19 (2011 Valuation Yearbook).

1. Not Book Value. The asset-based approach needs to be distinguished from "net book value." In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 923 (Tex. 1977), the Supreme Court made this comment about "net book value":

> The reasoning of the court of civil appeals, then, was erroneous unless the net book value of Tenneco's gas transmission system is equal to its market value. [4] For the reasons discussed below, we hold that it is not.
>
> The net book value figure used by the court of civil appeals is the accounting figure representing the original cost of Tenneco's pipeline division utility plant plus the value of construction work in progress, less depreciation, amortization and depletion. It was undisputed at trial that this figure was not equal to market value. Tenneco's expert testified a number of times that the net book figure was not necessarily equal to market value and that he did not contend that it was. The evidence showed that the net book value of the pipelines in Polk County was $842,798, but Tenneco contended the pipelines' market value was $2,178,000. Given these facts, and the definition of market value in *City of Austin v. Cannizzo*, supra, we hold that the court of civil appeals erred in equating net book value with market value.

2. Excludes Goodwill. The problem with using the asset approach to valuing a business is that it ignores goodwill. A functioning and profitable business is worth more than the sum of its parts. The goodwill of a business can only be estimated using the market approach or the income approach to valuation. See Section XX below.

Note that "net book value" on accounting convention is based on historical cost, with adjustments, while the asset-based approach considers the current value of the assets of the business.

D. COST APPROACH. The cost approach is a valuation approach used in valuing real estate. Shannon Pratt says this about the cost approach:

> The cost approach is based on the economic principle of substitution. That is, no one would pay more for an asset than the price required to obtain (by purchase or by construction) a substitute asset of comparable utility. This assumes, of course, that the subject asset is fungible. In other words, the cost approach assumes that substitute properties of comparable utility can be obtained.

Shannon Pratt, VALUING A BUSINESS 358 (5th ed. 2008).

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977), the Supreme Court said this about the cost approach:

> The cost approach to value assumes that an informed purchaser of the property would pay no more than the cost of constructing a like property with the same usefulness as the property to be valued. Real Estate Appraisal Terminology 53 (1975). In using this method, the appraiser first estimates the cost of reproducing or replacing the subject property; he then subtracts accumulated depreciation and adds estimated land value to arrive at his value estimate. The method is usually a secondary approach to valuation and tends to set the upper limit of true market value. E. Johnson, Cost Approach to Value, Encyclopedia of Real Estate Appraising 37 (1959).

In *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 183 (Tex. 2001), the Supreme Court said:

> The cost approach, which looks to the cost of replacing the condemned property, is best suited for valuing improved property that is unique in character and not frequently exchanged on the marketplace. *Religious of the Sacred Heart*, 836 S.W.2d at 616 (citing American Institute of Real Estate Appraisers, The Appraisal of Real Estate 62, 349 (9th ed.1987)). While the cost method takes the property's depreciation into account, it still "tends to set the upper limit of true market value." *Polk Cty. v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977).

E. HIERARCHIES OF INPUTS IN DETERMINING FAIR MARKET VALUE. The IRS through Treasury Regulations, and the accounting profession, through FASB standards, have established a hierarchy of inputs for the valuator to consider in determining the fair market value of an asset using the market approach.

1. Indicators of Value for Tax Purposes. The IRS Regulations set out a hierarchy of information to consider in estimating fair market value for estate and gift tax purposes. The more reliable indicators of value must be used if they are available; if none are available, then the next highest level of indicator should be used, and so on, in descending order.

IRS Regulation § 20.2031-2 Valuation of stocks and bonds.

(a) In general. The value of stocks and bonds is the fair market value per share or bond on the applicable valuation date.

(b) Based on selling prices. (1) In general, if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond. [Note: the *closing* price is not used to fix value for tax purposes.] If there were no sales on the valuation date but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales on the nearest date before and the nearest date after the valuation date. The average is to be weighted inversely by the respective numbers of trading days between the selling dates and the valuation date. If the stocks or bonds are listed on more than one exchange, the records of the exchange where the stocks or bonds are principally dealt in should be employed if such records are available in a generally available listing or publication of general circulation. In the event that such records are not so available and such stocks or bonds are listed on a composite listing of combined exchanges available in a generally available listing or publication of general circulation, the records of such combined exchanges should be employed. In valuing listed securities, the executor should be careful to consult accurate records to obtain values as of the applicable valuation date. If quotations of unlisted securities are obtained from brokers, or evidence as to their sale is obtained from officers of the issuing companies, copies of the letters furnishing such quotations or evidence of sale should be attached to the return.

* * *

(c) Based on bid and asked prices. If the provisions of paragraph (b) of this section are inapplicable because actual sales are not available during a reasonable period beginning before and ending after the valuation date, the fair market value may be determined by taking the mean between the bona fide bid and asked prices on the valuation date, or if none, by taking a weighted average of the means between the bona fide bid and asked prices on the nearest trading date before and the nearest trading date after the valuation date, if both such nearest dates are within a reasonable period. The average is to be determined in the manner described in paragraph (b) of this section.

(d) Based on incomplete selling prices or bid and asked prices. If the provisions of paragraphs (b) and (c) of this section are inapplicable because no actual sale prices or bona fide bid and asked prices are available on a date within a reasonable period before the valuation date, but such prices are available on a date within a reasonable period after the valuation date, or vice versa, then the mean between the highest and lowest available sale prices or bid and asked prices may be taken as the value.

(e) Where selling prices or bid and asked prices do not reflect fair market value. If it is established that the value of any bond or share of stock determined on the basis of selling or bid and asked prices as provided under paragraphs (b), (c), and (d) of this section does not reflect the fair market value thereof, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value. Where sales at or near the date of death are few or of a sporadic nature, such sales alone may not indicate fair market value. In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the block of stock being valued shall be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

(f) Where selling prices or bid and asked prices are unavailable. If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:

(1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and

(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the "other relevant factors" referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

(g) Pledged securities. . . .

(h) Securities subject to an option or contract to purchase. Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at § 25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

It is interesting to note that the description of factors to consider, when there is no market data from which to draw value inferences, is very much like *Intrinsic Value*. See Section X.

IRS Ranking of Inputs

(1)	Mean of highest & lowest quoted selling prices on a public market (not closing price)
(2)	If no sales, mean of bid and asked
(3)	If no (1) or (2), weighted average (mean) of bid-and-asked further away in time
(4a)	Where sale price or bid-and-asked do not reflect FMV, consider other relevant facts
(4b)	Large blocks may require underwriting
(5)	If no (1) - (4), use net worth, earning power, dividend paying ability.

2. Indicators of Value for Purposes of Financial Statements. The accounting profession has developed its own hierarchy of indicators of fair market value to be used by accountants when they are valuing assets (and liabilities) to be listed at fair value on a financial statement. Take care to note that the accounting profession uses the term "fair value" to mean what lawyers mean when lawyers say "fair market value."

In the USA, the ultimate authority on Generally Accepted Accounting Principles (GAAP) is the Financial Accounting Standards Board (FASB). In September 2006, FASB promulgated Financial Accounting Standard 157 ("FAS 157"). FAS 157 established a hierarchy of information to use in determining the "fair value" of assets or liabilities under GAAP.

Here is the Federal Reserve Bank of New York's summary of FAS 157:

> FASB Statement No. 157, Fair Value Measurements (FAS 157), issued in September 2006, defines fair value, establishes a framework for measuring the fair value of assets and liabilities based on a three level hierarchy, and expands disclosures about fair value measurements. The FASB's three-level fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the reporting branch or agency has the ability to access at the measurement date (e.g., the FFIEC 002 reporting date). Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

<http://www.newyorkfed.org/banking/regrept/2q08002.pdf> (7-12-2021).

Here is what FAS 157 itself says about the hierarchy of inputs for estimating fair value:

> Fair Value Hierarchy
>
> 22. To increase consistency and comparability in fair value measurements and related disclosures, the fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls shall be determined based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input to the fair value measurement in its entirety requires judgment, considering factors specific to the asset or liability.

23. The availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within Level 2 or Level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

Level 1 inputs

24. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, except as discussed in paragraphs 25 and 26.

25. If the reporting entity holds a large number of similar assets or liabilities (for example, debt securities) that are required to be measured at fair value, a quoted price in an active market might be available but not readily accessible for each of those assets or liabilities individually. In that case, fair value may be measured using an alternative pricing method that does not rely exclusively on quoted prices (for example, matrix pricing) as a practical expedient. However, the use of an alternative pricing method renders the fair value measurement a lower level measurement.

26. In some situations, a quoted price in an active market might not represent fair value at the measurement date. That might be the case if, for example, significant events (principal-to-principal transactions, brokered trades, or announcements) occur after the close of a market but before the measurement date. The reporting entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements. However, if the quoted price is adjusted for new information, the adjustment renders the fair value measurement a lower level measurement.

27. If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.[11]

[FN11] The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

Level 2 inputs

28. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

a. Quoted prices for similar assets or liabilities in active markets

b. Quoted prices for identical or similar assets or liabilities in markets that are not active, that is, markets in which there are few transactions for the asset or liability, the prices are not current, or price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is released publicly (for example, a principal-to-principal market)

c. Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)

d. Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

29. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and/or location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.11 The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries.

Level 3 inputs

30. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs shall be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, un-observable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Unobservable inputs shall be developed based on the best information available in the circumstances, which might include the reporting entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. However, the reporting entity shall not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the reporting entity's own data used to develop unobservable inputs shall be adjusted if information is reasonably available without undue cost and effort that indicates that market participants would use different assumptions.

It should be noted that business valuators, in valuing closely-held business, are usually relying 100% on Level 3 inputs.

Accounting Levels of Inputs

- Level 1 - quoted prices in *active markets* for *identical* assets
- Level 2 - Other observable indicators, like:
  - quoted prices for *similar* assets in *active markets*
  - quoted prices for *identical* or *similar* assets in *non-active markets*
  - *observable inputs* other than quoted prices
  - inputs derived principally from *market-corroborated inputs*
- Level 3 - Assumptions about the assumptions that market participants would make in pricing the asset. (Use when no Level 1 or 2 inputs)

3. When The Market Approach Cannot be Used. The Supreme Court has recognized that the market approach may have to be abandoned in some instances, and reliance placed on the cost and income approaches. In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex. 1977), the Supreme Court said:

> The market value of Tenneco's pipelines was highly contested at trial, and it was not an easy question to resolve. Segments of natural gas pipelines, such as those which lie in Polk County, are rarely sold; and their market value therefore generally cannot be determined by comparing the prices brought by sales of similar properties. This fact makes the assessment of pipelines by the taxing authority a difficult task, because market value is defined as "the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it . . . ." *City of Austin v. Cannizzo*, 153 Tex. 324, 334, 267 S.W.2d 808, 815 (1954). See also Article 7174, and *State v. Carpenter*, 126 Tex. 604, 89 S.W.2d 194 (1936). Thus, the "comparable sales" method of appraising property is of little use in valuing pipelines; and two other methods of appraisal must be used in assessing those properties. These two methods are the cost approach to value and the income approach to value.

V. THE IMPORTANCE OF AN ACTIVE MARKET FOR DETERMINING FAIR MARKET VALUE. Wikipedia defines "marketplace" as "a location where people regularly gather for the purchase and sale of provisions, livestock, and other goods."[1] An "efficient market" is a marketplace where "the aggregate decisions of all the market's participants accurately reflect the value of public companies and their common shares at any moment in time."[2] Stated differently, an "efficient market is one where the market price is an unbiased estimate of the true value of the investment."[3] Both federal tax law and FASB standards treat the price indicators of an active market as superior inputs compared to "Fundamental Analysis" of the company in question.

Larry J. Kasper, BUSINESS VALUATIONS: ADVANCED TOPICS (Quorum Books 1997) pp. 13-20, discusses the efficient market hypothesis that underlies the idea of fair market value:

> The efficient market hypothesis is the cornerstone for the foundation of modern financial theory. It also provides a basis for examining many well-established and long-held assumptions and concepts in the valuation of privately held businesses. The validity of the definition of fair market value, the basis for comparisons to publicly held companies, the development of capitalization rates, and the application of premiums and discounts can all be tested by reference to the efficient market hypothesis. As such, it, is the appropriate place to begin the study of advanced business valuation topics for privately held companies.
>
> * * *

The efficient market hypothesis states that security prices in a market reflect all relevant and ascertainable information about a company. Because the security price reflects all relevant information about the security, that price must represent its fair market value. Security analysts of publicly held companies and business valuators of privately held companies must implicitly believe in the correctness of the hypothesis each time they make comparisons to and draw inferences from the prices of other publicly traded stocks and securities. The efficient market hypothesis is one of the most tested hypotheses in the financial literature.

Kaspar continues:

The efficient market hypothesis has been expressed at three different levels, each testable to some degree [3]. How widely available information needs to be for there to be efficiency in the market depends upon the form of the hypothesis.

* * *

Weak Form

The weak form asserts that stock prices already reflect all information that can be derived from studying market trading data, such as past transaction prices and trading volume.

* * *

Semi-Strong Form

The semi-strong form of the hypothesis states that all publicly available information regarding the prospects of a firm must already be reflected in the stock prices. All publicly available information includes not only trading information (weak form) but also published information regarding financial statements, product information, forecasts, and management. As this information is readily available, at least to professional analysts, one would expect it to be reflected in stock prices.

* * *

Strong Form

The strong form of the efficient market hypothesis states that stock prices reflect all information relevant to the firm, even including information available only to insiders.

* * *

Kaspar continues:

IMPLICATIONS FOR VALUING PRIVATE SMALL BUSINESS

The implicit assumption in the efficient market hypothesis (in any form) is that there exists a market where securities can be traded with little effort or cost. When this is not true, efficient (information) markets cannot exist. Small private company stocks do not have an established market. If they did, there would be little need for business valuations.

However, there are lessons to be learned by examining the efficient market hypothesis. First, more is to be learned about the appropriate price of a stock by examining current events and information than by examining past events, including stock sales (weak form). Second, the more diligent the gathering of information and analysis, the better the estimate of value for small companies (semi-strong form). Third, as with publicly held companies, the analyst hopes, through fundamental analysis, to attain insight into future performance of the firm in order to estimate the appropriate price for the company (semi-strong form). Finally, the small-company analyst, like the public security analyst, will probably never have access to all information (strong form).

Fundamental analysis will have a more fruitful role in a private company valuation than in a publicly held company valuation because little information is public. Furthermore, as there are not many other analysts competing for information about the privately held company, estimates of pri-

> vate-company value are likely to have much more variation than one would expect for estimates of the value of a publicly traded company by members of the security analysis industry. Expressed another way, the confidence that can be placed in a single estimate of value for a privately held company is less than that for a publicly traded company, and the range of estimates is likely to be wider.

VI. WHEN THERE IS NO MARKET TO COMPARE TO. The Texas Supreme Court has recognized that in some situations property has no ascertainable fair market value.

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977), the Supreme Court said:

> Segments of natural gas pipelines, such as those which lie in Polk County, are rarely sold; and their market value therefore generally cannot be determined by comparing the prices brought by sales of similar properties. This fact makes the assessment of pipelines by the taxing authority a difficult task, because market value is defined as "the price which the property would bring when it is offered for sale by one who desires, but is not obliged to sell, and is bought by one who is under no necessity of buying it ...." *City of Austin v. Cannizzo*, 153 Tex. 324, 334, 267 S.W.2d 808, 815 (1954). See also Article 7174, and *State v. Carpenter*, 126 Tex. 604, 89 S.W.2d 194 (1936). Thus, the "comparable sales" method of appraising property is of little use in valuing pipelines; and two other methods of appraisal must be used in assessing those properties. These two methods are the cost approach to value and the income approach to value.

In *Missouri-Kansas-Texas R. Co. v. City of Dallas*, 623 S.W.2d 296, 300 (Tex. 1981), the Supreme Court said:

> This court in *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 921 (Tex.1977), recognized the difficulty of determining market value of pipelines because comparable sales are of so little use. We also recognized that alternative methods, such as the cost approach and the income approach to value, may be used as alternative tax valuation methods when correctly used.

The Texas Supreme Court has recognized that railroad right-of-ways and pipeline easements do not have a fair market value. What about closely-held business interests?

In *Bendalin v. Delgado*, 406 S.W.2d 897, 900-01 (Tex. 1966), the Supreme Court said:

> By his seventh and eighth points, petitioner asserts that there is no evidence to support the jury's finding that the value of the stock was $2,867.44, or $57.35 per share, at the time respondent's employment with Consumers terminated. Consumers was a small, closely held corporation, and there was no market for its stock. The par value of the stock was $100.00 per share, and respondent introduced a balance sheet showing that its book value on December 31, 1961, was $63.22 per share. 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. *See Warner v. E. C. Warner Co.*, 226 Minn. 565, 33 N.W.2d 721; *Marnik v. Northwestern Packing Co.*, 335 Ill. App. 568, 82 N.E.2d 195; *Barsan v. Pioneer Savings & Loan Co.*, 163 Ohio St. 424, 127 N.E.2d 614; *Kelley v. 74 and 76 West Tremont Ave. Corp.*, 24 Misc.2d 370, 198 N.Y.S.2d 721; O'Neal, Close Corporations § 7.24.
>
> On the present record the book value of the Consumers stock constitutes nothing more than a scintilla of evidence as to its reasonable worth. The company had lost a substantial amount of money since its organization, and evidently was still losing money in 1962. Petitioner testified that its assets were not worth book value. He was the only witness who undertook to estimate the value of the stock, and according to his testimony it was worth only ten or fifteen cents on the dollar. His testimony in this respect could be disregarded by the trier of fact, but no attempt was made to prove the actual

value of the assets or the rate of earnings or losses at or about the time respondent left the company's employ. It does appear that on an undisclosed date in 1962 petitioner bought 100 shares of stock for $35.00 per share, and some time in 1963 he bought another 100 shares for ten cents per share. He claimed that the relatively high price paid in the earlier of these transactions was due to his sympathy for the seller, whose husband had died recently, and that the low price paid in the later transaction was attributable to the seller's desire to take a tax loss. The foregoing is a summary of all the evidence tending to establish the value of the stock. In our opinion it is sufficient to warrant submission of Special Issue No. 2, but the record is devoid of any evidence to support the conclusion that the stock was worth as much as $57.35 per share as found by the jury.

