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EDITOR'S NOTE

by Bob Cerceo, Esq.

In your hand is a retrospective of all cite-able NFLR business valuation articles from the inception of this publication in 1986. Caution: all internal case cites and author bios are original to the date of the article. The formal NFLR citation for each article is stated above its title.

This was a fun project. Reading through the years of early volumes gave me a great appreciation for the strong writing of the authors and for the initial members of the Family Law Section. They are each owed a debt of gratitude for their hard work in getting things off the ground, guiding the Section to success, and mentoring us. Two decades later, the Section and the NFLR are still going strong.

A special note of appreciation is in order for Ron Logar, who, besides writing salient articles on a variety of topics for more than 20 years for the education of all of us (like the one reprinted here), went above and beyond the call as the founder of the Family Law Section, and who successfully lobbied the Bar to obtain the initial funding. Thanks.

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IN THIS ISSUE:

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Nev. Fam. L. Rep., Vol. 1, No. 1, March 1986, at 1..

VALUATION OF STOCK IN CLOSELY HELD CORPORATIONS IN THE CONTEXT OF A MATRIMONIAL ACTION

by Kenneth L. Fortney

Introduction

The value of stock in a closely held corporation frequently represents the most significant asset of the marital estate. Those shares must be valued and included in the property division. The valuation of a closely held corporation or an interest in such corporation may represent one of the most perplexing and difficult tasks at the time of marriage dissolution.

Each valuation problem is unique; there is no one proper valuation theory to be applied in all instances. The question of value is one of fact and therefore subject to solution only in the light of all circumstances having a bearing on the issue as of the valuation date. It is, furthermore, a matter which is to be resolved in all cases on the basis of sound judgment and common sense. There is no mathematically “right” answer, only a range of possible right answers which can be supported by convincing and logical reasoning. In each case the expert must be sure there is ample justification for the value placed on the shares of a closely held corporation.

Related to the valuation of stock in a closely held corporation are appraisals of other kinds of business interests: partnership or sole proprietorship interests; associations; joint ventures; and other noncorporate entities. Most of the same factors used in valuing stock in closely held corporations apply equally well to the valuation of such other business interests.

A closely held corporation has been defined “as a corporation . . . the shares of which are owned by a relatively limited number of stockholders. Often the entire issue is held by one family.”[1] Further, its stock is rarely traded and is unlisted on any exchange. It has also been defined by the Internal Revenue Service as “a corporation whose market quotations are either unavailable or of such scarcity that they do not reflect the fair market value.[2]

“Value” and “valuation” can be defined a number of ways, depending upon the particular context in which they are used. Most commonly, they have been judicially defined as “fair value” or “fair market value.” The Internal Revenue Service defines the “fair market value” of property in general as “the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.”[3] Inherent in the definition of fair market is the willing buyer-willing seller concept. Obviously, the best indicator of such a concept is the open market where buyers and sellers communicate with one another and where exchange takes place. A lack of such a market for stock in a closely held corporation compels the need for a valuation process.

The Valuation Process

The valuation process is generally a two-stage procedure. In the first stage, the appraiser determines the gross value of the stock in the closely held corporation. In the second stage, the appraiser would adjust the first-stage estimate to account for factors which a market would consider in valuing stock but which ordinarily would not be take into account when calculating the value of a company. Second-stage adjustments include discounts and premiums. An appraiser's final estimate of value of the shares of stock at issue would be the first-stage estimates of value properly adjusted in accordance with all relevant second-stage factors.

Revenue Ruling 59-60 may be the single most important summary of accepted valuation objectives and techniques for closely held corporations or an interest in such corporations. This Revenue Ruling specifically lists eight factors to consider in valuing the shares of stock in a closely held corporation. The relevant valuation factors set forth are as follows:

(a) The nature of the business and the history of the enterprise from its inception.
(b) The economic outlook in general and the condition and outlook of the specific industry in particular.
(c) The book value of the stock and the financial condition of the business.
(d) The earning capacity of the company.
(e) The dividend-paying capacity.
(f) Whether or not the enterprise has goodwill or other intangible value.
(g) Sales of stock and the size of the block of stock to be valued.
(h) The market price of stock of corporations engaged in the same or similar line of business having their stock actively traded in a free and open market, either on the exchange or over-the-counter.

Revenue Ruling 59-60 also provides a brief discussion of each of the foregoing factors. The purpose of the ruling is to summarize the factors to be considered in valuing shares of stock in closely held corporations for estate and gift tax purposes. However, several divorce courts have concluded that all of the factors noted in Revenue Ruling 59-60 should be considered in order to establish an appropriate value of an interest in a closely held corporation.[4]

Of the factors outlined in Revenue Ruling 59-60, this article focuses on capitalized earnings, net asset value and representative sales or exchanges.

Capitalization of Earnings

Earnings may be the single most important factors in determining the value of stock in a closely held corporation. The essence of value in such assets is their income-producing ability; past, present and potential. Daily evidence of the importance of earnings is seen from the stock market analyses which refer to the price-earnings ratios of shares of various companies. Authorities on valuation, other than for tax purposes, having place even greater weight on earnings in valuing operating businesses. For example, Dewing states:

> The businessman, frankly, is interested neither in the engineer's appraisal of physical property, according to some arbitrary rule of unit values, nor in the accountant's report of past expenditures. He is primarily interested in the past earnings capacity of the business so far as this can throw light on future earnings in his hands. He is buying earning capacity and not physical assets.[5]

In making a valuation of shares of a closely held corporation by reference to earnings, it should be kept in mind that what a hypothetical willing buyer would pay a hypothetical willing seller is based upon the expected future earning power of the corporation. In predicting future earning power, past earnings are usually the most reliable guide.

In determining future earning power by reference to past earnings, several points must be examined. Revenue Ruling 59-60 states that preferably five or more prior years earnings should be taken into account. Usually five years is an appropriate period to consider. Whatever period of prior earnings is used, the earnings for that period are not simply averaged in order to arrive at predicted future earnings. Earning trends must also be considered. Comparative income statements for the last five years should be scheduled. Trends of income statement items such as sales, gross profit, income from operations, net income and earnings per share should be analyzed. Adjustments should be made for nonrecurring items, shareholder-officers' salaries or loans, shareholder-officers' perquisites, unreported income and unreported expenses. After the adjusted earnings are determined they should be average for the five-year period. If the earnings show an upward or downward trend, the earnings should be weighed to emphasize the trend. This method gives greater weight to the final year's earnings. The earnings from the most recent to remote period are weighed according to factors 5, 4, 3, 2 and 1. The result is weighted average earnings.

Once average earnings have been determined, an appropriate price-earnings multiplier, or capitalization rate, must be determined and applied to those earnings. The earnings multiplier is the reciprocal of the capitalization rate. The capitalization rate is the rate of return that a new investor going into a particular industry would expect on his or her investment, as affected by the risk of loss and the prevailing rate of return other investors in the same industry are receiving. The riskier the business, the higher the capitalization rate. The higher the capitalization rate, the lower the value of capitalized earnings.

Valuation based on earning power can very greatly depending upon the multiplier (capitalization rate) chose. A comparatively large error in computing average earnings is not of as much importance in the final result as a comparatively small difference in the ratio at which earnings shall be capitalized.

(cont'd. on page 4)

STOCK VALUE
cont'd. from page 3

The best guide to finding the appropriate price-earnings multiple is to determine the price earnings multiples of comparable companies whose shares are publicly traded. The problem, however, is to find a company which is publicly traded that is truly comparable. A comparable company should be one whose lines of businesses are the same as that of the company whose shares are being valued, and it should also be of approximately the same degree of riskiness.