The Texas courts of appeals also have spoken to that issue.

In *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ), the court said:

Fair market value has been consistently defined 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). This standard or test presupposes an existing, established market.

The case of *Roberts v. Harvey*, 663 S.W.2d 525, 528 (Tex. App.--El Paso 1983, no writ), says:

There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price. Where there is no evidence of market value, it is error to submit to the jury an issue on market value. *Continental Oil and Cotton Co. v. Wristen & Johnson*, 168 S.W. 395 (Tex. Civ. App.--Fort Worth 1914, no writ). In the absence of testimony or evidence of a reasonable cash market value of corporate stock, the method employed in determining the worth or value of such stock is to determine the difference between the value of the assets and the amount of liabilities of the corporation. *Citizens National Bank of Lubbock v. Maxey*, 461 S.W.2d 138 (Tex. Civ. App.--Amarillo 1970, writ ref'd n.r.e.).

Beavers v. Beavers, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ), said:

Mr. Beavers' third point of error addresses the proper valuation to be placed on the community one-third interest in all outstanding stock of Great West Energy, Inc. The valuation problem arises because the sale of these shares is restricted by a requirement that they be offered first to other shareholders at book value. Experts from both parties testified that essentially because of this restriction, the market value of the stock was zero. This does not mean, however, that the trial judge erred in assigning a value of $170,000.00 to the stock for the purpose of making an equitable division of the community property. While market value is usually the best evidence of the value of the personal property, in the absence of a market value, the actual value of the property to the owner may be shown. *Bryant v. Stohn*, 260 S.W.2d 77, 83 (Tex. Civ. App.--Dallas 1953, writ ref'd n.r.e.); *Ft. Worth and D.C. Railway v. Hapgood*, 210 S.W. 969 (Tex. Civ. App.--Amarillo 1919, no writ). There is expert testimony from Mrs. Beavers' witness that, based on the value of the assets of the company, a one-third interest would be worth as much as $395,850.00. Even according to Mr. Beavers' expert witness, the book value of the company was $173,000.00 when substantial oil reserves were valued at only development costs. In assigning values to closely held corporations in contested divorce actions, those considerations given here by the trial judge to company assets and to the realities of corporate control are appropriate. *Dorfman v. Dorfman*, 457 S.W.2d 417 (Tex. Civ. App.--Texarkana 1970, no writ). The third point of error is overruled.

In *Strenk v. Strenk*, 2001 WL 1379924, *6 (Tex. App.--Austin 2001, no pet.) (unpublished opinion), the court said:

> Swanson's expert, Peña, testified as to the stock's "book value"; he did not calculate its fair market value. Strenk objected to the evidence of book value and questioned Peña regarding his failure to analyze the stock's fair market value. Strenk cites authority for the proposition that the value of an asset is its fair market value. *See City of Pearland v. Alexander*, 483 S.W.2d 244 (Tex. 1972); *Wendlandt v. Wendlandt*, 596 S.W.2d 323 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ). Neither case holds that fair market value is the only basis for valuing a closely held stock; indeed, *City of Pearland* involved the narrow question of valuation damages for severed property in an eminent domain proceeding. *See City of Pearland*, 483 S.W.2d at 245-46.

The case of *Elliott v. Whitten*, 2004 WL 2115420 at *12 (Tex. App.--Houston [1st Dist.] 2004, pet. denied) (mem. op.), says:

> There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price.

The case of *Roberts v. Harvey*, 663 S.W.2d 525, 528 (Tex. App.--El Paso 1983, no writ), says:

> There can be no cash market value of corporate stock where it has not been sold in sufficient quantities to establish a prevailing sales price. Where there is no evidence of market value, it is error to submit to the jury an issue on market value. *Continental Oil and Cotton Co. v. Wristen & Johnson*, 168 S.W. 395 (Tex. Civ. App.--Fort Worth 1914, no writ). In the absence of testimony or evidence of a reasonable cash market value of corporate stock, the method employed in determining the worth or value of such stock is to determine the difference between the value of the assets and the amount of liabilities of the corporation. *Citizens National Bank of Lubbock v. Maxey*, 461 S.W.2d 138 (Tex. Civ. App.--Amarillo 1970, writ ref'd n.r.e.).

In *Akin, Gump, Strauss, Hauer & Feld, L.L.P. v. National Development and Research Corp.*, 232 S.W.3d 883, 890 (Tex. App.--Dallas 2007), *reversed on other grounds*, 299 S.W.3d 106 (Tex. 2009), the court of appeals said:

> Generally, the fair market value of closed corporation stock, or stock having no public market, as here, is "what a willing purchaser would pay to a willing seller who was not acting under compulsion to sell." *Willis v. Donnelly*, 118 S.W.3d 10, 40–41 (Tex. App.-Houston [14th Dist.] 2003), *aff'd in part and rev'd in part on other grounds*, 199 S.W.3d 262, 279 (Tex.2006); *InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 889 (Tex. App.--Texarkana 1987), *disapproved on other grounds by Tex. Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240 (Tex. 2002). When stock sales do not exist upon which fair market value may be determined, other methods of assessing fair market value include the asset approach and the earnings, or income, approach. *See Willis*, 118 S.W.3d at 41.

In *Mandell v. Mandell*, 310 S.W.3d 531, 536-37 (Tex. App.--Fort Worth 2010, pet. denied), the court said:

> As a general rule, the value to be accorded community property that is to be divided in a divorce proceeding is "market value." *See R.V.K. v. L.L.K.*, 103 S.W.3d 612, 618 (Tex. App.--San Antonio 2003, no pet.) (citing *Walston v. Walston*, 971 S.W.2d 687, 690 (Tex. App.--Waco 1998, pet. denied)). "Fair market value has been consistently defined 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." *Id.* (quoting *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App.--Houston [1st Dist.] 1980, no writ)).

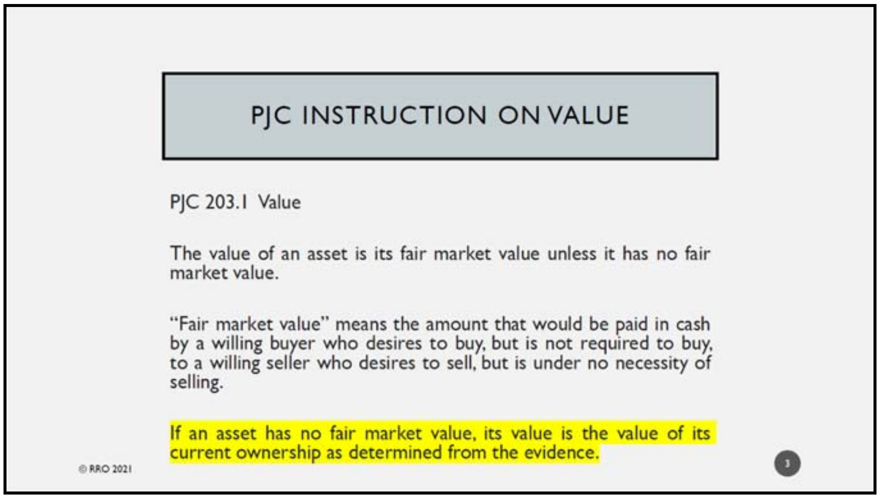
A straight fair market value is not an appropriate valuation method, however, when a community estate owns shares in a closely held corporation and, by agreement, any sale of the shares of stock is restricted to the corporation or other stockholders. *See Beavers v. Beavers*, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ). When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. *See id.* FN5 In this situation, the parties may show the actual value of the property interest to the owner. *See R.V.K.*, 103 S.W.3d at 618. Such evidence might include the value of being able, by virtue of ownership of the closely held stock, to drive a new automobile, to have health insurance paid for by the company, to have a company-financed life insurance policy, to belong to a country club at company expense, and other similar financial benefits. See James M. Loveless & Kimberly M. Naylor, Handling a Divorce Involving a Closely–Held Corporation, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, M, M–3 (1996).

FN5. See also Edwin Terry et al., Handling the Divorce Involving a Medical Practice, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, B, B–5 (1996) (explaining that "the concept of market value assumes an existing, established market" and that "as a practical matter there is often little or no actual market for a closely-held medical practice.... Therefore other methods of value must be used").

VII. IS FAIR MARKET VALUE REQUIRED FOR DIVORCE VALUATIONS? Accountants are accustomed to finding a fair market value for every business, since tax law requires it, and business valuation theory provides a model for doing so even in the absence of reliable market data. The question arises whether Texas case law requires that a business be valued at fair market value for purposes of divorce, which presents entirely different policy issues that gift tax or death tax. A review of Texas divorce cases suggests that a trial court is not required to use fair market value of a closely-held business in dividing the marital estate.

Divorce business valuations were litigated in *Nail v. Nail*, *Geesbreght v. Geesbreght*, *Finn v. Finn*, *Beavers v. Beavers*, *Keith v. Keith*, *Ashley v. Ashley*, *R.V.K. v. L.L.K.*, *Strenk v. Strenk*, *Von Hohn v. Von Hohn*, and *Mandell v. Mandell*. Of the cases listed, only *R.V.K.* dealt with a marketability discount associated with a sale to a third party, and in that case the evidence pitted testimony regarding the formula price set in buy-sell agreements against testimony of a hypothetical sale between a willing buyer and a willing seller. None of these Opinions (save Justice Duncan's Plurality Opinions in *R.V.K.*) say whether a marketability discount should or should not be considered when valuing a closely-held business interest on divorce.

The Texas Pattern Jury Charges (Family & Probate) recognizes that sometimes an asset has no fair market value:



Under PJC 203.1, an asset either has a fair market value or it does not. If it does, then the fair market value must be determined. If the assets does not have a fair market value, then an alternative approach to value must be used.

VIII. FAIR VALUE (IN CORPORATE LAW). In Section III.C above we noted that the accounting profession uses the term "fair value" to mean what lawyers call "fair market value." The term "fair value" as used in the law, as distinguished from its use in the accounting profession, is a special type of value that is used when minority owners of a business require the business to buy their interest at "fair value" in the event of a merger or sale of substantially all of the business's assets. Texas Business Organizations Code § 10.362, "Procedure for Dissent by Shareholders as to Said Corporate Actions," provides:

> § 10.362. Computation and Determination of Fair Value of Ownership Interest
>
> (a) For purposes of this subchapter, the fair value of an ownership interest of a domestic entity subject to dissenters' rights is the value of the ownership interest on the date preceding the date of the action that is the subject of the appraisal. Any appreciation or depreciation in the value of the ownership interest occurring in anticipation of the proposed action or as a result of the action must be specifically excluded from the computation of the fair value of the ownership interest.
>
> (b) In computing the fair value of an ownership interest under this subchapter, consideration must be given to the value of the domestic entity *as a going concern without including in the computation of value any control premium, any minority ownership discount, or any discount for lack of marketability.* If the domestic entity has different classes or series of ownership interests, the relative rights and preferences of and limitations placed on the class or series of ownership interests, other than relative voting rights, held by the dissenting owner must be taken into account in the computation of value.
>
> (c) The determination of the fair value of an ownership interest made for purposes of this subchapter may not be used for purposes of making a determination of the fair value of that ownership interest for another purpose or of the fair value of another ownership interest, including for purposes of determining any minority or liquidity discount that might apply to a sale of an ownership interest. [Emphasis added]

This Texas statute is representative of other state statutes that use the same concept. The essential feature of this concept of "fair value" is that the court must ignore the effect of the business event that triggered the liquidation of the minority interest, and the court must ignore a control premium, a minority discount, and a marketability discount, all of which are hallmarks of the concept of the fair market value mental construct of a sale to a hypothetical third party.

DIFFERENT MEASURES OF VALUE

- Fair Market value
- Investment value
- Intrinsic value
- Liquidation value
- Going concern value
- Book value
- Sentimental value

IX. INVESTMENT VALUE. *Investment Value* is the value of an asset to a particular investor, based on that investor's investment requirements. *Investment Value* can also be seen as the value of a business to a specific buyer, as distinguished from a hypothetical buyer.

X. INTRINSIC OR FUNDAMENTAL VALUE.

1. What is Intrinsic Value? Ibbotson defines "intrinsic value" as "the value that an investor considers, on the basis of an evaluation or available facts, to be the 'true' or 'real' value that will become the market value when other investors reach the same conclusion." IBBOTSON SBBI 12 (2011 Valuation Yearbook). The *Intrinsic Value* of a company is the value of a company determined from an analysis of its true value, as distinguished from the value that is recognized by others, as reflected in the marketplace. *Intrinsic Value* involves all aspects of the business, tangible and intangible. *Intrinsic Value* may or may not equate to fair market value, since fair market value represents the prevailing view of value of the business, or its *value in exchange* and not its actual value.

From an investment perspective regarding publicly-traded stock, *Intrinsic Value* is the underlying value of a company separate from its market value or share price. It is based on both quantitative factors (capital, earnings, revenue) and qualitative factors (management quality, intellectual capital, past record). The *Intrinsic Value* of a company may be lower or higher than what is indicated by the price at which its shares trade on an exchange, indicating that the firm is undervalued or overvalued. *Intrinsic Value* is most often determined using what is called "Fundamental Analysis." The theory of *Fundamental Analysis* holds that an individual security has an *Intrinsic Value* (equilibrium price) that depends on the security's earning potential. Eugene F. Fama, *Random Walks in Stock-Market Prices* 3 (1965) <http://www.chicago booth edu/ faculty/selectedpapers/sp16.pdf>. This earning potential depends on fundamental factors such as the quality of management, outlook for the industry, outlook for the economy, etc. *Id.* p. 3. *Fundamental Analysis* proceeds through the study of an investment by looking at the firm's (1) competitive advantage, (2) earnings growth, (3) sales revenue growth, (4) market share, (6) financial reserves, and (6) quality of management, all as reflected in its financial statements. <www.businessdictionary. com/definition/fundamental-analysis.html>. Through this form of analysis the investor can determine whether the current price of the security is above or below its *Intrinsic Value*. Because the actual price tends to move toward *Intrinsic Value*, the investment can be made so as to profit from the move of the price to intrinsic value. Fama (1965) p. 3.

2. Intrinsic Value Under Texas Law. In *City of Austin v. Cannizzo*, 267 S.W.2d 808, 812 (Tex. 1954), the Texas Supreme Court acknowledged case authority for the proposition that "where property has no market value its intrinsic value may be shown." The court said:

> We see no need to ferret out of the decided cases the nice distinctions made by our courts between 'market value' and 'intrinsic value' as those terms are used in eminent domain and kindred proceedings. Most of the cases to which we are referred and which we have investigated use the term 'intrinsic value' in the sense of intrinsic worth based upon such factors as cost, depreciation, present usefulness, past return on investment, etc., and hold that where the evidence establishes the absence of a market for the kind of property involved evidence of intrinsic value is admissible for the purpose of arriving at the final figure to be established whether that figure be for the purpose of awarding damages in an eminent domain proceeding, fixing a basis for tax liability, or establishing the rights of individual suitors. As examples, see *Lower Colorado River Authority v. Hughes*, Tex. Civ. App., 122 S.W.2d

> 222, writ dismissed; *West Texas Hotel Co. v. City of El Paso*, Tex. Civ. App., 83 S.W.2d 772, writ dismissed; *Foley Bros. Dry Goods Co. v. Settegast*, Tex. Civ. App., 133 S.W.2d 228, writ refused.

The Supreme Court neither endorsed or rejected the idea of intrinsic value, but found that it did not apply in that particular case. The land owners had not pled that there was no fair market value; they complained that they had not received fair market value; and they called three witnesses to testify to fair market value. The Court held that "[i]t was clearly error to instruct the jury that the 4.57 acre tract had no market value unless the evidence revealed 'a sufficient number of recent sales of comparable property to establish a prevailing price.'" *Id.* at 812-13. The Court concluded:

> Thus it appears as a matter of law that there was no such record before the court as justified the abandonment in the charge to the jury of the standard of market value and the adoption therein of the standard of intrinsic value in measuring damages.

Id. at 813. The Supreme Court cited *City of Trinity v. McPhail*, 131 S.W.2d 803, 806 (Tex. Civ. App.–Galveston 1939, no writ), which said:

> It is unquestionably the rule that where the evidence is uncontradicted, or where the jury finds that the property involved has no market value, that then the intrinsic value of the property becomes the measure in determining damages in condemnation suits. However, where the measure of damages in an action is based upon market value, as in a condemnation suit, and there is evidence that the property in question has a market value, it is error for the trial court to submit to the jury an issue on the measure of damages based upon the intrinsic value of the property, without a prior determination by the jury that the property has no market value.