Net Asset Value

Net asset value is the fair market value of all assets less liabilities. Net asset value is also referred to as adjusted book value. Book value represents the total assets of the company based on its financial statements less stated liabilities, commonly referred to as stockholders' equity. Book value per share is the total book value or stockholders' equity of the company divided by the number of issued and outstanding shares.

The stated assets on the corporation's financial statements will usually be at cost, or sometimes at the lower of cost or market value. The book value per share of shares of a corporation may have little relation to the fair market value of assets underlying each share. For example, the historical cost of land reflected in the corporation's financial statements may be far below its current fair market value.

At the valuation date the stock of the corporation had a certain net asset value or book value. Ordinarily, we cannot find balance sheets as of the specific date; thus the alternative is to use the latest available financial statement. The latest balance sheet available should be analyzed and adjusted to net asset value. As previously indicated, real estate must be adjusted to its current fair market value. A current appraisal may be required. Depreciation schedules of all principle classes of fixed assets should be reviewed. Machinery and equipment may be fully depreciated or depreciated under an accelerated method. It may be necessary to have these items appraised. The allowance for uncollectible accounts receivable should be analyzed. The basis of valuing inventory should be examined since net asset value and earnings will vary depending on the inventory valuation method applied.

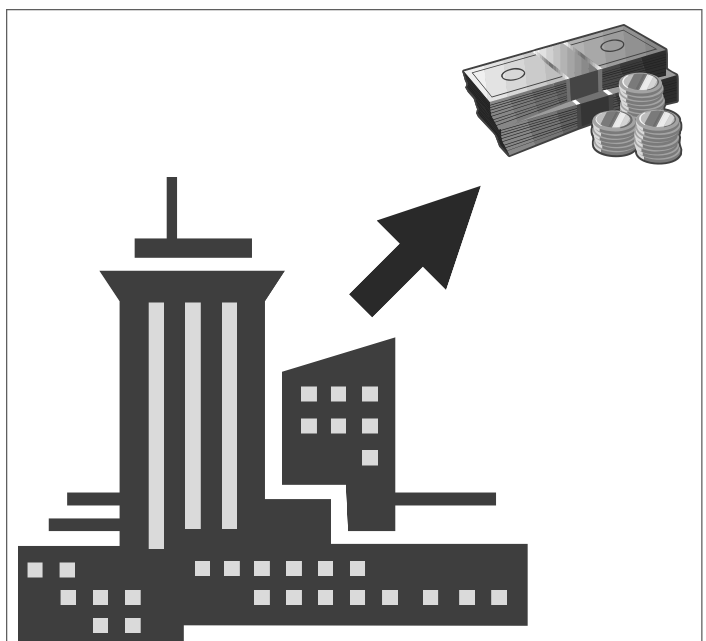
The above items are only a few of the balance sheet factors considered in a typical stock valuation. An important aspect of the net asset value study is to compare such significant items as working capital ratio or ratio of total debt to equity. Balance sheets for the last five years should be scheduled. Ratios for these same balance sheets should be scheduled and evaluated. Such a comparison gives greater meaning to the various balance sheet disclosures for valuation purposes.

Net asset value is generally a poor indicator of value in an operating company, but is considered the preferred method in evaluating the value of an investment or real estate holding company.

Representative Sales or Exchanges

Comparable sales are always a measure of fair market value, whether for real estate, personal property or a going business. The general rule is that market prices determined in a free and open market are the best indicators of value, and that such prices should be used in determining value whenever possible. Judge Learned Hand has articulated the rational for this rule as follows:

> When there is an open market in which property can be bought and sold, it may be very difficult, if not impossible, to avoid the conclusion that the market price is the 'value' for all purposes. That price is the sum which will secure the property if anyone wishes to buy it, or will replace it if anyone has parted with it; the price is the sum which represents the current estimate of the present value of its earnings and of its final liquidation.[6]



During the examination of the entity to be valued, it should be determined if: (1) there is an indication that a contemporaneous sale occurred; (2) such transaction, if any, was at arm's length; and (3) the parties to such transaction had full knowledge of the conditions surrounding the transaction. If such questions are answered in the affirmative, then the appraiser has a good value basis upon which to build. Even if all of the above three elements are not present, a starting point for the valuation process has been established. The market in which sales occur before or after the valuation date must be examined. Such market should generally be free from abnormal influences or pressures and be truly representative of a willing buy and willing seller negotiating for a sales price at arm's length.

The general rule for use in representative sales is that the closer the sale is to the valuation date, the greater the weight the sale will receive. The amount of weight a representative sale will receive depends largely upon the change in financial condition of the subject company during the intervening period between the valuation date and the representative sales date.

The size of the representative sale must also be considered. Obviously, the closer the representative sale size (shares of stock, percentage interest, etc.) Is to the interest to be valued, the more credible the representative sale value. On a comparative basis, if the size of the interest sold is within reasonable range of the size of the interest to be valued, and the market conditions have remained substantially the same, then a representative sale should provide the needed indication of value, provided the original sale was a bonafide sale.

Those sales involving non-arm's-length or private transactions must be analyzed. Sales of business interests among family members subsequent to prior to the valuation date have a lesser bearing on determination of fair market value than do other representative sales. The preferential treatment given family members in intrafamily transactions creates a non-arm's length implication even though the substance of a bonafide sale may be present. The implication that a "donative" intention is involved in many intrafamily transactions has been recognized by the courts.

Sales of business interests between or among so-called "corporate insiders" before or after the valuation date may be considered fairly reliable for determination of a relevant value range. The reasoning is that insiders generally are well informed of the true status of the entity, have a better understanding of the worth of the business, and have negotiated in a "willing seller-wiling buyer" environment. The sales price of the interest sold when corporate insiders are involved must, however, be closely examined to make sure no additional consideration is involved (e.g., performance of services or other forms of disguised payments).

A representative sale may receive more weight if the Internal Revenue Service has accepted, or failed to contest, the value used in such sale. If, for example, shares were sold wherein the taxpayer had significant long-term capital gains and such gains were not contested or disallowed upon audit of the taxpayer's return, then the real value has withstood Internal Revenue Service scrutiny.

In summary, some weight should be given to representative transactions occurring before or after the valuation date. The amount of weight afforded such representative sales will depend upon the following elements:

- the proximity of the sale to the valuation date;
- the amount of disparity between the number of shares sold and the number of shares to be valued;
- the motives surrounding the sale, other than to determine a fair price; and
- the amount of intervening change in the financial condition of the business and environment from the sale date to the value date.

These conditions determine the degree of reliance which should be placed on representative sales.

Discounts

The question of discounting from gross value in order to arrive at a fair market value must be considered. After the appraiser determines the gross value of the stock in the closely held corporation, discounts from gross capitalized values are allowable for any of the following reasons:

- Lack of marketability
- Minority interest
- Restrictive agreements

1. Lack of Marketability

By far the most frequent claim for substantial discounts in value of closely held securities is made on the basis that the stock lacks marketability. The extent, however, to which any restriction or limitation on marketability will reduce the value of a specific stock as of a certain date is entirely a matter of opinion.

2. Minority Interest and Control Premium

One of the significant problems in the valuation of shares of closely held corporations is whether and to what extent a reduction from the value otherwise determinable for such shares may be allowable by reason of the fact that the block of shares being valued is a "minority" interest in the business; or conversely, whether or to what extent an increase in value is in order because the shares represent a controlling interest.

The minority interest discount principle is, again in theory, distinct from the lack of marketability principle since lack of marketability is present whether a minority or a controlling interest is involved. The courts, however, tend to lump the minority interest and lack of marketability principles together and apply a single discount.

Minority interest shares in a closely held corporation are usually not readily saleable because they lack the power to control the election of the board of directors which oversees corporate policy with respect to issues such as officer salaries dividends and liquidation of assets. Often times, the field of potential buyers or minority interest stock is limited to the group consisting of the controlling shareholders.

Ownership of a controlling interest in a closely held corporation entitles the control block owner the powers to elect and remove directors, fix salaries, assure oneself a job at a reasonable salary, declare dividends and dissolve or merge the corporation.

In general, a minority discount and/or a control premium can only be supported if an actual control interest exists. If there is a control interest, the appraiser must decide whether the block of stock at issue is a control interest or a minority interest.

(cont'd. on page 6)

STOCK VALUE: *cont'd. from page 7*

For purposes of determining whether a given block of shares represents a minority or a controlling interest, the courts have generally adopted the rule that more than 50 percent of the voting shares constitutes a controlling interest and less than 50 percent constitutes a minority interest.

Since premiums and discounts rest on the hypothesis that the control interest can and will divert from minority interests portions of the latter's pro rata claims to corporate income and assets, and since such diversion inherently is an illegal act from which minority interests are entitled to relief under most states' laws, we should presume that diversion will not take place and therefore that control premiums and minority discounts are unwarranted.[7]

A possible exception to this general rule might be allowed– and thus a control premium or minority discount considered– if the party urging such an exception can prove that, due to the costliness and riskiness to minority interests of enforcing their rights to pro rata treatment, diversion activities by the control interest can be expected in the particular case at hand.[8]

The burden always should be on the party urging the premium or discount, and the court should demand that the party present, at the very least, evidence showing that under the laws of the state of incorporation the minority interest would have a particularly difficult time obtaining relief from diversion. The burdened party also should have to prove with some measure of certainty the degree to which diversion activities could be expected in the case, and this should require a showing that private diversion-preventing arrangements were not used by minority shareholders. If the burdened party in the case could successfully prove the degree of diversion that can be expected, then the court should apportion the present value of expected diversion from minority interests in the corporation to majority interests, thus assessing the proper control premium or minority discount in the case.[9]

In several instances, the interest at issue may represent an ownership interest in a family-owned corporation. Generally, no minority interest discount should be contemplated for transfers of shares of stock among family members where at the time of the transfer either majority voting control or de facto control of the corporation exists in the family. However, where there is evidence of family discord or other factors indicating that the family would not act as a unit in controlling the corporation, a minority interest may be appropriate. Generally, there is unity of ownership and interest in a family corporation, and the shares owned by family members must be valued as part of that controlling interest. Typically, shares that are part of the controlling interest in a closely held corporation are unlikely to be sold in an arm's length trans-action except as part of the controlling block. Thus where the family owns a controlling interest in a corporation, the value per share is the same as stock owned by any other family member and is the same value that would exist if all the stock were held by one person.

3. *Restrictive Agreements*

Frequently in valuing closely held stock, it will be found that the stock is subject to an agreement restricting its sale or transfer. Agreements are executed, for example, to keep ownership and control of the enterprise within a limited group and to assure that new entrants into the stockholding group are acceptable to the owners.

Unlike the nonmarketable and minority interest discounts, the existence of a restrictive agreement does not create the opportunity for a percentage discount from a gross valuation derived from intrinsic factors. Rather, the restrictive agreement, containing as it usually does a designated purchase price derived under a negotiated price or formula scheme, may be, depending upon form, determinative of value. In other situations the presence of a restrictive agreement may simply be a factor to be considered in arriving at a reasonable rate.

Conclusion

This article has focused on the major issues and methods involved in the valuation of stock in a closely held corporation. In valuing an interest in a closely held corporation, the appraiser must analyze the corporation's capital and control structure, its financial position and its future prospects with extreme care. In examining and weighting all relevant factors, he must make many judgments and choices which can significantly affect value. The real test of the appraisal lies in the ability of the appraiser to document and back up his valuation effectively and rationally. If the appraiser has been professional, the judgments reasonable, and the results supportable, the expert should be able to successfully defend his evaluation.

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FOOTNOTES:

[1] Rev. Rul. 59-60, 1959-1 C.B. 237, Sec. 2.

[2] Ibid, Section 1.

[3] Ibid, Section 2.

[4] *See, e.g., In re Marriage of Hewitson*, 142 Cal. App. 3d. 874, 882-83, 191 Cal. Rptr. 392, 397 and fn9 (1983); *Kaye v. Kaye*, 478 N.Y.S. 2d 324, 328 (A.D. 2 Dept. 1984); *Muller v. Muller*, 116 Misc. 2d 669, 668, 456 N.Y.S. 2d 918 (Sup. 1983); *Nehorayoff v. Nehorayoff*, 198 Misc. 2d 311, 316, 437 N.Y.S., 2d 584 (Sup. 1981).

[5] Dewing, "The Financial Policy of Corporations," 264 n.b. (Rev. Ed. 1926).

[6] *Comr. v. McCann*, 146 F.2d 385 (2nd Cir., 1944).

[7] Hall, "Valuing Closely Held Stock: Control Premiums and Minority Discounts", 31 Emory L.J. 139 (1982).

[8] Ibid.

[9] Ibid.

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Nev. Fam. L. Rep., Vol. 1, No. 3, Winter 1987, at 5.

AWARDING THE FAMILY BUSINESS TO THE WIFE

By Ronald J. Logar

It is difficult to convince the trial court to set aside the family business to the wife. The reasons for denying such relief are persuasive: the husband has been the operating spouse, with wife having little if any participation in its operation; where the husband has the special skill and training, the wife does not have experience in the field. Simply, the operating spouse is favored to continue in the sole management of the family business after dissolution.[1]

The presence of other factors, however, may support the wife's position. A recent case provides certain guidelines to follow, *In Re Marriage of Kozen* (9/29/86).[2]

In *Kozen*, the parties owned two Burger King franchises in southern California– one "highly profitable" in Hollywood and another, newer operation in Burbank, owned with a partner. The husband had been solely responsible for their management. Wife, during the 13-year marriage, had been a homemaker and mother to their children. The Hollywood Burger King was valued at $1,187,000, and their residence at $700,000.

Wife decided to become the Burger Queen of Hollywood by requesting that the larger and more profitable Hollywood franchise be set aside to her. A representative of Burger King testified that the franchisor maintained a management training program available to all franchisees, that the wife could satisfactorily complete the program, and that the company would accept her as an owner-franchisee.

Much to husband's dismay, the trial court awarded the Hollywood franchise to wife, awarded the residence and Burbank franchise to husband, required wife to make an equalizing payment to husband, and ordered husband to assume the remaining debt on the Hollywood Burger King.

The trial court explained that wife carried the burden of proving that she could operate the business profitably. It found that she could learn the business with no prior experience, much like the husband did when the first franchise was developed. Further, the court pointed out that wife could support herself and the children from the profits, without relying upon the husband in a dissolution given to acrimony between the two parties. Husband's motion for reconsideration and a new trial was denied. On appeal, the decision was affirmed– the appellate court distinguishing the many cases cited by the husband as authority for overruling the trial court, as being inopposite.