Id. at 806.

Texas Pattern Jury Charges (Family & Probate) PJC 203.1 reflects this line of authority when it says: "if an asset has no fair market value, its value is the value of its current ownership as determined from the evidence." The Pattern Jury Charges cites to *Crisp v. Security National Insurance Co.*, 369 S.W.2d 326, 329 (Tex. 1963), which said "[w]here property, such as household goods and wearing apparel, has no recognized market value, the actual value to the owner must be determined without resort to market value."

XI. LIQUIDATION VALUE. *Liquidation Value* describes the total value that could be realized if all of a company's physical assets were sold and the business terminated. Liquidation value is determined by assets such as the real estate, fixtures, equipment and inventory. Residual intangible assets are not included in a company's liquidation value. <http://www.investopedia.com/terms/l/liquidation-value.asp>. Shannon Pratt distinguishes "value as an orderly disposition" from "value as a forced liquidation." Shannon Pratt, VALUING A BUSINESS 47-48 (5th ed. 2008).

XII. GOING-CONCERN VALUE. *Going Concern Value* is the value of a company viewed as an operating enterprise. A profitable, functioning business is made up of individual assets, but the assets taken as a whole are worth more when they are assembled into a functioning business than if each asset were to be valued separately. *Going Concern Value* at a minimum reflects the cost and time it would take for someone to assemble a going concern from replacement assets. But if the business is profitable, the *Going Concern Value* reflects not only the cost of duplicating the business, but also the proven ability of the business to make a profit for its owners. The.Free.Dictionary.com describes *Going Concern Value* in this way: "the value inherent in an active, established company as opposed to a firm that is not yet established; the value of the assets of a business considered as an operating whole."

XIII. BOOK VALUE. *Book Value* is the value of a company as reflected in its accounting records and on its financial statements (that are not marked to market). *Book Value* is constructed from the historical purchase price of its assets, less depreciation. Depreciation is a creature of tax law, and does not necessarily relate to the economic or functional obsolescence of the improvements or equipment that are being depreciated. *Book Value* can vary from actual value when assets have appreciated or diminished in value since being purchased, or when depreciable assets have declined in value more or less than the tax law assumes. *Book Value* includes some intangible assets, but almost never reflects enterprise goodwill, except for the enterprise goodwill of acquired businesses that have been purchased for more than the value of their tangible and recognized intangible assets. *Book Value* also omits self-created intangible value, which accounting principles requires to be expensed rather than booked as an asset. It is possible that *Book Value* could reflect the fair market value of a business, but that would usually occur only when the business is a passive vehicle for holding saleable assets.

BOOK VALUE Historical cost + Improvements - Depreciation Book Value

In *Polk County v. Tenneco, Inc.*, 554 S.W.2d 918, 923 (Tex. 1977), the Supreme Court held that "net book value" did not equate to market value. In *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724 (Tex. App.--Austin 1997, pet. denied), the court approved the "development approach" for use in valuing tracts of land that had been subdivided, or nearly so. In *Cheek v. Humphreys*, 800 S.W.2d 596 (Tex. App.--Houston [14 th Dist.] 1990, writ denied), the court said "[b]ook value is an improper method of determining the value of partnership equipment on dissolution of the partnership. . . . Book values are arbitrary values and cannot be used in the valuation of partnership assets." [Citations omitted]. In *Coastal States Petroleum Co. v. Corpus Christi Indep. Sch. Dist.*, 707 S.W.2d 206, 212 (Tex. App.–Corpus Christi 1986, writ ref'd n.r.e), the court said "At most, book value is recognized as only an indication or approximation of true value. . . . Book value is not a proper measure of taxable value when the evidence shows that it differs from market value." [Citation omitted]. In *Bendalin v. Delgado*, 406 S.W.2d 897, 900-01 (Tex. 1966), the Supreme Court said: "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." The statement is a bit overbroad.

The appellate court in *Sears Roebuck & Co. v. Dallas Cent. Appraisal Dist.*, 53 S.W.3d 382, 390 (Tex. App.--Dallas 2000 pet denied), noted that"[n]one of these cases involve the valuation of merchandise inventory and there is no indication that the book value at issue in any of these cases was calculated in accordance with GAAP." These cases were therefore distinguished from the case at hand, which involved a property tax valuation of a business's inventory. The Dallas Court of Appeals rejected a blanket assertion that *Book Value* was no evidence of market value. The Court said:

> In some circumstances, book value of inventory may be probative of market value by either serving as some indication of market value or by being equivalent to market value. *See In re Quality Beverage Co.*, 170 B.R. at 316–17; *Coastal States*, 707 S.W.2d at 211, 212; *Cauble v. Handler*, 503 S.W.2d 362, 365 (Tex. Civ. App.--Fort Worth 1973, writ ref'd n.r.e.). In other circumstances, the two values may be entirely unrelated. *See Polk*, 554 S.W.2d at 923; *Cheek*, 800 S.W.2d at 598. Whether the book value of inventory is in fact indicative of or equivalent to its market value is an issue to be determined by the trier of fact on a case by case basis. We decline Sears's invitation to hold that, as a matter of law, inventory book value derived according to generally accepted accounting principles is not equal to market value.

XIV. SENTIMENTAL VALUE. The Texas Supreme Court has recognized the right of persons to recover for the loss of the sentimental value of personal property. In *City of Tyler v. Likes*, 962 S.W.2d 489, 496-97 (Tex. 1997), the Supreme Court said:

While few persons suffering serious bodily injury would feel made whole by the mere recovery of medical expenses and lost wages, many whose property has been damaged or destroyed will be entirely satisfied by recovery of its value. As a rule, this is measured by the property's market value or the cost of repairing it. *See Pasadena State Bank v. Isaac*, 149 Tex. 47, 228 S.W.2d 127, 128–29 (1950). In some cases, however, the damaged property consists of "articles of small market value" that "have their primary value in sentiment." *Brown v. Frontier Theatres, Inc.*, 369 S.W.2d 299, 304–05 (Tex.1963). Such property can only be adequately valued subjectively; yet, the owner should still be compensated. As the Court discussed in *Brown*, special rules apply in a suit to recover for the loss of property that is primarily of sentimental value:

> It is a matter of common knowledge that items such as these generally have no market value which would adequately compensate their owner for their loss or destruction. Such property is not susceptible of supply and reproduction in kind, and their greater value is in sentiment and not in the market place. In such cases the most fundamental rule of damages that every wrongful injury or loss to persons or property should be adequately and reasonably compensated requires the allowance of damages in compensation for the reasonable special value of such articles to their owner taking into consideration the feelings of the owner for such property.

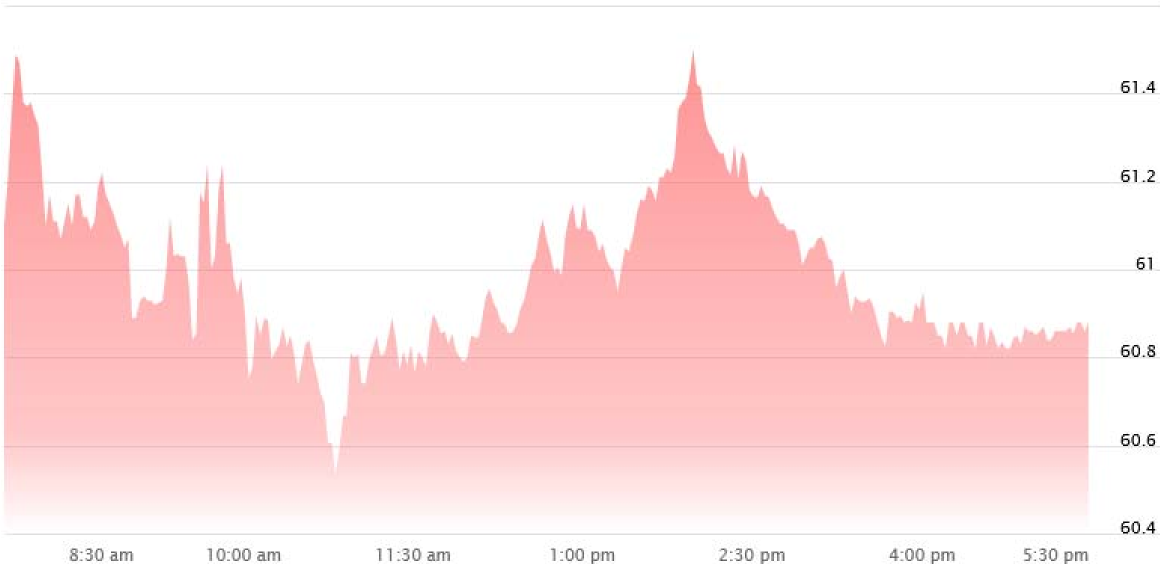
XV. ISSUES WITH BUSINESS VALUATION IN A DIVORCE. Valuing a closely-held business interest in a divorce presents policy considerations that are not addressed by the approaches to valuation taken for purposes of tax reporting and financial reporting, or even the appraisal of businesses for purposes of purchase or sale.

1. Tax Focus on Fair Market Value. Federal tax law requires that the estate tax and gift taxes be levied on the fair market value of assets. The Federal tax law concept of fair market value involves the sale of the asset -- the so-called "willing buyer/willing seller" test. Federal tax law does not recognize that some assets may not have a fair market value. Federal tax law does not recognize that, in the absence of a true market, there is no way to directly observe a market price. In 1959, the IRS promulgated Rev. Rul. 59-60, which essentially fell back on *Fundamental Analysis* of a business as a way to estimate fair market value when no free and active market existed for the company's stock. Tax practitioners, including the people who value closely-held business interests for tax purposes, when faced with no market in which to observe a true market value, are by necessity forced to engage in the legal fiction of hypothesizing a market value using *Fundamental Analysis*, to arrive at a figure for what a theoretical buyer would pay for the interest in the business if such a buyer could and would buy the business.

2. Accounting Focus on Exit Price. The accounting industry, as reflected in FAS 157, is interested for financial reporting purposes in reporting the "exit price," or the money which the asset (including a business) would fetch if sold.

This focus on "exit price" is problematic. For example, as of March 31, 2021, Exxon Mobil Corporation had 4.23 billion shares outstanding. On July 12, 2021, 17,147,347 shares of XOM traded that day. That means that 4/10 of one percent of the outstanding shares were sold that day. The holders of 99.6% of the shares chose not to sell their XOM stock that day at the price range in question. On what basis can we conclude that the opinion of value of 0.4% of the shareholders represents the opinion of value of the holders of the remaining 99.6% of the shares? How can we know how many buyers that day would have been willing to pay more for shares of XOM if they had been unable to buy shares at a lower price? On July 13, 2021, the sales price of XOM shares dropped to $60.5+ per share at 10:49am. At 1:59pm the price rose to $61.5 per share. That swing of $1 per share caused the total value of ExxonMobil's market capitalization to increase by $4.23 billion over a four hour period.

July 12, 2021
Nasdaq.com
https://www.nasdaq.com/market-activity/stocks/xom



The philosophical, economic, or financial justification for insisting on an exit price for assets that have no market, or assets that are not being held for sale, is not explained in industry literature. One suspects that accountants use "exit price" because sales prices of many assets are observable, where intrinsic value is not observable. At the policy level, how do you justify using an "exit price" in a divorce for an asset that no one is exiting?

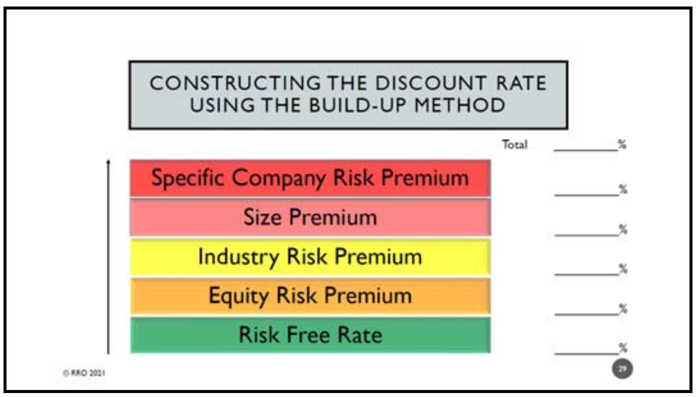
3. Modern Business Valuation Methods. In recent times, the business valuation community has striven to connect the *Fundamental Analysis* of a closely-held business to objective market data as much as possible. The Income Approach requires two things: a projection of future revenues/cash flows, and the proper capitalization rate or the proper discount rate to discount the future stream of payments to present value. The "build up method" reflects this, where the discount rate is arrived at through the addition of measurable components: the safe rate (objective), the equity risk premium (objective), the industry premium (objective), the size premium (objective), and specific company risk (subjective). The Capital Asset Pricing Model ("CAPM") does this by determining the Beta (a measure of volatility) for investments that are comparable to the business being valued. Both methods are discussed below.

a. Revenue. Ruling 59-60. Modern business valuation theory originates with Revenue Ruling 59-60, where the IRS grappled with the difficulty of determining the fair market value of an ownership interest in a business where there was no market from which a fair value could be determined. The IRS eschewed any specific instructions on how to value the business: "No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases." Rev. Rul. 59-60 § 3.01.

Rev. Rul. 59-60 § 3.03 asserts that the best indicator of value is the price at which stock in a company trades in a free and active market. But where the stock is closely-held, or traded infrequently, or traded in an erratic market, some other measure must be used. *Id*. § 3.03. Rev. Rul. 59-60 suggests that the next best measure may be the price of stock in comparable companies that are trading in a "free and open market." *Id*. If comparable companies whose shares are traded on an exchange cannot be found, then sales of comparable companies whose stock is sold "over the counter" should be used. *Id*. § 4.02 (g).

Rev. Rul. 59-60 thus talks in terms associated with the market data approach to business valuation. In current practice, however, modern business valuation theory relies more heavily on the income approach, which does not look to guideline companies to develop market multipliers. Part of Rev. Rul. 59-60 is easily adapted to the income approach. Earning capacity and dividend paying capacity are both listed as factors to consider in valuing a company. *Id.* § 4.01. In Section 5, Rev. Rul. 59-60 says: "Earnings may be the most important criterion of value in some cases . . . . In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public. . . ." *Id.* § 5(a). Section 6 discusses capitalization rates, saying that "[a] determination of the proper capitalization rate presents one of the most difficult problems in valuation." *Id.* § 6. The buildup method and Capital Asset Pricing Model (CAPM) are the way most business appraisers arrive at a defensible capitalization rate or discount rate.

b. The Buildup Method. The buildup method is an additive model in which the rate of return on an investment that would be sufficient to attract a buyer is estimated by taking the "risk free rate" and adding to that various premia that reflect a return investors require for taking a specific risk. These premia include the equity risk premium, the firm size premium, the industry premium, and the specific company risk premium.



In theory, there is an investment that has no risk of default, and the rate of return on that investment is the "risk free rate." For most purposes, the risk free rate in the U.S. is the interest rate on a three-month U.S. Treasury bill. However, for longer-term investments, a longer term government security (i.e., a 10-year Treasury note or 20-year Treasury bond) would be considered the risk free rate. In 2011, Standard and Poor downgraded the United States' long term sovereign credit rating from a triple A to double A rating, but Moody's and Fitch have maintained an AAA rating. Years of quantitative easing by the Federal Reserve and the prospect of record-breaking Federal spending as part of COVID-19 relief and investment in "infrastructure" that is not paid for by tax increases, portend trouble ahead. In July of 2020, Fitch issued a "negative outlook" on the U.S. government's credit worthiness. The U.S. national debt-to-GDP ratio is 100%, compared to Germany's 71%, Norway's 40%, the UK's 107%, France's 118%, and Japan's 256%. It makes less sense to talk of a risk-free rate. *See* <https://en.wikipedia.org/wiki/United_States_federal_government_credit-rating_downgrades> (7-14-2021). With the Federal Reserve System buying Treasury securities in order to artificially depress the rate on U.S. Treasury securities, the "risk free rate" is no longer solely determined by market forces and may therefore be sending inaccurate signals about investors' expectations.

The expected "equity risk premium" is the additional return an investor expects to receive to compensate for the additional risk associated with investing in equities as opposed to investing in riskless assets. It is the excess return of stocks over bonds. An article on the Internet commented: "If we do a little data picking, we can see that long-term Treasury bonds have outperformed stocks since the summer of 1987, and come in just behind stocks since late 1980. Reasonable people can disagree but that certainly sounds like the long-term to me. This means that you could have sat out the entire stock market over the last 28 years, parked your money in long-term T-bonds and done just as well as the stock market, which we know beats the vast majority of fund managers." http://www.crossingwallstreet.com/archives/2008/10/what-equity-premium.html> (7-13-2021). However, long term rates of return can be affected by the beginning and ending points you select. And the return on equities is biased because it does not include investments lost in small companies who go out of business.