In *In Re Marriage of Burlini* (1983),[3] the family business was a coin laundry operation consisting of washers and dryers located at various apartment complexes. The court denied wife's request for one-half of the business since only the husband had the skill and experience to service the machines, which was necessary to prevent the destruction of the business.

Similarly, in *In Re Marriage of Smith (1978)*,[4] the husband had performed the technical work for the family's custom sign-making business while the wife performed the clerical and bookkeeping duties. Again, the business was awarded to husband since his technical knowledge and experience were necessary to the business.

In *Kozen*, the evidence clearly showed that wife could do as good a job as the husband at running the business even though the husband had formed and developed it. There was no showing that the husband had any special training when the franchise was acquired years ago. There was no reason that the wife could not perform the same functions as the husband– and as well– such as "interfacing" with the franchisor, restaurant managers, purveyors, equipment manufacturers and the insurance company.

The *Kozen* decision provides certain guidelines to be applied where both parties seek the family business. First, if it is the husband who has operated the business, then the wife must provide proof that she possess the necessary skills to run the business, or that she can learn the skills without substantial impairment of its operation. An expert witness should be used for this purpose. Second, show

(cont'd. on page 8)

FAMILY BUSINESS TO WIFE: *cont'd. from page 7*

that the income from the business is necessary to support the wife, children or another legitimate need. Third, establish that the wife needs to be self-sufficient without dependence upon the husband. (This latter consideration is relevant where the divorce has been acrimonious or where husband's income fluctuates.)

Kozen can serve the practitioner well by providing guidelines for reasonable consideration of the wife's request for the family business.

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FOOTNOTES:

1 *Goss v. Edwards*, 68 CA 3.d 264, 137 CR 252 (1977).

2 California Court of Appeals, 2 Civil B008375 and B009412 (DIV.4) _____ CA 3.d _____, 230 CR 304.

3 143 Cal. App. 3.d 65, 70-71, 191 Cal. Rptr. 541.

4 79 Cal. App. 3.d 726, 748-751, 145 Cal. Rptr. 205.

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Nev. Fam. L. Rep., Vol. 15, No. 1, March 2000, at 1.

VALUATION OF BUSINESS INTERESTS IN DIVORCE: THE SIGNIFICANCE OF THE BUY-SELL AGREEMENT

by Gregory G. Gordon, Esq.

It is not uncommon for the owners of a professional practice or small business to execute a buy-sell agreement setting forth the terms and conditions under which an owner can sell or transfer his or her interest. The agreement usually addresses such events as the death, retirement, or withdrawal of a shareholder or partner, with the business reserving the right to purchase the outgoing member's interest for a predetermined price before the interest can be sold to an outsider.

The Problem

Buy-sell agreements rarely address the situation of divorce. Therefore, when divorce does occur, a dispute often arises as to how much weight to give the agreement in establishing the value of the business interest for purposes of property division.

Taking Sides

The owner spouse usually takes the position that the agreement is controlling for purposes of determining value. There are several reasons for this. First, the buy-sell agreement usually establishes an artificially low stock price to discourage stock transfers and keep the business in the hands of the original owners.[1] Second, the agreement avoids the need for an independent appraisal, which can be intrusive, time-consuming, and expensive.

The nonowner spouse, on the other hand, who may never have seen or approved the agreement prior to the commencement of divorce proceedings usually challenges the agreement as not a true reflection of fair market value and insists upon a thorough review of the business' books and records by an outside appraiser.[2]

Survey of the Law

The majority of jurisdictions that have considered this issue have held that buy-sell agreements are not controlling when it comes to valuing a business interest for purposes of divorce, but may be a factor considered by the court depending upon the particular facts and circumstances of the case.[3] In other words, an existing buy-sell agreement is just one factor among many to be considered by the appraiser as part of the valuation process.

In *Bosserman v. Bosserman*,[4] the Virginia Court of Appeals explained why courts should not focus exclusively on buy-sell agreements for purposes of determining value by stating:

> Many legitimate business purposes, such as protecting the business from outside interven-

> tion or changes in ownership, providing economic continuity, and estate and tax planning, are served by such provisions. The price established for buy-out purposes, however, is often artificial and does not always reflect true value. The very purpose of such provisions or agreements often is to discourage sales by restricting the price which could b e realized to less than the actual value of the owner.[5]

For these reasons, courts have generally not regarded buy-agreements as controlling for purposes of divorce valuation.

A minority of jurisdictions hold that the terms of the restriction presumptively control value,[6] while an even fewer number of courts regard the value specified in the agreement as controlling.[7] The rationale often used by these courts is why should the non-owner spouse receive greater rights in divorce than those the owner spouse would receive in the event of an actual sale of transfer.[8] Basically, these courts believe that it is the "realizable" value of the business interest as determined by the agreement and not "fair market value" that is relevant for purposes of valuing the interest in divorce.[9] The concept of "realizable" value often becomes an issue in cases involving professional practices where ownership interests cannot be freely bought and sold separate and apart from the services of the owner spouse.[10]

What about Nevada?

Although the Nevada Supreme Court has yet to address the significance of buy-sell agreements in divorce, the *Ford v. Ford*[11] decision offers some insight as to how the court would decide the issue. In *Ford*, Dr. Ford argued that as a solo practitioner any goodwill attaching to his medical practice was dependent on his continued participation in the practice, and thus, not salable and not subject to distribution upon divorce.

The Nevada Supreme Court, however, disagreed with Dr. Ford and held that the important consideration in determining value is not whether the business can be sold without the personal services of the professional spouse but whether it has value to that spouse.[12] Essentially, Dr. Ford asked the court to limit the value of his practice to its "realizable" value, which the court refused to do.

Based on *Ford*, one would expect Nevada to reject the minority view limiting recovery to realizable value and instead treat the agreement as just one of the many factors to be considered in measuring fair market value. Such an approach would also be consistent with Nevada's stated preference for allowing latitude in the appraisal process.[13]

Important Factors to Consider

So, when does a buy-sell agreement become significant? Well, the most common criticism of buy-sell agreements it that they are usually written at an early stage in the development of a business and do not reflect actual growth, inflation, and goodwill, all elements that may have an impact on practice value. Therefore, it is important to look at the date of the agreement, the activity that has taken place in accordance with its terms, and the apparent underlying intent of the drafters in assessing the usefulness of the agreement.

Courts usually give little or no weight to agreements that set forth an outdated value or formula that is not revised or updated on a regular basis.[14] Obviously, an agreement that provides up-to-date numbers will bear a closer relationship to what is actually being measured at divorce and is more likely to be accepted by a trial court.

In *Stern v. Stern*,[15] for example, the New Jersey Supreme Court decided that a formula used for determining what shall be paid to a partner upon death was the best measure of value for property division purposes where the agreement was periodically and regularly reviewed and updated and, therefore, adequately reflected the current economics of the law practice and the divorcing lawyer. On the other hand, in *Butler v. Butler*, the Pennsylvania Supreme Court disregarded a shareholder's agreement signed in 1974 that had not reviewed or updated prior to the time of the divorce in 1987.

Courts have also typically rejected values for formulas set forth in agreements that appear on their face to be arbitrary or artificially low. For example, agreements that limit recover of goodwill will not be afforded much weight.

In *Marriage of Nichols,*[16] a California court adopted a three-part test for determining how much weight to give an agreement. The factors include:

(1) the proximity of the date of the agreement to the date of valuation to ensure that the agreement was not entered into in contemplation of marital dissolution;
(2) the existence of an independent motive for entering into the buy-sell agreement, such as a desire to protect all partners against the effect of a partnership dissolution; and
(3) whether the value resulting from the agreement purchase price formula is similar to the value produced by other approaches.