"Specific company risk" has been defined to be "[a]n unsystemic risk specific to a certain company's operations and reputation." <http://financial-dictionary.thefreedictionary.com/Company-Specific+Risk> (7-13-2021). Some judges are skeptical about specific company risk, as the following passage indicates:

> In an appraisal action, "the proponent of a company specific premium bears the burden of convincing the Court of the premium's appropriateness."41 Defendants accept this burden and point the Court to cases in which the Court has deemed a company-specific risk premium to be appropriate.42 Yet as Vice Chancellor Strine explained in one of the cases defendants cited, even though courts may approve the use of these premiums, "[t]o judges, the company specific risk premium often seems like the device experts employ to bring their final results in line with their clients' objectives, when other valuation inputs fail to do the trick."43 Proponents of a company-specific risk premium thus not only bear a burden of proof but also must overcome some level of baseline skepticism founded upon judges' observations over time of how parties have employed the quantitative tool of a company-specific risk premium.
>
> FN42 See, e.g., Delaware Open MRI Radiology Assoc. P.A. v. Kessler, 898 A.2d 290, 340-41 (Del. Ch. 2006) (declining to "quibble" with including a company-specific risk premium, and ultimately selecting the more conservative of the two premiums the parties presented); Henke v. Trilithic Inc., 2005 WL 2899677, at *10 (Del. Ch. Oct. 28, 2005) (agreeing that an upwards adjustment to account for company-specific risk was appropriate); Lane v. Cancer Treatment Ctrs. Of Am., Inc., 2004 WL 1752847, at *30-31 (Del. Ch. July 30, 2004) (accepting adjustments for company-specific risk); ONTI, Inc. v. Integra Bank, 751 A.2d. 904, 919-20 (Del. Ch. 1999) (applying a company-specific risk premium yet reducing the suggested value thereof after finding that not all risks outlined by valuation experts were risks specific only to the company).
>
> FN43 Delaware Open MRI, 898 A.2d at 339.

In re Sunbelt Beverage Corp. Shareholder Litigation, Consol. C.A. No. 16089-CC (Del. Chancery Ct., Feb. 15, 2010) (memo. op.), <https://law.justia.com/cases/delaware/court-of-chancery/2010/131480-1.html>.

See Kroll, *From the Parlor to the Courtroom: The Use of a Company-Specific Risk Premium in Valuations* (Mar 15, 2011).[4]

Shannon Pratt suggests that the required total rate of return on an equity investment in a small closely-held business varies from 20% to 40%.

c. The CAPM. The Capital Asset Pricing Model (CAPM) is used to describe the expected future rate of return on a security or portfolio of securities. According to the originator of the Model, William F. Sharpe, the CAPM can be used to determine the rate of return required before an investment should be added to an existing well-diversified portfolio. According to portfolio management theory, risk of an investment is broken down into firm-specific risk and market risk. An investor tries to diversify away as much firm-specific risk as possible, by spreading investments throughout the entire market, in the theoretical extreme leading to an investment portfolio that includes every asset in the market in proportion to that asset's share of the market. Such an investment strategy (at its theoretical extreme) eliminates all risk but market risk. Market risk can be reduced by diversifying the array of markets in which investments are made.

In portfolio management theory, risk is measured statistically as the variance around an expected rate of return. In theory, assuming a well-diversified investor, the only risk of variance in the portfolio is systematic or non-firm-specific-risk that cannot be diversified away.

Under the CAPM, the correct price for an investment is determined by discounting to present value its expected rate of return, after adjusting that rate of return by a risk factor. That risk factor is known as the beta coefficient (β). Beta is a measure of the volatility of an investment, which is determined by determining how much the stock price moved when the entire market moved up and down by one percent, viewed over a historical 5-year period. A market index, like the S&P 500 or Wilshire 5000, is used to reflect movements of the entire market. Higher Betas mean more volatility. A Beta of more than one means the stock is more volatile than the market; a Beta of 1 means that the stock has moved up and down in step with the market; a Beta between one and zero means the stock is less volatile than the market. A Beta of zero means there is no correlation between the investment and the market, which would apply to a cash and to risk-free investments like Treasury bills. A negative Beta means that the investment moves inversely to the market (i.e., decreases in value when the market goes up, or vice versa). See https://financial-dictionary.thefreedictionary.com/Beta.

For an investment, the difference between the actual rate of return and the risk free rate is called "excess return." Under CAPM, the expected return of an investment is equal to the risk free rate, plus the product of Beta times the investment's excess return. The Arbitrage Pricing Theory (posited in 1976) determines overall Beta for an individual investment by comparing the investment's volatility to multiple macro-economic factors (GDP, inflation rate, etc.), determining a Beta for each factor, and combining these measures into an overall Beta for that investment.

The original CAPM was based on simplifying assumptions that made the model perform poorly against empirical data. Successive efforts to make the model more robust have addressed particular criticisms, but on the whole, according to Professor Eugene F. Fama, "the empirical record of the model is poor–poor enough to invalidate the way it is used in applications"). *Eugene F. Fama and Kenneth R. French*, The Capital Asset Pricing Model: Theory and Evidence (2004) p. 1.[5]

XVI. LAW AND LOGIC OF APPLYING BUY-SELL FORMULAS UPON DIVORCE. Federal cases distinguish between transfer restrictions that destroy marketability of an ownership interest and transfer restrictions that merely impair it.

In *Helvering v. Tex-Penn Co.*, 300 U.S. 481, 499, 57 S. Ct. 569, 577, 81 L. Ed. 755 (1937), the U.S. Supreme Court said:

> The court is also of opinion that the judgments must be affirmed upon the ground that in the peculiar circumstances of this case, the shares of Transcontinental stock, regard being had to their highly speculative quality and to the terms of a restrictive agreement making a sale thereof impossible, did not have a fair market value, capable of being ascertained with reasonable certainty, when they were acquired by the taxpayers.

However, in *Kolom v. C. I. R.*, 644 F.2d 1282, 1288 (9th Cir. 1981) *cert. denied*, 454 U.S. 1011 (1981) the Ninth Circuit considered the effect of the six-month resale restriction imposed by Section 16(b) of the Securities and Exchange Act of 1934, which reads as follows:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer ... within any period of less than six months ... shall inure to and be recoverable by the issuer ....

The taxpayer exercised employment-related options that were "in the money." The IRS taxed the taxpayer based on the market value of the shares on the day he exercised his options, without regard to the fact that if he had sold the shares for a profit on that day he would have had to turn over the profit to the issuing company. The taxpayer unsuccessfully argued that the value to him was zero, because if he had sold the shares on that day Section 16(b) would have required him to turn the proceeds back to the company. The taxpayer also unsuccessfully argued that his shares had no market value on the day of exercise, because he could not be a willing seller. The Ninth Circuit rejected this contention, saying that the fact he was unwilling to sell his stock did not establish that he could not sell his stock. *Id.* Justice Powell dissented to the Supreme Court's denial of certiorari. *Kolom v. C.I.R.*, 454 U.S. 1011, 102 S. Ct. 548 (1981).

See Mailloux v. Commissioner, 320 F.2d 60, 62 (5th Cir. 1963) ("where there is no absolute prohibition against a sale, a restriction may reduce but does not destroy fair market value"); *Cohu v. Commissioner*, 8 T.C. 796 (1947) (trial court overvalued shares that were subject to contingencies and restrictions); *Goldwasser v. Commissioner*, 47 B.T.A. 445 (1942), *aff'd*, 142 F.2d 556 (2nd Cir.), *cert. denied*, 323 U.S. 765, 65 S. Ct. 119, 89 L. Ed. 612 (1944) (while contract provision requiring no public offering of stock "did not constitute a restrictive covenant preventing petitioner from disposing of the stock if she had seen fit to do so, we think it did have the effect of depressing the market for her particular shares").

In *United States v. Cartwright*, 411 U.S. 546, 550-51, 93 S. Ct. 1713, 1716-17, 36 L. Ed.2d 528 (1973), the U.S. Supreme Court invalidated a Treasury Regulation that valued shares in a front-end loaded mutual fund at the cost to buy into the mutual fund, not the price at which the decedent's interest could be liquidated, which was solely through redemption by the mutual fund. In response to the government's argument that the only true market transaction was when buyers bought into the mutual fund, the U.S. Supreme Court reasoned that the redemption was the final act in a willing buyer-willing seller transaction. Thus, the redemption price for sellers prevailed over the market price for buyers.

Texas cases on the effect of buy/sell provisions on divorce value include:

-- *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 201-202 (Tex. Civ. App.--Houston [1 Dist.] 1975, no writ):

> The legal justification for the refusal to effectuate transfer of the 1300 shares of capital stock of Earthman's, Inc. was based upon a provision of Article V of the articles of incorporation of that company which provides as follows:
>
> 'The shares of stock of the corporation are to be held by each shareholder upon the condition that he will not sell, assign, transfer, pledge or in any way dispose of or encumber any of such shares without first offering (in writing, mailed to the Corporation's office) the same for sale to the Corporation which shall have the right to purchase all or any portion of such shares within sixty (60) days from the date of the offer. . . . If for any reason the Corporation does not purchase any shares of stock which it has the right to purchase under any provision of this Article, the remaining shareholders of the Corporation so electing shall have the right to purchase all or any portion of such shares (prorata, according to their stock ownership, or as they may otherwise agree) within ten (10) days following the end of the time during which the Corporation had the right to purchase such shares under this Article . The price for purchase of shares of stock under any provision of this Article shall be the book value of such shares as at the close of the month preceding the date of the offer . . . such book value to be determined by the certified public accountants serving the Corporation at such time, in accordance with the accounting practices followed in preparing the most recent annual financial statement to the corporation. Such purchase price shall be paid in cash forthwith after notification of the election to purchase or, at the option of the purchaser, 20% Of the purchase price may be so paid in cash and the balance may be paid in no more than four equal annual installments with interest at the rate of 6% Per annum.'
>
> In the letter of April 5, 1972 counsel for Earthman's, Inc. stated that Earthman's, Inc. construed the delivery of the two certificates representing 1300 shares of the company stock as an attempt by J. B. Earthman, III to transfer stock to Mrs. Earthman in derogation of Article V, that the company was therefore entitled to purchase such stock at book value and that it exercised its right and option to purchase such stock on terms as stated in the article.

A provision which restricts a stockholder's right to sell or transfer his stock, particularly one which affords a prior right of purchase to the corporation or to another stockholder, is not looked upon with favor in the law and is strictly construed. *Casteel v. Gunning*, 402 S.W.2d 529 (Tex. Civ. App. 1966, writ ref'd n.r.e.); *Gulf States Abrasive Manufacturing, Inc. v. Oertel*, 489 S.W.2d 184 (Tex. Civ. App.--Houston (1st), 1972, writ ref'd n.r.e.). It has generally been held that such a restriction is inapplicable to a transfer occurring as a result of an involuntary sale or by operation of law unless by specific provision in the restriction it is made applicable. 18 C.J.S. *Corporations* § 391 (1939); 2 A.L.R.2d 745, 754, *Restrictions on Corporate Stock.*

In *Messersmith v. Messersmith*, 229 La. 495, 86 So.2d 169 (1956), it was contended that certain community owned stock should not be divided in kind, as decreed by the divorce court, and that the husband should be permitted to retain the stock and to pay his wife one-half its book value in accordance with a restrictive clause in the corporate charter requiring a stockholder, who wished to sell his stock, to first offer it to the other stockholders or officers of the corporation. The Louisiana Supreme Court determined that the restrictive provision of the charter could not prevent the recognition of the wife's share of ownership in the corporation and held that she was entitled to have delivered to her in kind the interest awarded to her under the divorce decree. In so holding that court stated:

'. . . The restriction in the charter cannot affect the status of the stock purchased during the existence of the community or the rights the wife may assert thereunder. Such a restriction cannot negative the wife's present interest as a co-owner, and as a co-owner in community she is clearly entitled to be recognized as such and obtain the exclusive management and control of her vested interest. (citing cases).' (86 So.2d p. 173)

We are of the opinion that the restrictive provision in question should not be construed so as to preclude Mrs. Earthman's right to have her shares of ownership reflected on the books of the corporation and to have the stock certificates evidencing her ownership issued to her. We hold that the trial court properly determined that this provision did not afford to the corporation the right or option to purchase the shares of Earthman's, Inc. so awarded to Mrs. Earthman.

--*Finn v. Finn*, 658 S.W.2d 735, 742, 749-750 (Tex. App.--Dallas 1983, writ ref'd n.r.e.):

VANCE, Justice.

The lack of any legal right of the husband to realize the value of the firm's goodwill is a decisive factor. It distinguishes the present case from Geesbreght wherein the corporate structure provided a mechanism which enabled Dr. Geesbreght to realize the value of accrued goodwill by enhancing the value of his stock. In the present case the only mechanism through which the husband may possibly realize the value of the accrued goodwill is through continuing to practice law as a member of the firm, a circumstance depending not only on his own individual capacity, but also on the uncontrolled discretion of his partners. Thus his position is no better than that of the physician in Nail, in which the supreme court found the value of accrued goodwill in an individual professional practice to be realized only through enhanced future earning capacity. Such realization in the future is no more than an expectancy entirely dependent on the husband's continued participation in the firm, and, therefore, is not property in the community estate. Nail, 486 S.W.2d at 764. Consequently, we hold that the trial court properly instructed the jury not to consider the law firm's accrued goodwill or future earning capacity FN3 when placing a value on the community interest in the husband's law practice.

STEWART, Justice, concurring.

The partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. *Slater v. Slater*, 100 Cal. App. 3d 241, 160 Cal. Rptr. 686, 688-689 (1980). The formula in the partnership agreement may represent the present value of the husband's interest, but it should not preclude a consideration of other facts. *Slater*, 160 Cal. Rptr. at 689; *Stern v. Stern*, 66 N.J. 340, 331 A.2d 257 (1975). The value of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any. Goodwill is property and, although intangible, it is an integral part of a business, the same as its physical assets. *Taormina v. Culicchia*, 355 S.W.2d 569, 573 (Tex. Civ. App.--El Paso 1962, writ ref'd n.r.e.); *Ordway-Saunders Co. v. Little*, 568 S.W.2d 711, 717 (Tex. Civ. App.--Amarillo 1978, writ ref'd n.r.e.). Whether the law firm possessed goodwill, and, if so, its value are fact questions for the trier of facts. *Taormina*, 355 S.W.2d at 574.

The majority are concerned with future contingencies. All assets of the community estate are valued as of the time of dissolution of the marriage. There is no valid reason to exclude a professional partnership interest from this basic rule when the partner intends to continue as a member of the firm.

--*Keith v. Keith*, 763 S.W.2d 950, 953 (Tex. App.--Fort Worth 1989, no writ):

Charles asserts in point of error number three that the trial court erred by failing to find the market value of the partnership by applying the formula set forth in the partnership agreement, since his wife, Glenda, signed the agreement stating her approval of the agreement and her acceptance of its provisions, agreeing to be bound by it.

The partnership agreement entered into between Charles and Ty provided a method for determining the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners. The trial court did not use the method provided in determining the value of the partnership. 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.

--*R.V.K. v. L.L.K.*, 103 S.W.3d 612 (Tex. App.--San Antonio 2003, no pet.):

Opinion by: SARAH B. DUNCAN, Justice.

Contrary to R.V.K.'s argument, the divorce proceeding has not triggered the buy/sell agreements. There has not been an "operative event"--an attempted sale, transfer, gift, mortgage, or pledge of stock without the corporations' consent; termination of R.V.K.'s employment; or termination of his marriage by death or divorce in a manner that dictates that R.V.K. will not succeed to L.L.K.'s community interest in the Medical Practice Group and the Medical Equipment Business stock.

* * *

Concurring and Dissenting opinion by: ALMA L. LÓPEZ, Chief Justice.

I concur in the majority's conclusion that the trial court erred in failing to properly derive a fair market value for R.V.K.'s ownership interest, but I agree with the dissent that we should address whether *Finn* or *Keith* should be followed in determining whether goodwill should be included in valuing a professional practice. I also agree with the dissent that we should follow the holding in *Keith* and the reasoning in Justice Stewart's concurring opinion in *Finn*.

* * *

Dissenting opinion by: SANDEE BRYAN MARION, Justice, joined by CATHERINE STONE, Justice.

I respectfully dissent and I would affirm the trial court's judgment. [FN1] I believe this court should answer the question presented at trial and on appeal: should the *Finn* decision or the *Keith* decision be followed when determining the value of a professional practice upon divorce? I agree with Annette Stewart's concurring opinion in *Finn* and the court in *Keith*, and would hold that the value of R.V.K.'s interest should be based on the present value of the entities as ongoing businesses, which would include such factors as limitations associated with the buy/sell agreements and consideration of commercial goodwill.

--*Von Hohn v. Von Hohn*, 260 S.W.3d 631 (Tex. App.--Tyler 2008, no pet.):

Based on these facts, we agree with the concurrence in *Finn* that the Nix Law Firm partnership agreement does not control the value of the individual partnership interests in the event of a divorce. *See Finn*, 658 S.W.2d at 749. The Nix Law Firm was an ongoing partnership as of the time of divorce, Edward had not died nor had he withdrawn from the partnership, and, thus, none of the triggering events specified in the partnership agreement had occurred. *See R.V.K.*, 103 S.W.3d at 623; *Keith*, 763 S.W.2d at 953. Consequently, the formula in the partnership agreement was not determinative of the value of Edward's interest in the Nix Law Firm. *See Keith*, 763 S.W.2d at 953. Therefore, the trial court did not err when it determined that the proper measure of the value of the community interest in the Nix Law Firm could include methods other than those set forth in the partnership agreement.

In answering the legal policy question of what to do about transfer restrictions in determining value for purposes of divorce, the choices fall into four categories: (i) always assume the restrictive provision will trigger at the time of divorce; (ii) never assume the restrictive restriction will trigger at the time of divorce; (iii) determine from the evidence whether and when the restrictive provision will trigger; and (iv) use a value that permits a just and right property division. The plurality Opinion in Finn tacitly assumed that the withdrawal provision applied at the time of divorce. The Opinion in Earthman, the Concurring Opinion in Finn, the opinion in Keith, all three Opinions issued in R.V.K. and the Opinion in Von Hohn all said that the transfer provision did not trigger and thus did not control the divorce value. Intellectually we must be ask whether the definition of fair market value, which assumes a hypothetical sale by an imaginary seller to an imaginary buyer, forces us to assume that there is an imaginary trigger of the buy-sell or withdrawal clause that results from the hypothetical sale.

--*Mandell v. Mandell*, 310 S.W.3d 531, 537 (Tex. App.–Fort Worth 2010, pet. denied):

A straight fair market value is not an appropriate valuation method, however, when a community estate owns shares in a closely held corporation and, by agreement, any sale of the shares of stock is restricted to the corporation or other stockholders. *See Beavers v. Beavers*, 675 S.W.2d 296, 299 (Tex. App.--Dallas 1984, no writ). When the sale of stock is restricted by a requirement that the shares be offered first to the corporation or to other shareholders, then essentially the fair market value of the stock is zero. See *id.* FN5 In this situation, the parties may show the actual value of the property interest to the owner. See R.V.K., 103 S.W.3d at 618. Such evidence might include the value of being able, by virtue of ownership of the closely held stock, to drive a new automobile, to have health insurance paid for by the company, to have a company-financed life insurance policy, to belong to a country club at company expense, and other similar financial benefits. See James M. Loveless & Kimberly M. Naylor, Handling a Divorce Involving a Closely–Held Corporation, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, M, M–3 (1996).

FN5. See also Edwin Terry et al., Handling the Divorce Involving a Medical Practice, State Bar of Texas Prof. Dev. Program, Marriage Dissolution Institute, B, B–5 (1996) (explaining that "the concept of market value assumes an existing, established market" and that "as a practical matter there is often

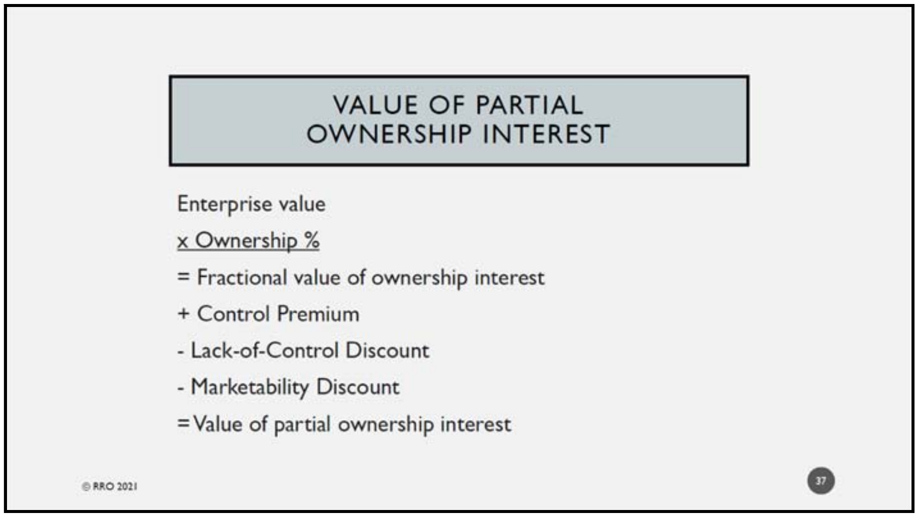
> little or no actual market for a closely-held medical practice.... Therefore other methods of value must be used").

XVII. THE PARADOX OF VALUING NON-CONTROLLING OWNERSHIP INTERESTS. When all ownership interests in a business are minority interests, and the value of each minority interest is reduced below its proportionate share of the entity's overall value due to a minority (lack-of-control) discount, then a paradox occurs: the values of all ownership interests added together do not total to the value of the entire business. This problem was exemplified in the context of real estate in *Watkins v. Shurley*, No. 03-09-00393-CV, 2010 WL 5690100, *5 (Tex. App.-Austin Feb. 4, 2011, no pet.) (mem. op.). There the issue was an agreed division of land owned by a trust into two undivided fractional interests, a 5/12 interest and a 7/12 interest. Under a settlement agreement, one family member's original contribution was to be valued at fair market value, but would remain in trust. The person's contribution amounted to a 5/12 interest in the land. In determining the fair market value of the 5/12 interest, the appraiser did not apply a marketability discount because, after the valuation, the two interests would be combined into a whole again. *Id.* *6. The appellate court criticized this approach as not arriving at fair market value. In an explanation that demonstrates the weakness of using the fair market value concept in a situation where there is no sale, the Austin Court of Appeals wrote:

> "Fair market value" attempts to ascertain the price a willing buyer would pay to a willing seller on the open market if the seller and buyer were not compelled to enter into the transaction. *State v. Windham*, 837 S.W.2d 73, 77 (Tex. 1992). It is, by its very nature, a hypothetical determination-"an imaginary price to be paid by an imaginary buyer to an imaginary seller in an imaginary sale." *City of Austin v. Cannizzo*, 267 S.W.2d 808, 816 (Tex. 1954) (Garwood, J. dissenting). The sale in question "has not been made and never will be," *id.* at 818, and the seller and the buyer are unidentified. Further, Texas courts have long held that it is appropriate to consider "all factors ... which would reasonably be given weight in negotiations between a seller and a buyer" of the property in arriving at a fair market value. *Cannizzo*, 267 S.W.2d at 813-14; *State v. Carpenter*, 89 S.W.2d 194, 200 (Tex. 1936) ("Generally, it may be said that it is proper as touching the matter of the value and depreciation in value to admit evidence upon all such matters as suitability and adaptability, surroundings, conditions before and after, and all circumstances which tend to increase or diminish the present market value."). Thus, to arrive at the fair market value required here, the appraiser must determine the price at which a hypothetical unobligated seller would sell the undivided 5/12 interest in the tract to a hypothetical unobligated buyer, whom the appraiser must assume will consider the size, ownership interest, and various other conditions of the property being conveyed in determining what he is willing to pay for that tract. *See Spindor v. Lo-Vaca Gathering Co.*, 529 S.W.2d 63, 65 (Tex. 1975) (noting that a "hypothetical willing buyer-willing seller would take [relevant factors related to certain property] into consideration in negotiating for the purchase of that property"). Here, the settlement agreement provides that the undivided 7/12 interest be removed from the appraisal process. Thus, because the agreement requires a division based on fair market value, the appraiser must value the undivided 5/12 interest on its own, taking into account its fractional undivided status without regard to who owns or will eventually own the undivided 7/12 interest in that tract.

Id. at *5.

To be fair to the family member whose contribution was being valued, the settlement agreement should have provided that the family member's interest would be the pro rata value of the entire tract. It is interesting to note that a lack of control discount would not be appropriate since a partial cotenant's undivided interest in land is not subject to the control of any one cotenant or even a group of other cotenants. However, since the property was held in trust, both the 5/12 and the 7/12 interests were subject to the control of the trustee, who could refuse to sell a 5/12 interest to a third party. While the Court of Appeals was constrained to recognize the "fair market value" determination contained in the settlement agreement, it is easy to see how the willing buyer-willing seller approach can lead to undesirable results in certain situations where it would be better to avoid it or abandon it.



XVIII. THE IMPORTANCE OF INTANGIBLE ASSETS IN THE "NEW ECONOMY." In 1975 the market caps for the five biggest corporations were: IBM ($31billion), AT&T ($29 billion), Exxon ($21 billion), Eastman Kodak ($17 billion), and GM ($14 billion). On July 1, 2020, the ten publicly-traded companies with the highest market cap were Apple ($1.58 trillion), Microsoft ($1.55 trillion), Amazon ($1.4 trillion), Alphabet (Google) ($978 billion), Facebook ($676 billion). What is remarkable about the 2020 list is that the perceived value of most of these companies is based on income derived primarily from intangible tangible assets like "operating systems, product designs, organizational structure, and reputation among customers." In 2018, the CEO of Aon (a risk management company) estimated that "75 percent of market capitalization is now driven by intangible assets." In a March 2019 speech, Lloyd's of London CEO, John Neal stated: "If you looked at a classic S&P 500 company 40 years ago, 83% of their balance sheet would have been tangible assets. Today, it's only 12%." Our society --in fact our world-- is transitioning away from reliance on tangible (physical) assets to generate value and toward reliance on intangible (non-physical) assets as the generators of income. The accounting profession is lagging behind these changes, but the legal profession is even further behind. The law changes slowly, which in good since that provides a stable platform for our economic and social lives. However, this inertia becomes a disadvantage when it comes to the topic of this discussion, which is dividing the goodwill of a business in a divorce and, more specifically, how to distinguish between goodwill that inheres in a business and goodwill that is personal to the owner.

XIX. GOODWILL. In the mind of the law, the "goodwill" of a business is some attribute that makes the business more valuable than the sum of its parts. In the past, when business was conducted face-to-face, success in business was associated with location, or buying habits, or personal connections between the business owner and his employees and his customers. This conceptualization dating back to the store on Main Street still persists in many court opinions to this day. However, in the present economy of shopping from mail order catalogues, on cable tv, over the internet, and even on your cell phone, with physical delivery by U.S. mail, Federal Express, UPS, or Amazon Prime, and delivery of software, entertainment and information over telephone lines, coaxial cable, or microfiber wires, of free trade and world-wide price competition, of Walmarts replacing small stores, of HMOs and PPOs controlling the delivery of medical care, and of drug manufacturers and lawyers advertising directly to the public, personal loyalty between business owner and customer has been replaced by brand loyalty, convenience, and price, as the factors that bring in new customers and keep old customers returning.

Rethinking Our Approaches to Determining Divisible Goodwill Upon Divorce

Alongside the shift away from personal relationships between business-owner and customers has been a shift of importance to intangible assets as the source of business value.

> The importance of intangible assets is the distinguishing feature of the new economy. By and large, existing financial statements recognize those assets only when they are acquired from others. Accounting standard setters should develop a basis for the recognition and measurement of internally generated intangible assets.

Wayne S. Upton, Jr., *Special Report: Business and Financial Reporting, Challenges from the New Economy*, FINANCIAL ACCOUNTING STANDARDS BOARD (April 2001).[6]

Leonard Nakamura, an economic advisor in the Research Department of the Philadelphia Federal Reserve Bank wrote, in *Intangibles: What Put the New In the New Economy?*, 4 FEDERAL RESERVE BANK OF PHILADELPHIA BUSINESS REVIEW 3 (July/August 1999):

> Patents and copyrights on new consumer products are not the only types of intangible assets. New processes for making existing goods, such as the process for coating cookie wafers with chocolate, and new producer goods, like PC servers and fiber optic telephone cables, can also be patented or copyrighted or, perhaps, protected as trade secrets. Other intangible assets are brand names and trademarks, which can help a firm certify the quality of an existing product or introduce new products to potential purchasers. Not only can a reputation for quality persuade shoppers to try an item for the first time, but a clever use of advertisements can go a long way toward targeting precisely those who will gain the most from the product and thereafter become loyal, repeat customers. Yet, because they are not investments in tangible assets, most expenditures on intangible as-sets are not recognized as investments in either U.S. companies' financial accounts or the U.S. national income and product accounts. This practice may have been reasonable when investment in such assets was a negligible portion of our total investment, but that is no longer the case.

Twenty-one years later Nakamura wrote:

> We are living in an age in which U.S. investments in intangibles —investments to create new products and processes – are very large and rising and exceed U.S. investments in tangible goods (Corrado et al., 2005, Nakamura, 2003). Although some of this expenditure is now recognized in U.S. GDP as investment, most of it remains unrecorded. In particular, when a corporate intangible investment is successful, a corporation must spend additional resources to market and support it; roughly half of corporate "Sales, General, and Administrative" expenditures appear to function as capital investments, although they are not considered such in the national income accounts. These expenditures are a reliable marker of the ex post value of intangible investment and are very useful in measuring the market value of a firm's intangible investment. Yet it is precisely these corporate investments that are omitted from GDP."

Leonard I. Nakamura, *Evidence of Accelerating Mismeasurement of Growth and Inflation in the U.S. in the 21st Century*, Fed. Reserve Bank of Philadelphia Working Paper 20-41(Oct. 2020).

Although Nakamura focuses on the failure to recognize intangible assets at the aggregate macroeconomic scale, the problem exists also at the microeconomic level, which is the focus of this Article.

Authors Jarboe and Furrow at the Athena Alliance wrote the following:

> The economy of the United States is now largely driven by intangible assets. These assets

> include worker skills and know-how, innovative work organizations, business methods, brands, and formal intellectual property, such as patents and copyrights. They are producing an economy very different from the one of the past. As the U.S. moves away from a manufacturing-based economy and toward a technology-and-innovation driven one, intangible asset investments are becoming vital to economic growth and sustainability. Just as physical assets were used to finance the creation of more physical assets during the industrial age, intangible assets should be used to finance the creation of more intangible assets in the information age.

Kenan Patrick Jarboe & Rolan Furrow, *Intangible Asset Monetization: The Promise and the Reality* (April 2008).[7]

A. WHAT IS GOODWILL? Goodwill has troubled the accounting profession for more than a century, and that profession's approach to goodwill has changed substantially over time. Unfortunately, the accounting profession is still far behind the curve of modern economic times. Smart business people have already realized that there is a new normal, which is that oftentimes a business's value is mostly if not entirely made up of intangible value that must be created, grown, managed, insured, and protected. In other words, the value of some businesses is mostly, and some businesses entirely consists of goodwill.

B. GOODWILL IS ONE TOUGH CONCEPT. George R. Catlett and Norman O. Olson, in their significant booklet Accounting Research Study No. 10, *Accounting for Goodwill*, p. 9 (AICPA 1968), wrote:

> The nature of goodwill, the characteristics which distinguish it from the separable resources and property rights of a business, and its treatment in the accounts are among the most difficult and controversial subjects in accounting. John B. Canning stated, "Accountants, writers on accounting, economists, engineers, and the courts, have all tried their hands at defining goodwill, at discussing its nature, and at proposing means of valuing it. The most striking characteristic of this immense amount of writing is the number and variety of disagreements reached."

C. INTANGIBLE VALUE HAS CHANGED. In 1991, Hiroyuki Itami authored a book on MOBILIZING INVISIBLE ASSETS (1991)[8] in which he wrote: "Intangible assets are invisible assets that include a wide range of activities such as technology, consumer trust, brand image, corporate culture, and management skills." In 1992, R. Hall authored a paper[9] in which he wrote: "Intangible assets are value drivers that transform productive resources into value-added assets." In 1994, G. V. Smith authored a book THE NEW ROLE OF INTELLECTUAL PROPERTY IN COMMERCIAL TRANSACTIONS[10] in which he wrote: "Intangible assets are all the elements of a business enterprise that exist in addition to working capital and tangible assets. They are the elements, after working capital and tangible assets, that make the business work and are often the primary contributors to the earning power of the enterprise. Their existence is dependent on the presence, or expectation, of earnings." In 1997,[11] Annie Brooking examined the "intellectual capital" of a business, which she divided into "human-centered assets," "infrastructure assets," "intellectual property assets," and "market assets." Another seminal 1997 book[12] by Leif Edvinsson and Michael S. Malone, divided a business's intellectual capital into human capital, structural capital, and customer capital.[13] For present purposes we will conduct our quick overview of the current thinking about intangible assets of a business based on Wikipedia, which labels all non-separately-identifiable intangible assets of a business as "Intellectual Capital," and divides that into "Human Capital," "Relational Capital," and "Structural Capital."

1. INTELLECTUAL CAPITAL. According to Wikipedia[14]:

> Intellectual capital is the result of mental processes that form a set of intangible objects that can be used in economic activity and bring income to its owner (organization), covering the competencies of its people (human capital), the value relating to its relationships (relational

> capital), and everything that is left when the employees go home (structural capital),[1] of which intellectual property (IP) is but one component.[2] It is the sum of everything everybody in a company knows that gives it a competitive edge.[3] The term is used in academia in an attempt to account for the value of intangible assets not listed explicitly on a company's balance sheets.[4] On a national level intellectual capital refers to national intangible capital (NIC).[5]
>
> A second meaning that is used in academia and was adopted in large corporations is focused on the recycling of knowledge via knowledge management and intellectual capital management (ICM).[6][7][8] Creating, shaping and updating the stock of intellectual capital requires the formulation of a strategic vision, which blends together all three dimensions of intellectual capital within the organisational context through exploration, exploitation, measurement, and disclosure.[9] Intellectual capital is used in assessing the wealth of organizations.[3] A metric for the value of intellectual capital is the amount by which the enterprise value of a firm exceeds the value of its tangible (physical and financial) assets.[10][11] Directly visible on corporate books is capital embodied in its physical assets and financial capital; however all three make up the value of an enterprise.[12] Measuring the real value and the total performance of intellectual capital's components is a critical part of running a company in the knowledge economy and Information Age. Understanding the intellectual capital in an enterprise allows leveraging of its intellectual assets.[6] For a corporation, the result will optimize its stock price.