Applying these factors, the trial court in *Nichols* determined that the company had an independent motive for entering into a restrictive stock purchase agreement. There was also

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BUY-SELL AGREEMENT:
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no indication that the agreement was specifically designed to deprive shareholders' spouses of any rights as the agreement was signed more than eight years prior to the parties' separation. Furthermore, the husband's expert testified that the amount established by the agreement did not vary greatly from the value he arrived at using another methodology. The appellate court ultimately affirmed the trial court's valuation of the husband's interest in his law practice based on the agreement.

Occasionally, as a practitioner, you will come across an agreement that actually provides for a meaningful valuation. Even in those instances, however, it is important that any argument for adopting the agreement be supported by other accepted valuation methods. In *Money v. Money,*[17] for example, the Alaska Supreme Court upheld the value set forth in a restrictive shareholder's agreement where the value arrived at using the agreement was similar to that found under a capitalization of earnings method. It is always advisable to supplement your best arguments as to why the agreement should (or should not) be considered with other valuation evidence as well.

Never should you or your appraiser ignore a buy-sell agreement. In most cases, the terms of a restrictive transfer agreement, even if not controlling, will have some impact on value. In *Amodio v Amodio,*[18] for example, the New York Court of Appeals adopted the value set forth in the shareholders' agreement where it was the only record of actual value in evidence. The wife's expert argued for a larger value but failed to consider the restrictions in the agreement when calculating the value of the business. In rejecting the testimony of wife's expert, the *Amodio* court explained that although the agreement is not controlling, it is a factor that should have been considered.

Spousal Consent

You may on occasion come across a buy-sell agreement bearing the signature of the nonowner spouse. If you are representing that spouse, however, do not waive your white flag just yet. The fact that the nonowner spouse has signed the buy-sell agreement does not necessarily guarantee the agreement's validity for purposes of divorce valuation.

In *Keith v. Keith,*[19] a Texas appellate court rejected the use of a formula set forth in a partnership agreement despite the fact that the divorcing partner's wife had signed the agreement"stating her approval of the agreement and her acceptance of its provisions, agreeing to be bound by it."[20] Similarly, in *Mitchell v. Mitchell,*[21] the Arizona Supreme Court concluded that the agreement, although consented to by wife, valued her husband's accounting practice for purposes of business dissolution only, not marital dissolution.

In the absence of a full and complete disclosure of the rights that are being waived, which would require a thorough valuation of the business interest, it is unlikely that a court would construe a spouse's mere signature on such a document as a knowing waiver and relinquishment of valuable community property rights, especially if the spouse did not know what he or she was signing at the time (which is most likely the case).

Conclusion

Litigating the value of a small business or professional practice is never easy, especially in the context of a divorce. As a practitioner, you should always be on the look out for an existing buy-sell agreement or other provision affecting the transferability of an ownership interest in that business. Make sure this is included in your initial discovery requests. Make sure when you depose the owner spouse and/or the business manager or accountant that you are finding out everything there is to know about such restrictions. Finally, make sure you are discussing with your appraiser how the agreement affects the value of the business interest being appraised.

Professional spouses will undoubtedly clean to their buy-sell in divorce situations. While not all agreements provide meaningful valuations, there are exceptions. Regardless of whom you are representing, make sure the buy-sell receives proper attention from both you and your expert when preparing the case for trial.

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FOOTNOTES:

1 ROBERT D. FEDER, VALUATION STRATEGIES IN DIVORCE § 15.24 (4th ed. 1977).

2 *Id.*

3 *Id.*

4 384 S.E.2d 104 (Va. Ct. App. 1989).

5 *Id.* at 108.

6 *See Stern v. Stern,* 331 A.2d 257 (N.J. 1975); *In re Marriage of DeCosse,* 936 P.2d 821 (Mont. 1997).

7 *See Hertz v. Hertz,* 657 P.2d 1169 (N.M. 1983).

8 RONALD L. BROWN, VALUING PROFESSIONAL PRACTICES AND LICENSES, A GUIDE FOR THE MATRIMONIAL PRACTITIONER § 16.03[c] (1998).

9 *See Rosenberg v. Rosenberg,* 536 N.Y.S.2d 605 (App. Div. 1989).

10 *See McCabe v. McCabe,* 575 A.2d 87 (Pa. 1990); *Ford v. Ford,* 840 P.2d 36 (Okla.Ct. App. 1992).

11 105 Nev. 672, 782 P.2d 1304 (1989).

12 *See also In re Brooks,* 756 P.2d 161 (Wash. Ct. App. 1988).

13 *See generally Alba v. Alba,* 111 Nev. 426, 892 P.2d 574 (granting trial courts wide latitude in determining the value of personal property).

14 *See* FEDER, *supra* note1, at § 15.30.

15 331 A.2d 256 (N.J. 1975).

16 33 Cal. Rptr. 2d 13 (Cal.Ct. App. 1994).

17 852 P.2d 1158 (Alaska 1993).

18 70 N.W.S.2d 5 (Ct. App. 1987).

19 763 S.W.2d 950 (Tex. Ct. App. 1989)

20 *Id,* at 593.

21 732 P.2d 208 (Ariz. 1987).

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Nev. Fam. L. Rep., Vol. 20, No. 1, Winter 2007, at 10.

BUSINESS VALUATION APPROACHES AND METHODS BOILED DOWN– THE BASICS

by Bob Cerceo, Esq.

Nevada has only a few reported cases on the valuation of a wholly owned business. *See Robison v. Robison*, 100 Nev. 668, 691 P2d 451 (1984), *Wilford v. Wilford*, 101 Nev. 212, 699 P.2d 105 (1985), *Ford v. Ford*, 105 Nev. 672, 782 P.2d 1304 (1989). Much more case law has been devoted to the "apportionment of a business started prior to marriage" issue, which the cases are related, but only tangentially.

With the fundamental question being "How do we value the business?", the sources of law must first be examined. As Nevada law does not provide specifics on approaches and methods, guidance in the valuation field is provided, at least initially, by IRS rulings in the valuation of stocks and bonds. Rev. Rul. 59-60 provides the broadest scope of review, and in §4, eight factors are enumerated which form the scope of the work. As this ruling was initially conceived for estate computations, it was later expanded for valuation for all tax purposes under Rev. Rul. 65-193. Additional guidance has been provided by the addition of Rev. Rul. 68-609 for calculation of goodwill by capitalizing "excess earnings," a subset of the overall valuation scheme.