In this scheme, intellectual capital is classified as consisting of human capital, structural capital, and relational capital.[15]

a. Human Capital. According to Wikipedia[16]:

> Human capital is the stock of habits, knowledge, social and personality attributes (including creativity) embodied in the ability to perform labour so as to produce economic value.[1]
>
> Human capital is unique and differs from any other capital. It is needed for companies to achieve goals, develop and remain innovative. Companies can invest in human capital for example through education and training enabling improved levels of quality and production.

One YouTube presentation describes human capital simply as "the value people can deliver within an organization."[17]

b. Structural Capital. According to Wikipedia[18]:

> Structural capital is one of the three primary components of intellectual capital, and consists of the supportive infrastructure, processes, and databases of the organisation that enable human capital to function.[1] Structural capital is owned by an organization and remains with an organization even when people leave. It includes: capabilities, routines, methods, procedures and methodologies embedded in organisation[2]
>
> Structural capital is the supportive non-physical infrastructure that enables human capital to function.
>
> There are three subcomponents that comprise structural capital:[3][4]
>
> Organizational capital includes the organization philosophy and systems for leveraging the organization's capability.

> Process capital[5] includes the techniques, procedures, and programs that implement and enhance the delivery of goods and services.
>
> Innovation capital[6] includes intellectual property and certain other intangible assets. Intellectual property includes protected commercial rights such as patents, copyrights and trademarks. Intangible assets are all of the other talents and theory by which an organization is run.[7]

One YouTube presentation describes structural capital as non-physical assets like databases, processes and procedures, protected ideas such as trademarks and patents, brands, the arrangement of the organization, and unique knowledge like trade secrets.[19]

c. Relational Capital. According to Wikipedia[20]:

> Relational capital is defined as all relationships - market relationships, power relationships and cooperation - established between firms, institutions and people, which stem from a strong sense of belonging and a highly developed capacity of cooperation typical of culturally similar people and institutions.

A YouTube presentation describes relational capital as "intangible relationships that a company has, including customer, supplier, third party partnerships, licenses, trademarks; the amount of value a company has in the relationships that it maintains."[21]

These concepts are explored in more detail in Richard R. Orsinger, *Rethinking Our Approaches to Determining Divisible Goodwill Upon Divorce*, Kentucky Society of CPAs, (August 20-21, 2020) (available from the author).

C. MODERN VIEWS OF GOODWILL, FROM THE ACCOUNTING PROFESSION. On July 9, 2019, FASB issued an Invitation to Comment on *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*.[22] On page 6, the Board asked: "1. What is goodwill, or in your experience what does goodwill mainly represent?" There were 103 responses that give us a fascinating and eye-opening and even remarkable opportunity to see a variety of current perspectives on how to define or describe goodwill.

Letter No. 10 said: "We believe that goodwill is a premium paid by an acquirer for an acquiree over and above the fair value of the identifiable net assets acquired. Presumably, the acquirer is willing to pay this premium because it believes that there is additional intangible value (e.g., synergy or strategic value) associated with merging the acquiree's business with its business and operations that cannot be attributed to an identifiable tangible or intangible asset. That additional value is expected to result in higher revenues, reduced costs, or higher profit margins over some future period that at least equals the premium paid. This strategic value also could be attributed to a defensive measure to protect a public company's market share or acquiring certain technology that it currently does not possess."

Letter No. 12 said: "We generally agree with the definition of goodwill as described in the basis of conclusions in Statement 141 ® that states that goodwill represents the fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. We do observe, however, that *it is different on each deal* and can represent both items that might theoretically diminish in value over time and those that do not." [Italics added.]

Letter No. 13 (the Japanese Institute of CPAs) said: "The basis for conclusions in FASB Statement 141® describes some of the main components of goodwill, which are also referred to in the ITC as (a) fair value of the expected synergies and other benefits from combining the entities' net assets and businesses, (b) fair value of the "going concern" element which is the ability of the established business to earn a higher rate of return than if the collection of net assets were acquired separately, and (c) fair values of other net assets that had not been recognized by the acquired entity. We recognize through a number of business combination transactions that goodwill is represented by such components and we don't have any arguments with the Board's view on this matter." ... In some cases, goodwill might even end up including a component of 'overpayment' made by an acquirer.... Furthermore, we recognize that goodwill amount represents the acquisition-date value of synergies, excess earning power, and other benefits from combining the entities, which generally decreases over time after the acquisition. For example, it is our understanding that excess earning power generally decreases over time due to competition among entities. Just like in the case of excess earning power, we believe that many of the goodwill components actually have the feature of decreasing in their value over time."

Letter No. 15 (KPMG) said: "How to account for goodwill is a question that has long perplexed the accounting profession, so much so that *goodwill has been defined by what it is not rather than what it is*. Given the challenge of even defining goodwill, we believe there are merits to multiple perspectives about what goodwill represents and how to account for it." (Italics added.)

Letter No. 16 (Regions Financial Corp.) said: "We believe goodwill represents the premium paid above the price supported by the assets acquired. In our view, *this does not represent a probable future economic benefit, but is a deployment of capital*. The acquiring entity will use the acquired identifiable assets with the company's existing assets for future benefit in excess of the fair value of the identified assets." (Italics added.)

Letter No. 17 said: "We believe goodwill represents the competitive, strategic and/or opportunistic value in excess of the fair value of the underlying identifiable assets and liabilities an entity acquires in an acquisition. This is often referred to as synergies in many instances."

Letter No. 19 (Price Watershouse) said: "From an accounting perspective, goodwill represents the excess of the cost of an acquired business over the aggregate amount assigned to the identifiable net assets acquired. From an enterprise valuation perspective, the majority of goodwill cash flows are expected to extend beyond the lives of the identifiable net assets that exist at the acquisition date (e.g., the expectational value created through developing new technologies and winning new customers). From an economic perspective, *it incorporates the established reputation of a business, excellence of management, future growth potential, culture, and the worth of corporate identity as well as the value of inseparable but important intangible assets, such as a skilled workforce and institutional knowledge that emerge from, and are maintained by, the ongoing operation of the business*. Goodwill can also be described as the expected value of the ability, as a function of institutional knowledge and excellence of management, to maintain a competitive advantage beyond the life of existing assets (i.e., the expected value of generating excess returns on capital into the future). Goodwill represents the presumption that an established business will continue to identify and successfully execute on new projects, thus earning a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. All of these elements are typically expected to appreciate in value over time as the business grows. (Italics added.)

"Goodwill is fully enmeshed in the fabric and going concern nature of a business, and has value specifically because a business operates and is expected to continue operating in perpetuity. *It is important to understand that goodwill exists in almost all businesses, even in the absence of a transaction*. (Italics added.)

"Synergies are also typically present, particularly in transactions that represent industry consolidation. However, goodwill is not solely a function of synergies. As noted above, goodwill is present in all businesses. Goodwill is present even if synergies are nominal. For example, material goodwill amounts may be recognized in acquisitions by private equity firms that have limited synergies as the acquired business is not being combined with an existing business of the acquirer. Similar to most other elements of goodwill, the value derived from synergies is presumed to be long-lived by market participants. In the cash flow models that support the purchase price and that are the basis for the purchase price allocation, synergies, particularly cost synergies, are typically expected to persist indefinitely. For example, if two businesses combine and as a result, the finance function of one of the businesses is eliminated, this cost reduction is deemed to be permanent."

Letter No. 22 (BDO) said: "We believe that the description from the FASB Master Glossary and the main components identified in FASB Statement No. 141 (revised 2007), Business Combinations, reasonably depicts the concept of goodwill. However, we note that the exact composition of goodwill will differ, sometimes dramatically, between industries and individual acquisitions, and thus *depends on the specific facts and circumstances*." (Italics added.)

Letter No. 70 (from four members of the Business Value Resource Panel of the Appraisal Foundation) said: "We believe that goodwill is a measure of a portion of a business entity's intangible value. Business entity intangible value results from the aggregate investment returns of the business entity exceeding the required investment returns on underlying monetary and tangible assets. These so-called 'excess' investment returns support additional (intangible) value above and beyond the entity's investment in monetary and tangible assets. *Such excess returns indicate the existence of non-tangible elements of the business entity (such as technology, brands, customer loyalty, etc.) which either might be viewed as specifically recognized intangible assets or lumped into an asset designated as 'goodwill'*. Goodwill arises as a recognized asset when applying the acquisition method under ASC topic 805 to a business combination. A portion of the acquired business entity's intangible value is first recognized as individual intangible assets. *Goodwill represents the remaining (or residual) intangible value of the acquired business entity which does not meet the recognition criteria for intangible assets*. 'Economic goodwill' (as opposed to the accounting notion of goodwill arising from the application of ASC topic 805) can be observed in public securities markets when the market capitalization value of the securities of a publicly traded business entity exceeds the underlying financial accounting 'tangible net worth' of the business entity. Investors in that business entity's securities believe that the investment returns of the entity exceed the returns on the underlying tangible and monetary assets which have been invested in by management of the business entity, due to 'value creation' exhibited by the successful operations of the business entity. Some of the intangible value may have been recognized as part of the 'book value' of the business entity, arising from prior acquisitions. Even when that is the case, additional economic goodwill still may exist as market capitalization often exceeds book value as well as tangible net worth. (Italics added.)

"Most, if not all business entities, on an economic basis, comprise three major sources of asset value which are commonly described as the following categories of assets/business elements: 1) monetary or near monetary assets (i.e. current assets), 2) property, plant and equipment (i.e. tangible assets) and 3) intangible assets/business elements. While recognition and measurement of current and tangible assets, either on an ongoing basis or as a result of a business combination is relatively straightforward, the dividing line between recognized intangible assets and other valuable business elements (which, under the current accounting model would comprise goodwill) is 'set' through the application of accounting principles. Conceivably, this dividing line could be set at either end of the spectrum of intangible value. On one end of the spectrum, for example, under current US tax regulations, most intangible value is classified as IRC section 197 goodwill, and the need to break out individually recognized intangible assets is unnecessary as effectively all intangible value is subsumed into goodwill and amortized and deducted over a 15-year statutory life. On the other end of the spectrum, one could imagine the notion that all intangible elements of value in a business entity are recognized as assets, and either amortized, if they are in the nature of a 'wasting asset' or classified as being of 'indefinite life"'and not amortized, but tested periodically for any decline in value.

"As an alternative, a comprehensive 'fair value' based accounting model, would allow all assets/business elements to be re-measured at their fair value periodically (rather than depreciated or amortized), with any increase or decrease in value being recognized as a gain or loss through the income statement. While such a fair value based accounting model might allow investors in a business entity to fully understand the total increase or decrease in the economic benefits which their investment has experienced over a particular measurement period, the concept of a comprehensive fair value based accounting model has been viewed as being far too administratively burdensome and costly relative to any perceived added benefits to investors of such a model. Further, such an accounting model would represent a departure from the US GAAP tradition of 'accounting conservatism'. As a result, our current accounting model can best be described as a 'mixed model' of amortized/depreciated historical cost measurements and fair value measurements.

"The current accounting model assumes goodwill is initially recognized at its fair value, but can only be re-measured downward if it is found to be impaired. Thus, the initially recognized amount of goodwill may be viewed as being representative of the fair value of all elements of a business entity that do not meet the recognition criteria for intangible assets at that initial measurement date. At a later measurement date, if subjected to an impairment charge, goodwill may again be viewed as being roughly representative of the fair value of all elements of that same business entity that do not meet the recognition criteria for intangible assets at that later measurement date. However, if the business entity appreciates in value (implying that its goodwill has also appreciated in value), its recognized goodwill is effectively "frozen" at its initial recognition amount.

"To summarize, We believe that, depending on where the dividing line of intangible asset recognition is set, goodwill could represent all or some of the intangible value of a business entity as of a particular measurement date, or goodwill could, in the opposite extreme, not be recognized at all if the entire intangible (residual) value resulting from the application of the acquisition method under ASC topic 805 to a business combination were to be recognized as individual intangible assets on that same measurement date. We believe that investors benefit from information associated with the recognition of intangible assets and goodwill in a business combination."

<u>Letter No. 74</u> (Ford Motor Company) said: "Goodwill is the difference between the consideration transferred and the identifiable assets and liabilities received in a business combination. A company acquires other companies to achieve specific business objectives, such as achieving synergies, growth, competitive advantage, or improving economies of scale.

"These same business objectives could also be developed internally. *Companies often choose to acquire versus develop internally because it may not be feasible within a reasonable time frame and can be more cost effective.* Therefore, we believe goodwill represents a portion of the cost that a company would have incurred internally to achieve the same business objective." (Italics added.)

Ford Motor Company also wrote: "<u>Intangible Assets.</u> Non-contractual intangible assets are difficult to identify and value in a business combination. Often, entities must incur costs to engage third-party firms to assist with the identification and valuation process. The identification and valuation requires judgment, and as a result, recognition of intangibles separately capitalized on the financial statements is inconsistent. These factors reduce comparability and, ultimately, the value of the information to financial statement users.

"For these reasons, *we recommend that non-contractual intangible assets be subsumed into goodwill*. We believe this approach, along with additional disclosures about the agreements underpinning material intangible assets acquired, will improve comparability, reduce preparer costs, and provide financial statement users more decision-useful information about assets acquired." (Italics added.)

<u>Letter No. 77</u> (Houlihan Lokey) said: "Under generally accepted accounting principles ('GAAP'), goodwill represents consideration paid to acquire a business, as a going-concern entity, that is in excess of the fair value of the identifiable tangible and intangible net assets. *From a valuation perspective, goodwill represents future cash flows generated by assets that are not identifiable as of the acquisition date.* Stated differently, the business enterprise generates cash flows by utilizing a portfolio of assets in each future discrete time period. The taxonomy of such portfolio of assets migrates from those that existed as of the acquisition date to those that are yet to

be developed as the business enterprise continues to evolve over time, into perpetuity, to maintain its competitive advantage. These yet-to-be developed assets may include, but are not limited to, future customers, future technology, as well as management's ability to innovate to remain competitive in order to achieve future growth and profitability as expected by the buyer and as reflected by the agreed upon purchase price. (Italics added.)

"Further, we note that market participant synergies may also be component of goodwill. Synergies are typically created via (i) cost reduction, and resulting enhanced margin, due to the economy of scale in the cost structure of the combined entity; or (ii) the ability to generate incremental revenue streams that would not have been realizable but for the combined entity. These synergies are typically reflected in the deal model in the form of enhanced revenue growth from realizing additional revenue streams; and/or in the form of enhanced profit margins from cost reduction due to the elimination of duplicative positions. The higher level of revenue and profits are typically capitalized into perpetuity in order to derive the proposed purchase price. As such, these synergies are implicitly assumed to persist indefinitely and not waste away. If goodwill comprises future cash flows generated by future assets (such as future technologies, future customers, etc.) and enhanced operational performance due to synergies that are expected to persist indefinitely (as reflected in the capitalization of the elevated revenue and profit into perpetuity when market participants derive proposed purchase price), these fact patterns appear to support the notion that goodwill is not a wasting asset. Therefore, the proposed amortization of goodwill appears to be inconsistent with the nature of goodwill."

Letter No. 78 said: "Value Knowledge response: Under ASC 805, goodwill is currently quantified as residual; it is purchase price minus acquired net assets. Goodwill can also be quantified with a present value of cash flows, by beginning with all the cash flow from the business and subtracting all the cash flows from the acquired net assets. When viewed as cash flows, most of the cash flows attributed to goodwill occur after the economic life of the identified intangible assets and other identified net assets. In a DCF of the business, the cash flows that most resemble the cash flows to goodwill would reside in the terminal value and have a perpetual growth assumption.

"That's what goodwill primarily is: the asset that represents the value of the potential for the business to continue indefinitely. In a going concern business, the DCF value that acquirers and sellers often rely on to understand the expected benefits of business ownership include the assumption of indefinite existence of that business. That assumption of indefinite existence of that business is implicit in almost every DCF-based business valuation. Goodwill, like the business, is expected to be perpetual and outlast the acquired depreciable and amortizable assets.

"The ITC cited the underlying logic in Statement 142: 'not all goodwill declines in value and for goodwill that does decline in value, it does not decline systematically over time. The Board also noted that goodwill may not be infinite lived, but it is indefinite lived.' I agree with that premise. Goodwill also includes workforce, going concern and other assets not quantified such as books and records, but those are minor considerations compared to the long-term ability of the business to continue past the decay of the current identifiable assets that make up the business."

Letter No. 103 (CFA Institute) is a blistering letter, which in part said: "A decision by the FASB to adopt private company accounting for goodwill would result in the write-off (amortization) over ten years of $5.6 trillion of assets on the books of U.S. public companies....

"Goodwill amounts to 6% of all public company assets and 8% of the assets of public companies with goodwill. Goodwill represents 32% and 40%, respectively, of the equity of such public companies. More staggering is the effect this would have on S&P 500 companies. With $3.3 trillion in goodwill, the S&P 500 represent nearly 60% of the goodwill of all U.S. public companies, though S&P 500 companies represent only 8% of U.S. public companies and 37% of the assets of U.S. public companies. Goodwill represents 10% of the assets

and 45% of the equity of S&P 500 companies with goodwill.
Adopting the private company approach to goodwill amortization would schedule the write-off (amortization) of a substantial portion of the assets and equity of U.S. public companies and reduce profits of the S&P 500 by $330 billion ($560 billion for all U.S. public companies) for ten years."

FASB Summary of Letters. FASB published a Comment Letter Summary on the Invitation to Comment.[23] Regarding the definition of goodwill, the summary said:

> 1. The July 15, 2020 Board meeting is a decision-making meeting. The purpose of this memo is to present comment letter feedback received on the Invitation to Comment(ITC), Identifiable Intangible Assets and Subsequent Accounting for Goodwill. The ITC was issued on July 9, 2019,with a 90-day comment period ending on October 7, 2019. This memo provides a summary of the feedback from the comment letters received in response to the document. Accordingly, this memo is intended to be read in conjunction with the ITC.
> ***
> Nature of Goodwill
>
> 7. To provide context for the ensuing discussion on the subsequent accounting for goodwill, the ITC asked respondents to consider the conceptual nature of goodwill. Stakeholders' views on the conceptual nature of goodwill often aligned with their views on the appropriate subsequent accounting for goodwill. Accordingly, respondents discussed the nature of goodwill in supporting their views on the various models proposed in the ITC. Those comments are included in the sections that follow related to the subsequent accounting for goodwill. Other general comments on the nature of goodwill are included below.
>
> 8. Seventy-seven respondents provided comments on the conceptual nature of goodwill. Respondents often discussed their views of what goodwill represents and where its value is derived, while others stated their positions on the current definition of goodwill.
>
> 9. Some respondents noted that goodwill's value represents a capital outlay for the opportunity of future economic benefit. For example, an academic respondent stated that goodwill refers to the opportunity for future economic benefit, rather than an explicit benefit, because expected synergies often do not materialize. Others explained that the benefit goodwill provides frequently requires additional investment of financial or nonfinancial resources to be transformed into identifiable assets. Similarly, a preparer noted that it is increasingly difficult to differentiate between acquired goodwill and internally generated goodwill.
>
> 10. Eleven respondents generally agreed with the current definition of goodwill as stated in the Master Glossary. This definition states that goodwill is"an asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. Conversely, two respondents asserted that goodwill does not represent an asset at all because it does not represent a present right or economic benefit.
>
> 11. Several respondents, based on their experiences in practice, cited major sources of the value of goodwill. For example, several respondents noted that the value of goodwill is derived from the workforce acquired in an acquisition. Other respondents often discussed the components of goodwill as noted in paragraph B313 of the basis for conclusions for FASB Statement No. 141(Revised2007), Business Combinations. Accordingly, respondents often cited the following sources of the value of goodwill:(a)Excess of fair values over the book

values of the acquiree's net assets at acquisition (b)Expected synergies created by the acquisition, including incremental increases in earnings potential (c)Going concern value(d)Overpayment by the acquirer.

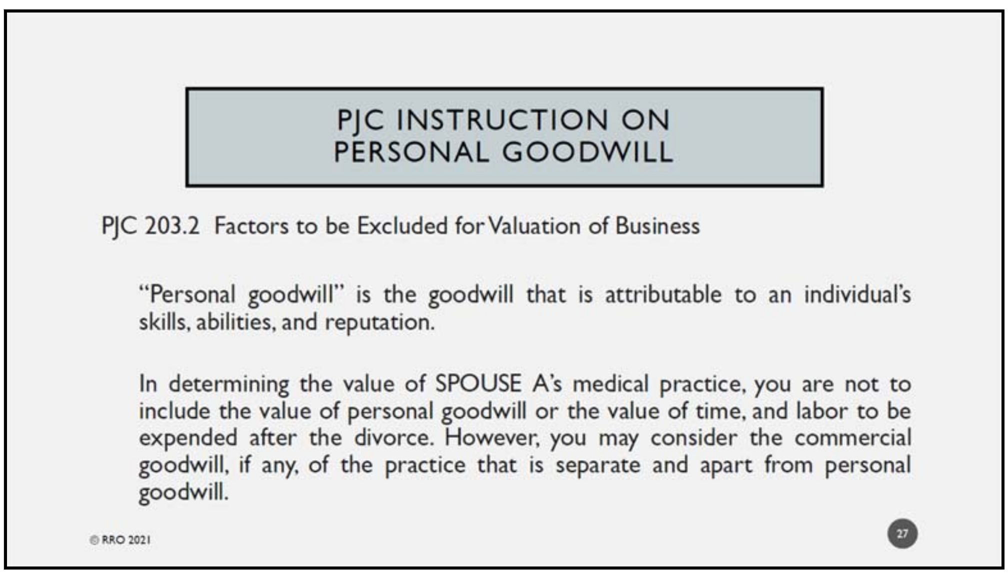
12. Some respondents noted that while the components of goodwill are generally consistent across the market, the specific goodwill recognized in a given business combination transaction may be made up of different components. For example, two respondents explained that a transaction's goodwill can be made up of various components or specifically one component.

13. Several respondents also commented on the separability of the components of goodwill. Those respondents commented on the difficulty of separately identifying the value of each individual component. On this topic, one preparer expressed concern that a model that separates components would be impractical even among components that have finite and indefinite lives.

14. Three respondents stated that the term goodwill is problematic and noted that the Board should further clarify what is represented by goodwill and intangible assets.

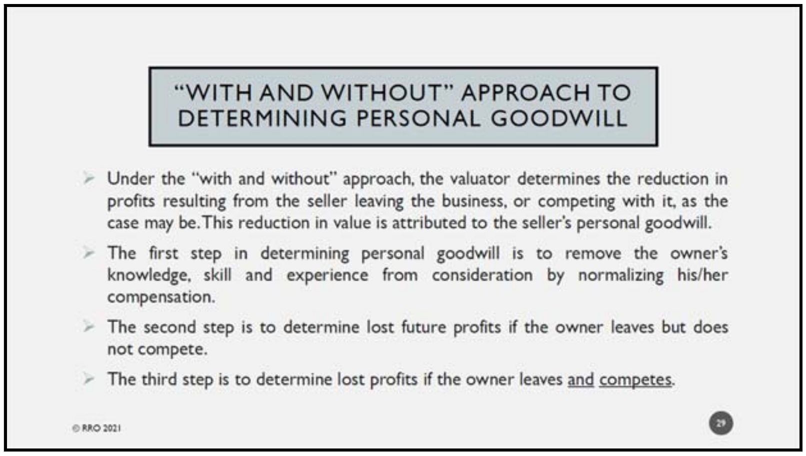
At the July 15, 2020 meeting, FASB resolved to pursue changes the amortization of recorded goodwill, changes to the goodwill impairment model, consider the accounting for identifiable intangible assets.[24]

D. TWO TECHNIQUES FOR VALUING PERSONAL GOODWILL. Personal goodwill must be excluded from the value of a community property business in a Texas divorce, because personal goodwill is not divisible property.



This Article explores two techniques for allocating between enterprise and personal goodwill.

1. The "With and Without" Approach. The "with and without" approach requires the business valuator to estimate two values for the business, one assuming that the selling owner remains involved in the business after the sale, and one assuming that the selling owner does not remain involved. The difference between the "with" and the "without" scenarios represents the personal goodwill of the selling owner. The "with" estimate involves ordinary business valuation techniques that rely on past performance projected into the future. The "without" scenario requires the business valuator to make assessments (assumptions) based on the loss of



employees, suppliers, or customers who discontinue their ties to the business because the selling owner has left. This requires the business valuator to engage in a task that is more speculative than the "with" scenario.

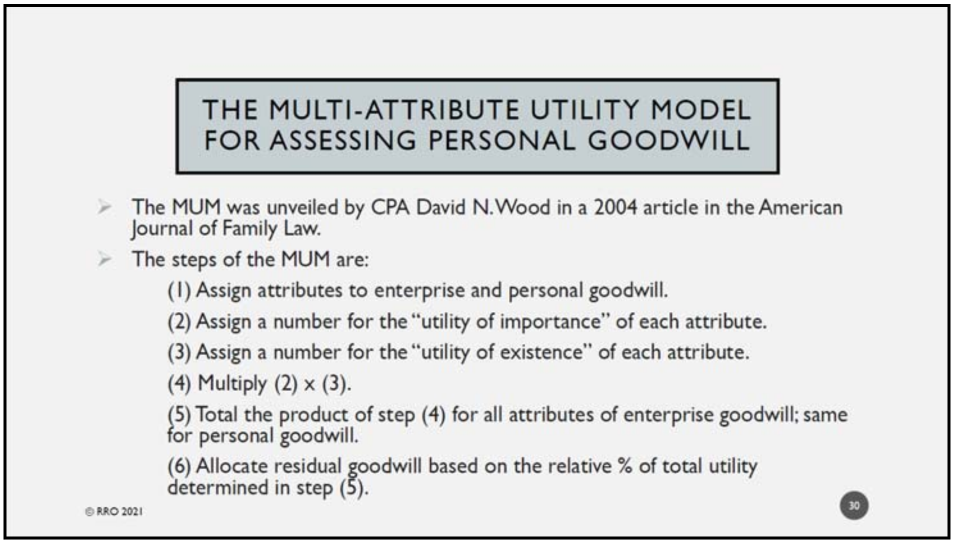
The "without" scenario can be avoided by the buyer keeping the selling owner as an employee or consultant or otherwise associated with the business long enough to transfer the seller's personal goodwill to the new owner or to other employees of the company or to the business itself. If the selling owner is paid a market rate for his/her labor and the labor is actually delivered, then the buyer has no extra cost associated with this method of perpetuating or transferring personal goodwill. However, if the selling owner doesn't have to show up for work, then the salary is essentially monetizing the transfer of personal goodwill. The mere fact that a buyer may desire or require that the seller remain with the business for a period of time suggests that the buyer might be trying to set up a transfer of personal goodwill. But it goes too far to say that the price of a covenant not to compete is the measure of personal goodwill, or worse that the value of the business with the owner staying, less the price at which the business would sell without a covenant not to compete, is the measure of personal goodwill.

Under the "with and without" approach, the valuator determines the reduction in profits resulting from the seller leaving the business, or competing with it, as the case may be. Capitalizing the remaining profit yields the business's commercial or enterprise goodwill. This Article proposed that the first step in determining personal goodwill is to remove the factor of knowledge, skill and experience from the goodwill determination by including that factor in the adjustment made to normalize the owner's historical compensation. The remainder of the goodwill can then be divided into the seller's relationship-based personal goodwill and commercial or enterprise goodwill.

Determining how the seller's leaving the business, or competing with it, will affect that business will vary from business to business. When the valuation is undertaken in connection with a divorce, the valuator cannot uncritically accept non-binding statements by the owner and his "buddies" that valued employees, or favorable supply relationships, or customers, or sources of future business, will sever connections to the business if the owner sells. The risk of such severances should be objectively analyzed. While loyalty does exist, most people make business decisions based on self-interest, when the cost of loyalty is high.

2. The Multiattribute Utility Model (MUM). The MultiAttribute Utility Model has been suggested as a way to approach the allocation between enterprise and personal goodwill in a more concrete way. Attributes of the business are listed, separating Personal Goodwill Attributes from Enterprise Goodwill Attributes, then each attribute is assigned a degree of importance and degree of likelihood. Those two numbers are multiplied, and the residual goodwill of the company is allocated based on the relative weight of all Enterprise Goodwill Attributes compared to the weight of all Personal Goodwill Attributes. This result is then compared to the earlier assumptions and further adjustments are made if indicated.

The MUM was first suggested for use in the allocation of intangible value between enterprise goodwill and personal goodwill by David N. Wood, a CPA/ABV located in Illinois. His seminal 2003 article, *An Allocation Model for Distinguishing Enterprise Goodwill from Personal Goodwill*, published in 18 AMERICAN JOURNAL OF FAMILY LAW #3, p. 167 (Fall 2004), is attached to this Article.



The first case to discuss MUM was in *In re Marriage of Alexander*, 368 Ill. App. 3d 192, 198–202, 857 N.E.2d 766, 771–74 (2006), an Illinois divorce. The Court said:

> In the instant case, Wood testified that in reaching his conclusion on what portion of the total goodwill in James's medical practice constituted enterprise goodwill and what portion constituted personal goodwill, he employed the multiattribute utility theory.2 Wood testified that he believed he was the first to use this approach in reaching his conclusion. Wood also testified that his approach was scientific. According to Wood, the multiattribute utility theory works as follows.
>
> First, the valuator (Wood in this case) sets forth an objective. In the instant case, the objective set forth by Wood was to form a conclusion on the value of the elements of total goodwill in James's medical practice that represent personal goodwill and enterprise goodwill.
>
> Next, the valuator establishes "alternatives." An alternative is a "range of percentages" that will define the choices "in which the method will result." Wood chose five alternatives but acknowledged that there is no set rule for the number of alternatives that a valuator must choose.
>
> Each alternative is then assigned a "range." Wood assigned a range of 20% for each alternative. To illustrate, Wood created a graph containing five rows and two columns. The rows were labeled "alternative 1" to "alternative 5," and the two columns were labeled "[personal] goodwill" and "enterprise goodwill." Where the rows and columns intersect, Wood inserted the range. For example, where personal goodwill and row 1 intersect, Wood inserted a range of "0 to 20 percent." Where enterprise goodwill and row 1 intersect, Wood inserted a range of "80 to 100 percent." Where personal goodwill and row 2 intersect, Wood inserted a range of "20 to 40 percent." Where enterprise goodwill and row 2 intersect, Wood inserted a range of "60 to 80 percent." This continued to row 5, where the range for personal goodwill was "80 to 100 percent" and the range for enterprise goodwill was "0 to 20 percent."
>
> After the objective and the alternatives are set, the valuator must then define the "attributes." An attribute is an element of goodwill to which the valuator must assign a value. Examples of attributes are personal reputation and business location. Attributes are categorized as either personal or enterprise. Wood does not contend that there are universal attributes that must be defined in every situation. Wood also does not contend that there is a set number of attributes

that must be defined. Instead, Wood leaves the creation ***373 **772 and categorization of attributes to the discretion of the valuator.

In the instant case, Wood created the following personal attributes: (1) lacks transferability, (2) specialized knowledge, (3) personalized name, (4) inbound referrals, (5) personal reputation, (6) personal staff, (7) age, health, and work habits, and (8) knowledge of end user. Wood created the following enterprise attributes: (1) number of offices, (2) business location, (3) multiple service providers, (4) enterprise staff, (5) systems, (6) years in business, (7) outbound referrals, and (8) marketing. Wood acknowledged that the attributes could be described as "opposite sides of the same coin" and testified that "if one valuator placed an attribute into the [personal] category and another valuator [placed the same attribute] into the enterprise category, the model would correct for this during the measuring process."

After defining the attributes, the valuator is then to assign a value to each attribute. This involves a two-step process. First, the valuator assigns a value known as an attribute's "utility of importance." The utility of importance is a value placed on an attribute based on how important the valuator feels the attribute is to the value of goodwill. The value assigned is taken from a range created by the valuator. Wood created a utility-of-importance range of 1 to 5, with 5 being most important and 1 being least important. Wood then assigned a utility-of-importance value to each attribute he defined.

Next, the valuator assigns a value known as an attribute's "utility of existence." The utility of existence is a value placed on an attribute based on the valuator's determination of the presence of that attribute in the business that the valuator is analyzing. The value is also taken from a range created by the valuator. Wood created a range of 0 to 4, assigning 0 to an attribute that has a weak presence and 4 to an attribute that has a strong presence. The values that Wood assigns to the utility of importance and the utility of existence are derived solely from his subjective opinion.

After assigning each attribute two values (a utility-of-importance value and a utilityof-existence value), the valuator then "aggregates the results." Aggregating the results simply involves multiplying the values assigned to an attribute to come up with a final value for that *200 attribute. For example, in the instant case, for the personal-reputation attribute Wood assigned a utility-of-importance value of 5 and a utility-of-existence value of 3, to give it a final value, or "multiplicative utility" as Wood calls it, of 15. Once each attribute has a final value, the valuator then takes the sum of the final values for each attribute from its assigned category (personal or enterprise) and derives a "total multiplicative utility" for that category. Wood calls the total value for the personal attributes the "total multiplicative (PGA) utility" and the total value for the enterprise attributes the "total multiplicative (EGA) utility." The valuator then adds the total multiplicative (PGA) utility to the total multiplicative (EGA) utility and comes up with a "total multiplicative (TMU) utility." The valuator then employs simple division to determine what percentage of the total multiplicative (TMU) utility consists of the total multiplicative (PGA) utility and what percentage consists of the total multiplicative (EGA) utility. At this point, the valuator has before him or her what percentage of the total goodwill is personal goodwill and what percentage is enterprise goodwill.

In the instant case, Wood calculated the total multiplicative (PGA) utility for the personal attributes at 52 and the total multiplicative (EGA) utility for the enterprise attributes at 114. Accordingly, he ***374 **773 found a total multiplicative (TMU) utility of 166 (52 plus 114). Employing the simple division set forth above, Wood concluded that the personal goodwill attributes constitute 31% of the total goodwill (52 divided by 166) and that the enterprise goodwill attributes constitute 69% of the total goodwill (114 divided by 166).