With the balancing of IRS rules, GAAP,[1] USPAP,[2] and the individual needs of each going concern, business valuation has developed into a highly complex endeavor, and it is now a recognized specialized field of knowledge with several national certifying agencies suitable for expert testimony. NRS 50.275. Although there are many books and articles on the subject, it is widely acknowledged that one of the leading authorities on business valuation is Dr. Shannon P. Pratt, and his most recent authoritative text on the subject is *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, Fourth Ed., Shannon P. Pratt, Robert F. Reilly and Robert P. Schweihs, McGraw Hill (2000), ISBN 0-07-135615-0.[3] Nationally, there is no uniform rule for fixing value of a going concern, the method used to value a company depends upon its unique status, and it is incumbent upon the appraiser to inform and educate the Court on the details of the methodology. Pratt at 840, 841. Boiled down to its most basic framework, the following is a brief overview of approaches (general) and methods (specific within each general approach):[4]

1. Asset Approach – Valuation on the basis of assets and liabilities.
   a. Liquidation Value Method – "at sale"
   b. Net Asset Value Method – tangible assets plus any non-Balance Sheet assets
2. Income Approach – Valuation on the basis of some form of economic stream.
   a. Capitalization of Earnings Method – capitalization rate applied to a period of earnings
   b. Discounted Cash Flow Method – project earnings and apply a discount, be aware of the "double dip" with alimony[5]
3. Market Approach – Valuation by reference to other transactions.
   a. Comparable Companies Method – compare to guideline companies
   b. Actual Sales of Stocks – a recent arm's length sale as an indicator
   c. Industry Formulas – "rule of thumb" or "ballpark" ranges

Virtually all business valuation reports can be understood within this frame work of approaches and methods, but each valuation will be tailored to the particular facts and circumstances of each case. Equally important, but beyond the scope of this article are: the Standard of Value used, as Fair Market Value and Fair Value (or Marital Value) are not equivalent terms; and, the question of applicable Discounts. ***

FOOTNOTES:

1 Generally accepted accounting principles promulgated by the AICPA.

2 Uniform Standards of Professional Appraisal Practices by the ASA.

3 A condensed review is published by the ABA, the *Lawyer's Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony,* Shannon P. Pratt ABA Section of Family law (2000), ISBN 1-57073-829-7. This is a "handbook" style overview of the practice, but not the authoritative text.

4 Pratt at 821 through 823.

5 There is a direct correlation between the projected earnings of a close held business and the alimony/spousal support orders, which if not addressed at the time of the issuance of the order, can result in two awards from the same stream of income, commonly referred to as the "double dip."

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Nev. Fam. L. Rep., Vol. 20, No. 2, Spring 2007, at 1.

IMPORTANT ISSUES OF BUSINESS VALUATIONS FOR ATTORNEYS AND THEIR CLIENTS

by Richard M. Teichner, CPA, CVA, CDFA™

I. Introduction

Attorneys often need to help their clients establish values for businesses or business interests. This article discusses some of the issues which need to be addressed before attempting to arrive at business values.

Some examples of situations in which business values may need to be established, particularly in connection with the practice of law, are:

- Drafting or assistance with implementing buy-sell provisions in agreements between and among shareholders, partners and limited liability company members.
- Business acquisitions and mergers.
- Litigation matters where a measurement of economic damages is the diminution in the value of a business.
- Bankruptcy matters, such as when determinations need to be made as to whether to keep operating a business and/or sell it, or liquidate it.
- Marital dissolution proceedings.
- Condemnation proceedings.
- Gifting for estate planning purposes.
- Establishing values of a decedent's estate.

Depending on the reason for the valuation, there are various factors that need to be considered, some of which are contained in the descriptions of the terms listed below. If an independent business valuation expert is called upon to assist in establishing a value and/or opine to a value, he or she must have access to all relevant information to be able to determine which factors apply in the particular situation. The attorney and client need to allow and encourage open communication between themselves and the valuator. Too often the intentions of the parties are not apparent, understood or properly articulated, and the facts and circumstances surrounding the true purpose of the valuation are not adequately disclosed. Also, the valuator should know the identities of all the parties to, and affected by, the valuation. Certainly, the valuator has a responsibility to seek all information necessary to do a thorough job, but all other parties involved have to be willing to collaborate in the effort of providing whatever information they and the valuator may deem to be pertinent.

II. Certain Terms Applying to Valuations

To aid the attorney and client during the process of establishing a business value, the following is a summary of some of the terms that generally apply to valuations:

Approach - there are three general approaches for establishing values, of which, depending on the circumstances, one of them or a weighted average of more than one of them can be used:

> **Income Approach**, whereby past or future income or cash flow streams are applied to a capitalization rate or discount rate.
>
> **Market Approach,** whereby values or sales of comparable businesses, or interests in comparable businesses, are the bases for value for the subject business.
>
> **Asset Approach** (or asset-based approach, adjusted net asset approach, and other variations on the term), whereby a value for each balance sheet item is determined (including intangibles which may or may not appear on the balance sheet) and then are added together (assets less liabilities).

Method (or Methodology)– examples of methods are:

> **For the Income Approach:** capitalization of earnings; capitalization of excess earnings (i.e., after calculating a return on assets); discounted future earnings plus residual value.
>
> **For the Market Approach:** use of comparable public company data and of comparable merger and acquisition data.
>
> **For the Asset Approach:** establishment of fair market value or replacement value or liquidation value of the assets and liabilities.

Standard of Value - examples of this are fair market value (i.e., buyer and seller are willing parties, but are not being compelled to enter into the transaction and have "reasonable knowledge of the relevant facts," as paraphrased and quoted from IRS Revenue Ruling 59-60 and sections of the estate and gift tax regulations), fair value (which can have different meanings, depending on the jurisdiction or the parties involved), intrinsic value (usually means value to the holder), investment value (the value to a particular investor or a strategic buyer), forced liquidation value, voluntary (or orderly) liquidation value.

Premise of Value - there is some overlap in the meaning of this term with the term "standard of value" but, essentially, premise of value refers to whether the entity is to be valued on a going concern basis or a liquidation basis.

Capitalization and Discount Rates - these rates are used under the income approach and can be determined by various different means (a discussion about which is beyond the scope of this article).

A capitalization rate is applied to an earnings figure that is expected most likely to occur, i.e., a projected earnings amount for the following year that is indicative of the earnings for all future years. Depending on the circumstances, this projected earnings figure can be based on the average or weighted average of prior years' net income, pre-tax income, EBIT, EBITDA, cash flows or some other measurement of earnings. Of course, the historical data needs to be adjusted for any anomalies or anything else that is not recurring or representative of future events.

A discount rate is applied to the stream of future earnings for a specified number of years, and the sum of the present value of each year's discounted earnings is then added to the value of the business as of the end of the last year specified (i.e., terminal value). This terminal value is normally determined by applying a capitalization rate to the earnings in the final year and then discounting this capitalized earnings amount to present value.

A discount rate applied to a stream of future earnings inherently includes a growth rate and thus is higher than a capitalization rate applied to a projected earnings amount (unless there is negative growth, in which case the discount rate would be lower than the capitalization rate).

Lack of Marketability (Or Nonmarketability) Discount - the extent of the discount principally depends on the time it would take for the business or, more commonly, the business interest to become liquid to the seller, i.e., when cash from the sale is received.

Lack of Control Discount - applied when the ownership interest in the business is 50 percent or less. However, when a business interest being valued is less than 100 percent but 50 percent or greater, a discount may still be appropriate by virtue of having less than complete control. The lack of control, or non-controlling interest, discount is applied to the owner's pro rata portion of the total value of the entity. The amount of the discount is based on limitations associated with the business interest as a result of agreements, statutes, practicalities or other factors. This discount is applied before the marketability discount is applied, i.e., as if the minority interest were completely liquid.

Control Premium - this premium is generally applicable when an interest in a business being valued is or will become one of control or partial control (unless, as is sometimes the case, the value of the business is based on financial data that was already adjusted as if there had been a controlling interest).

In the process of determining how the above terms (and possibly others not mentioned here) might apply in a situation, the valuator needs to gather extensive information on the business or entity (both quantitative and qualitative), the industry in which it operates, economic conditions and other items that could have an impact on the value. This kind of information, along with knowledge obtained regarding the purpose(s) of the valuation and the parties involved, is assessed and analyzed in deciding the application of the various factors for determining value.