According to Wood, once these figures are reached, the valuator is then to "evaluate the alternatives" by examining where the final results fit into the range of alternatives that was established at the beginning of this methodology. The valuator also must analyze his or her conclusions by looking at each attribute individually in light of the attribute's total contribution to the total utility, and the valuator must ask himself or herself if certain attributes should be "driving the results." After performing this analysis, the valuator then reaches his or her ultimate opinion.

Wood testified that although a valuator would most likely find it tempting to simply use the final percentage that is derived from the math above (in this case, 69% for enterprise goodwill and 31% for personal goodwill), he believes that "it is more effective and proper" to select the midpoint of the range that exists in the appropriate alternative. Accordingly, if the percentage for enterprise goodwill fell anywhere within the 20–to–40% range, Wood believes that the figure 30% should be used for the final percentage of enterprise goodwill. In *201 the instant case, because Wood calculated 69% for enterprise goodwill, for his conclusion he used 70%, which is located at the midpoint of his 60%–to–80% range. As noted above, the circuit court did not use 70% as suggested by Wood but instead used a two-thirds ratio.

After conducting a thorough examination of Wood's multiattribute utility theory, we are convinced that this method does not constitute scientific evidence subject to a *Frye* hearing. The methodology employed by Wood does not rely on the application of scientific principles but incorporates basic math with the observations and experience of the valuators. As Wood points out, the creation of the alternatives, the creation of the ranges, the creation of the attributes, and the values assigned to the attributes are all derived from the subjective determinations of the valuator. Wood never contends that there are universal alternatives, attributes, utility values, or ranges that must be applied in each and every situation. Furthermore, he does not allege that there are constant or universal values that must be assigned. Wood leaves just about everything to the sole discretion of the valuator.

Although Wood repeatedly describes his approach as "scientific," this does not make it so for purposes of subjecting it to a *Frye* hearing. Wood acknowledged that the "whole process" is "subjective" and that the methodology he uses simply attempts to make a "precise decision from imprecise and subjective criteria." In addition, to the extent that mathematics is employed in Wood's methodology, the types of mathematics employed by Wood (addition, multiplication, and division) are certainly not novel. Most people are at least familiar with these basic mathematical principles, although certainly some are more versed at applying them than others. But suffice it to say, to the extent that mathematics is employed in Wood's methodology, this does not make it a scientific methodology subject to *Frye*. However, even if it were sufficiently scientific to trigger a *Frye* hearing, the evidence would pass the general-acceptance test because elementary mathematics has gained general acceptance in all fields of science and engineering. *Southern Energy Homes, Inc. v. Washington*, 774 So.2d 505, 518 (Ala.2000).

On appeal, James argues that the methodology employed by Wood relies on literature and the expertise of others. We disagree. Although Wood may be using an equation or a process utilized by others in other fields, how Wood reached his opinion is no different from how the experts in Harris reached their opinion. Wood's opisnion was derived from his own observations and experience. Wood's methodology involved assigning a value, as determined

> by Wood, to certain attributes of James's practice that Wood subjectively determined, based *202 on his experience and observations, to be attributes that relate to the enterprise or personal goodwill value of James's medical practice. Wood then relied on simple math to quantify his opinion. We do not believe that Wood's approach is scientific for purposes of a *Frye* hearing. *See Harris*, 302 Ill.App.3d at 369–70, 235 Ill.Dec. 795, 706 N.E.2d 55 (if one's conclusion is based on experience and observations, combined with a deductive process familiar to the average trier of fact, it is generally not scientific). Wood does not employ a methodology that is beyond the realm of an average juror's understanding. Again, essentially "how" Wood reached his opinion was derived from his observation and experience.

The appellate court heroically gave a very detailed description of Wood's theory and application. The usefulness of this case outside of Illinois is limited by the fact that Illinois has not adopted the standard for reliability of expert testimony set out in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). Instead, Illinois applies *Frye v. United States*, 293 F. 1013 (D.C. Cir. 1923), which requires that, when an expert's opinion is based on scientific principles, those principles must be generally accepted. The appellate court in *Alexander* held that the MUM was not science, so *Frye* did not apply.

If the MUM encountered a *Daubert* challenge, things would go much differently. The MUM methodology has a "air" of mathematical certitude about it, but it remains fundamentally subjective, in the selection of alternatives, ranges, and attributes, in assigning values to the utility of importance and utility of existence, and in reassessing the output in light of original assumptions about range and importance. *Daubert* gave a non-exclusive list of five non-exclusive factors to be considered:

1. Whether the theory or technique can be and has been tested;

2. Whether it has been subjected to peer review and publication;

3. Its known or potential error rate;

4. The existence and maintenance of standards controlling its operation; and

5. Whether it has attracted widespread acceptance within a relevant scientific community.

The MUM would fail the first four factors. The MUM is not susceptible to scientific testing or determination of error rate because there is no absolute measure of enterprise vs. personal goodwill to test MUM against. MUM has not been subjected to peer review (up to the standards of a scientific journal). There are no standards controlling its application.

The MUM could be tested for *interrater reliability*, to see what degree of agreement there is between different business valuators applying the MUM to the same hypothetical fact scenario. Because all components of the MUM are subjectively determined, the results would probably show interrater reliability no better than what would be achieved if you ran the same test with the same facts while no one used the MUM. The MUM would begin to have a path toward measurable reliability if the alternatives and attributes were fixed, and the valuator was required to assign values of zero or higher to this fixed set of parameters. At this point in time, one must say that the reliability of MUM is undetermined if not nil.

Interested parties would have a hard time assessing the *validity* of the MUM. There is no way to assess *construct validity* or *content validity*, because the MUM framework is not standardized, since the alternatives and attributes are not fixed and will vary from evaluator to evaluator and from situation to situation. In essence, each MUM construct is unique, so no generalized sense of validity is possible.

An off-handed comment by an expert that the MUM is "widely used" or "generally accepted" is dubious. The MUM *may have* attracted some degree of acceptance, but we are lacking comprehensive surveys that would establish that the acceptance is widespread.

However, since the MUM is not science, it doesn't fall under *Daubert* anyway. The pertinent legal standard is contained in the *Joiner* and *Kuhmo Tire* cases. In *General Electric Co. v. Joiner*, 522 U.S. 136 (1997), the Supreme Court said: "Trained experts commonly extrapolate from existing data. But nothing in either *Daubert* or the Federal Rules of Evidence requires a district court to admit opinion evidence which is connected to existing data only by the ipse dixit of the expert. A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered." In *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (U.S. 1999), the Supreme Court said: "Rules 702 and 703 grant all expert witnesses, not just 'scientific' ones, testimonial latitude unavailable to other witnesses on the assumption that the expert's opinion will have a reliable basis in the knowledge and experience of his discipline."

Viewed in the light of "a reliable basis in the knowledge and experience of his discipline," the MUM does serve as a device to require the evaluator to identify and state relevant factors and to weigh their relative importance in a way that can be reviewed by others. But the implicit assumption of the MUM that subjective factors can be averaged in a mathematical fashion may actually deviate from a reliable basis in the discipline, where the accepted norm is for the valuator to rely on his/her education, experience, and judgment, in processing multiple factors into a single conclusion. The MUM actually could present a danger if it convinces the fact-finder that the MUM is somehow less subjective or more reliable than the purely subjective assessment of a valuator.

A final note about the averaging function of the MUM that gives it the seeming objectivity attributed to mathematics. In *Gaskill v. Robbins*, 282 SW 3d 306 (Ky. Sup. Ct. 2009), one of the valuation experts used four different approaches to valuation and then averaged them. The Supreme Court of Kentucky was not kind:

> In this case, both experts testified to multiple accounting methods of measuring value. Wheeler chose a specific method, gave his reasons for choosing that method, and explained where his data came from. Callahan, in contrast, did not directly obtain data, and calculated the value of the practice using four different methods, with a different value derived from each. He found all the methods to be reliable, and unable to choose, averaged the numbers to get a value.
>
> While the trial court is free to determine the credibility of any witness, it cannot make a determination that is clearly erroneous or an abuse of discretion. **Using an average to obtain a value, without some basis other than an inability to choose between conflicting and competing valuation methods, is nothing more than making up a number, for there is no evidentiary basis to support that specific number. Employing all four methods, then averaging them, is tantamount to no method at all.** If an expert believes four methods are valid, yet each produces a different number, this provides little or no help to the trial court. The trial court must fix a value, and there should be an evidence based articulation for why that is the value used. **While an average may present the easiest route, it lacks the proper indicia of reliability.** Thus, the trial court abused its discretion in relying on Callahan's estimate of $669,075 as the value of the practice." [Bold added]

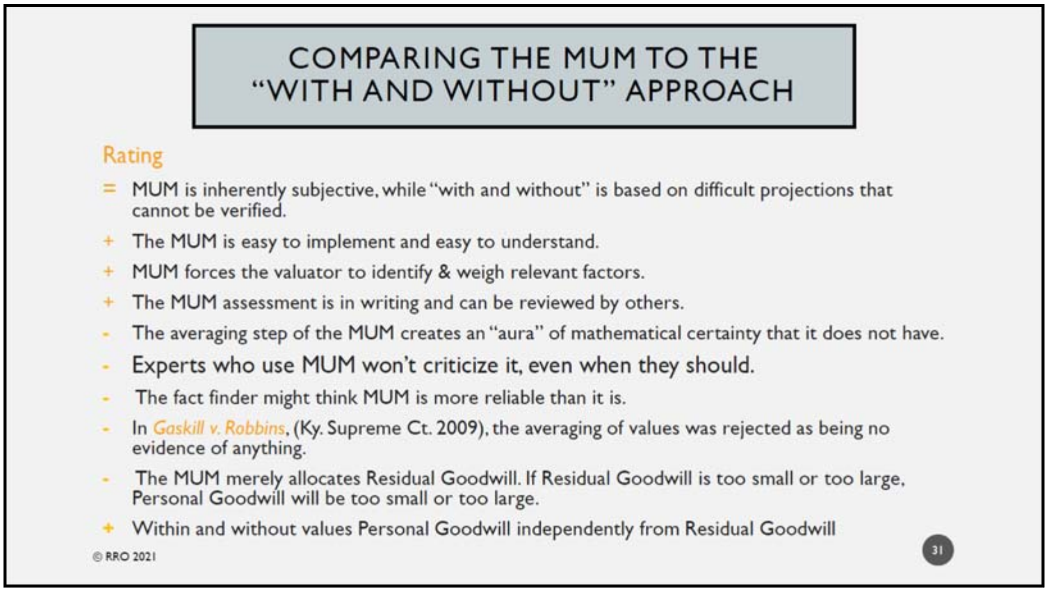
The MUM was litigated in *In re Marriage of Preston*, 2018, Il. App.2d 170656-U (Ill. App. 2nd Dist. August 1, 2018) (unpublished). The expert Hutler used the "with-and-without method" of allocating between enterprise and personal goodwill. The expert Richardson, who had never split goodwill before, applied the MUM, selecting ten attributes for each of two categories, assigning a value of one for significant presence, or zero for weak or no presence. This resulted in a score of six for personal goodwill and three for enterprise goodwill, so Richardson allocated 2/3 of goodwill to personal goodwill and 1/3 to enterprise goodwill. Hutler admitted that the MUM was "accepted in the valuation industry." *Id.* at ¶89. The trial court accepted Richardson's allocation and the appellate court affirmed. The sensitivity of the MUM in this case was diminished by reducing all differences to either one or zero. The averaging of the scores was an abdication of the exercise of professional judgment. It seems likely that the "air" of mathematical certainty of the MUM persuaded the fact-finder to prefer it over the more prevalent "with and without" approach.

The MUM was discussed in *Banchefsky v. Banchefsky*, No. 09AP–1011, 2010 WL 3527578 (Ohio Ct. App. 2010). During the pendency of the divorce, the husband sold his solo dental practice, along with the trade name, telephone and fax numbers, email addresses, website and web address, in an arm's length transaction for fair market value. *Id.* at ¶¶ 5 & 37. The sale included a covenant not to compete within a ten mile radius for five years except as an associate of the business. *Id.* at ¶¶ 10 & 15. The husband had to work as an independent contractor for the business for up to six months after the sale. *Id.* at ¶ 5. The court found that the husband had received additional income generated by other employees of the practice. *Id.* at ¶ 10. The sale price was $580,000. *Id.* at ¶ 5. The purchase agreement allocated the payment: Dental supplies and office furniture, $126,000; Dental Supplies, $3,000; Patient Records, $20,000; Covenant-not-to-Compete, $15,000; Goodwill, $416,000. *Id.* at ¶ 38. The husband 's expert, named Russell, reviewed another pre-sale valuation report, and gave the husband a self-report goodwill questionnaire. *Id.* at ¶ 40. Russell determined overall goodwill by subtracting the value of tangibles (furniture, supplies, and records) from the total sale, resulting is goodwill of $431,000. Russell said the allocation of $15,000 to the covenant was arbitrary, and he offered a conclusion based on the MUM that personal goodwill and the true value of the covenant not to compete was $215,000. The trial court "acknowledged the utility of the MUM in determining the impact an individual's departure might have on the fair market value of a business," but decided that the allocations in the purchase agreement controlled and set aside $15,000 as non-divisible property. *Id.* at ¶ 41-43. The appellate court wrote: "We agree with the trial court's conclusion that although the MUM may be useful in determining the fair market value of a business, its application and use is inappropriate in the instant case. Here, there was an actual, not hypothetical, sale of appellant's dental practice.... [I]t was simply unnecessary to determine a business model pertaining to the hypothetical sale of a hypothetical business." *Id.* at ¶ 44. The court concluded that the covenant was nonmarital property, and affirmed the $15,000 value set by the trial court. *Id.* at ¶ 45.

The MUM was mentioned in a pretrial ruling in a Federal district court case, *Muskat v. U.S.*, Civil No. 06-cv-30-JD, 2008 WL 138052, Jan. 10, 2008 (Dist. New Hampshire). At issue was the sale of a business, and whether the $1 million payment for a noncompetition agreement should be taxed as ordinary income or whether it was a payment for the taxpayer's personal goodwill that should have been taxed an a capital gain rate. *Id.* at *1. [See Dietrich, p. 11.] The taxpayer's expert asked the seller and the former senior vice-president of finance to submit a list of attributes for the MUM, and based on that determined that 73.06% of the goodwill in the transaction belonged to the taxpayer and 26.94% to the company. *Id.* at *3. The trial court questioned the relevance of this allocation to the question of the $1 million paid to the seller, but reserved that decision until trial. The government also attacked the qualifications of the expert to testify. The trial court said: "A ruling on whether O'Brien is qualified to give his opinions based on the 'MUM' analysis, under Federal Rule of Evidence 702, will be made at that time." *Id.* at *4.

NACVA has put on the WWW a Powerpoint by David Wood discussing MUM, accompanied by various of his writings.[25]

For further reading on the MUM, Business Valuation Resources published an article by Thomas Gillmore, a Florida CPA, Thomas Gillmore, *Simplified MUM for Determining Personal Goodwill*, 22 Business Valuation Update #2, (Feb. 2016).[26]



E. TAKE-AWAYS ON GOODWILL. Here is a list of take-aways on the subject of goodwill:

1. Goodwill is no longer confined to the continued patronage of existing customers.
2. Ignoring self-created intangibles is no longer viable in the new economy. They need to be recognized at current value, not cost.
3. Residual goodwill under current accounting standards is overbroad. Many unidentifiable intangible assets can in fact be identified and valued separately or in a group.
4. Enterprise goodwill can be determined by valuing intangible assets of the business that are currently recognized for accounting purposes together with those that are not currently recognized.
5. The Intellectual Capital of a business can be valued. Turn to economists and management theorists to learn how.
6. Assembled workforce can be valued using standard business valuation techniques.
7. If enterprise goodwill is valued first, the rest of the goodwill is personal goodwill.
8. If personal goodwill is valued first, the rest of the goodwill is enterprise goodwill.
9. The cost or value of a covenant not to compete does not capture all of the seller's personal goodwill. Costs may rise or revenues drop just because the seller leaves, even if s/he does not compete.
10. Comparing the "with and without" assessment against the MUM, both are subjective but the MUM has an "air' of mathematical accuracy that is unwarranted.
11. The MUM is helpful for organizing thoughts, and it makes the chosen factors visible and subject to review by others, but the mathematical component of the MUM is not mathematical.
12. Business valuators must do what the accounting profession has refused to do for over 80 years--that is to put a value on the goodwill of a business in the absence of a sale.
13. Economists are attempting to measure Human Capital at the aggregate level. Look to national and world-wide studies for guidance.
14. The management profession is more awake to the importance of Intellectual Capital than the accounting profession. Look to management theories for guidance.
15. Business valuation techniques applied to a company on the assumption that it will continue in its current form ignore the analytics of an acquiring company that will integrate the resources of the acquired company into a combined organization. In valuing goodwill, business valuators are using the wrong company's metrics.
16. A buyer's strategic considerations (entering a market, eliminating a competitor, etc.) may increase what the buyer would pay above a valuation based solely on the target company's metrics.

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17. In light of paragraphs 15 and 16, valuing a business based on its own metrics may be the minimum value that a willing buyer might pay.
18. Is a valuation based on a likely acquiring company's projected ROI or strategic gains too speculative to be admissible in court?

FINIS

Rethinking Our Approaches to Determining Divisible Goodwill Upon Divorce

ENDNOTES

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