Sometimes the valuator is not able to obtain all the information necessary to arrive at a conclusion of value because of the unavailability of all necessary information or other limitations on the scope of the work performed. In such instances, the parties may accept (or must accept under the circumstances) either an estimate of value or a range of values, as long as the valuator is comfortable providing such qualified amounts based on the information obtained. In this regard, among the various organizations that establish reporting standards and terminology for credentialed valuators some differences exist in the way limited scope situations should be treated.

However, for the most part, these organizations, among themselves, have established very similar principles and practices for valuation engagements and the valuation process. The term "appraisal" as used in referring to the appraisal of business interests or other assets is often used interchangeably with the term "valuation." In some circles there are subtle differences between the terms, but for all intents and purposes they are synonymous, as are "appraiser" and "valuator."

III. Examples of Valuation Scenarios

To illustrate how the purpose of the valuation and intention of the parties have an effect on which of the above terms that might apply, please see the following examples:

A. Sales of Entire Businesses

A threshold question is whether the net assets or the capital stock, in the case of a corporation or another form of equity holding in the entity, is being

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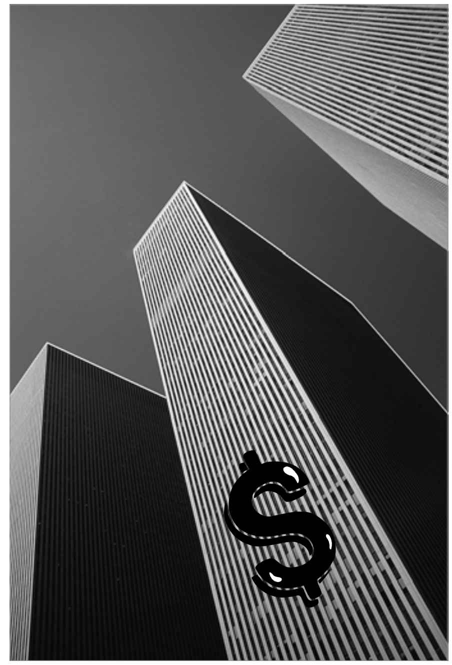
sold. Besides the possibility of actual liabilities being assumed in one instance and not in the other having a direct effect on value, there are other items impacting the value relating to a potential sale of a business, such as (1) the existence of contingent liabilities and possible unknown liabilities at the time of consummation (usually more so in stock sales, but will depend on indemnifications and the ability to enforce them), (2) the presence of simultaneous agreements, such as consulting contracts for management personnel expected to be retained after the sale, provisions for non-competition, and licensing arrangements, (3) if a company being sold is a corporation, whether it is a C or S corporation, and thus how are distributions to stockholders to be affected (4) whether the entity or the owners are subject to income taxes on earnings, e.g., determined by whether the company is a C corporation, S corporation, or partnership or limited liability company, and (5) the sales taxes and other transfer taxes that will be imposed.

Another issue that needs to be considered when establishing a value for a potential sale of a business is that often the buyer and seller and other parties involved may have presupposed that the sales/purchase price is to be based on fair market value or on some other standard of value. The term "fair market value" may suggest something different to the buyer than to the seller, so the party or parties for whom the valuation is being performed must be clear on the standard of value that is to be applied.

The definition of fair market value (FMV) is generally accepted as that which is a hypothetical value that is arrived at when the buyer and seller are willing parties, but are not being compelled to enter into the transaction and have "reasonable knowledge of the relevant facts." (Paraphrased and quoted from IRS Revenue Ruling 59-60 and sections of the estate and gift tax regulations.) In reality there are numerous possible scenarios to a sale, such as: a buyer may be looking for a strategic purchase and/or the seller may be looking for such a buyer who will pay a premium; the seller may be eager or forced to sell for some reason; the buyer may want to be very active in the business and have it as a means to provide a steady income in the form of compensation; or the buyer may want to be only a passive investor and is willing accept a steady but small rate of return.

Generally, when valuing a business for purposes of its being sold, the standard of value will be either FMV or investment value. FMV would be used, for example, when the seller has no particular preference as to a buyer and is not compelled to sell; an agreement calls for FMV; there needs only to be FMV as a starting point for negotiations (e.g., there may be compelling reasons to sell, the buyer might want to be active and might be looking for security); or the sale is to a related party, as the Internal Revenue Service requires FMV for income tax purposes (as well as for gift tax and estate tax reporting purposes). Investment value would normally be used when there is a possible synergistic buy/sell (although FMV could be a starting point) or when there is an investor looking for a particular rate of return.

The approach to be used when the standard is FMV will depend mainly on the purpose of the valuation and available data. Usually, the market approach is a primary consideration and should be used, at least as one of the approaches, but only if sufficient information about sales and/or values for comparable companies are available. For certain personal service businesses, and especially professional practices such as law, accounting and smaller medical practices, the market approach may not be a good indicator of value due to the shortage of sufficient market data. Also, this approach may not always be practicable for other privately held businesses, because the number of companies that are very similar to the business being valued might be insufficient so that producing



a meaningful comparison is not possible, or because important quantitative data about the companies are incomplete and/or information about relevant qualitative factors is lacking.

Generally, for privately held businesses, if the market approach is employable, it will be used in conjunction with the income approach, and the two approaches will be weighted (not necessarily equally) in arriving at the value. Even if comparable market data is relatively scarce, the market approach should be considered and, if at all possible, be given some weight or at least be used as a "sanity check" against the results arrived at in using the income approach. The asset approach may be used in conjunction with either or both the other two approaches. It is usually the sole approach used in situations such as when a business has a history of losses, or in a liquidation or in other piecemeal valuation situations. This is because the value of the net assets of the business would normally realize a greater fair market price than would the income stream (if any) of the business as a going concern.

As for the method applied, this will first depend on the approach that is used, as each approach has its own distinct available methods. For the income approach, the method will be determined based on the type of business being valued (e.g., service, manufacturing), its financial history, and various other influences. For the market approach, the data that is best available and most relevant is what should determine the method.

When valuing a start-up business or one whose major asset(s) is intellectual property, the method and other factors need to be considered very carefully. The valuator might be able to find other businesses or similar types of intellectual property, with historical data, having some characteristics similar to those expected of the subject business and/or might find justification for using an estimated future income stream for the subject business as a basis for the valuation. In most cases, however, the uncertainties are greater with start-ups and with virtually untested intellectual properties than with an established business or income stream. Accordingly, forecasts of expected income and other factors will need to be used as bases in arriving at a value.

B. Transfers of a Partial Interest in Businesses

When a partial interest in a business is being valued, such as for the purpose of a potential sale or gifting or estate tax reporting, lack of control and marketability discounts will normally be applied to the holder's portion (percentage) of the full value of the entire business. However, since a non-controlling interest holder is usually at the mercy of those in control, then applying a lack of control discount to the value of this interest, when it is based on expected cash flows (dictated by the owners who exercise influence), would normally be redundant and thus not indicated. The purpose of the valuation will determine whether: the method of applying a capitalization/discount rate to the expected cash flows attributable to the non-controlling interest should be used; whether the value of the entire business should be determined, and then a lack of control discount applied to the percentage interest in the business; or whether some other method is most appropriate. Another method, under the market approach, could be applied if there have been recent minority interest (or lack of control) transactions similar to the subject interest being valued, with the amounts from the similar transactions then used as the guideline.

In certain situations, there can be two or more tiers of lack of control discounts. Such situations are frequently seen in the gifting of partial interests in family limited partnerships or limited liability companies. An entity itself will own non-controlling interests in assets, which are discounted, and then the interest in the entity (with the value of its assets having been discounted) is further discounted for the fact that it is a non-controlling interest.

For lack of marketability discounts, and in many cases for lack of control discounts, there are various studies and other data that should be referred to and properly applied based on the specific set of circumstances of the partial interest being valued. Too often "rules-of-thumb" or data that are not complete are used or misapplied. A thorough analysis of all relevant information needs to be performed for arriving at appropriate and supportable discounts. In gift tax, estate tax and other tax cases, the tax court and appellate courts have recently been scrutinizing discounts more closely and are demanding that they are based on objective criteria.

C. Business Disputes and Litigation

In adversarial situations, there is often difficulty in obtaining all the information necessary to arrive at or opine to a value. When these conditions exist, there may be enough basic information to estimate a value, or to make assumptions under different likely scenarios that lead to a range of values.

Frequently, the nature of the dispute or litigation will determine the standard of value and other factors to be applied. In an action involving a damaged or dissenting stockholder, for example, each side could have different views on what should be the appropriate standard of value, approach, method, capitalization/discount rate, etc. If the action is brought under the statute of a state dealing with dissenting stockholder matters, the standard of value required is usually "fair value." This term "fair value" does not have the same meaning among different jurisdictions, and thus the valuator must have a clear understanding of how fair value is to be applied. In Nevada, fair value in connection with a dissenting stockholder's shares is defined in NRS 92A.320 as "the value of the shares immediately before the effectuation of the corporate action to which he objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion is inequitable." The problem with this definition is that, contained within it, there is the term "value," which is not defined. Conceivably, but highly unlikely, such a definition could mean that, if a company was earning large profits but never paid any distributions to its stockholders, a non-controlling interest would probably have a nominal if not a zero value.

When attempting to quantify economic damages from the loss of a company or a substantial reduction in the level of its business, one way the extent of the loss might be measured is by the diminution in value from the date immediately preceding the occurrence of the event to some specified date afterwards. (Clearly, this is only one way to measure the loss and, in many cases, not the preferable way.) Usually, for both valuation dates, FMV is used. However, arguably, a different standard of value (and other factors) might be considered more appropriate in the circumstances. For example, if an individual has owned a business that generated a relatively constant rate of return for many years, after his having drawn a "reasonable" salary, then the loss of the business to

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him might be based on what the business is worth to him (e.g., investment value), which is a steady rate of earnings using a low-risk capitalization rate. (The security of his receiving the consistent compensation from the business, his age and the likelihood of obtaining similar work elsewhere are some factors that would be used to assess damages in addition to the loss of the business.)

In marital dissolution matters, issues such as valuation dates, approach, and lack of control and non-marketability discounts greatly depend on the jurisdiction and the nature of the asset being valued. For example, in Nevada, the date of the valuation, generally, is as of the time close to the date of trial; discounts may or may not be appropriate for a business owned or controlled by one or both of the spouses. Also, in Nevada, as with many other states, if the income approach is used, the practice is that the earnings used in arriving at a value are not to be based on earnings projections.

IV. When to "Normalize" Financial Statements

As part of the process of performing a valuation for a business on a going concern basis, the earnings and other components of the financial statements are used as the basis for determining value. With the income approach, a capitalization/discount rate is applied to earnings, and such rate is arrived at, in part, by comparing elements of the financial statements and various financial ratios to corresponding data of other companies that are determined by the valuator to be comparable. With the market approach, the values and/or sales prices of other companies that are determined to be comparable to the subject business are used as the basis for its value. Usually, information on comparable companies is obtained from various sources that compile financial data by industry, SIC code, NAICS code or some other meaningful categorization.

Certain elements of the financial statements and other financial data of the subject business may not be considered "normal" for such a business, i.e., not equivalent to the corresponding financial information of comparable companies. The valuator needs to consider whether certain adjustments should be made to the subject business' financial statements so that they are stated on a basis equivalent to that of the comparable companies. An example of these types of items that may warrant adjustment are owner salaries and perquisites. Other such adjustments are usually more prevalent when the form of earnings used as a factor in determining value is something other than cash flows. In these situations (which can be under the income approach, and are most certainly under the market approach as discussed earlier), the adjustments usually are made for conforming the financial statement reporting to generally accepted accounting principles, or to account for unusual or nonrecurring transactions or events.

There are circumstances where adjustments are not made, even though they would be necessary to properly "normalize" the financial statements. For example, an adjustment would not be made for compensation where a minority interest is transferred, with the minority interest holder (and particularly the transferee) having a lack of control. Some other circumstances where adjustments, or certain adjustments, are not, or might not be, appropriate are when the standard of value is

investment value, the approach is the asset approach, or when the purpose for the valuation is for litigation, property settlement in a marital dissolution, and bankruptcy.

When determining the applicability of certain normalizing adjustments, particularly for owner salaries and perquisites, one needs to consider the implications of having reduced the expenses for these items vis-à-vis absentee owners or the IRS. Parties such as these who could gain access to the valuation documentation might draw inferences that the expenses actually incurred were excessive. Of course, the fact that certain expenses were reduced for the purpose of preparing a valuation does not automatically mean that owner compensation or other expenses were excessive. Also, inferences should not be drawn that the adjustments for reducing expenses were made to increase earnings and thus (artificially) augment the value. There are many valid reasons for expenses to be normalized for valuation purposes. For example, in the case where actual owner compensation has been reduced for the normalized financial statements, the owner may have been performing various functions for many years and to replace him with other newly hired personnel would cost less; may have special skills or personal customer relationships and, if there were a sale, would be retained on a consulting basis at a much reduced compensation amount, which, when added to a replacement's compensation, would be less than the owner's current compensation; or, may have taken insufficient compensation in prior years to preserve the company's working capital and thus his compensation in recent years included the shortfall. The parties involved in the valuation need to make certain they not only allow for the appropriate normalization adjustments but also can support them.

V. Conclusion

Whether the need arises to arrive at a value for a business agreement or transaction, a litigation or family law matter, or estate planning or estate reporting purposes, the parties involved should make every effort, to the extent possible and practicable, to work together in providing and seeking all relevant documents and other information. The valuator's job is to ask questions and request documentation that are germane and thus, with the cooperation of all involved, a comfort level can usually be achieved to enable the valuator to opine to and/or arrive at a conclusion of value. Also, the smoother the process, the less the fees will be of all the professionals involved.

When a determination is made that a business valuation is necessary, you and your clients need to keep in mind that, unless a thorough job can be done, the value arrived at will probably not stand up to a potential challenge. As a result, when, for example, the purpose of the valuation is related to some sort of business agreement or a transaction, inequities will inevitably occur, which can lead to disputes and litigation. When an inadequately arrived at value is introduced in a business litigation matter, an unfavorable outcome of the case might be the result. Certainly, in estate planning and estate tax reporting situations, if values are disputed by the IRS, an inadequate or unsupportable valuation could lead to a hefty tax bill that the client never expected. Frequently, you are in a position to make certain that the valuator will be provided enough lead time to gather together and analyze all necessary documents and other information in order that the valuation can be done properly.

In addition to your assistance with the promoting of dialogue among the parties involved and encouraging their participation in the valuation process, you can assume a role in educating your client on the importance of a presentable valuation in the legal matter for which you are representing him or her.

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Nev. Fam. L. Rep., Vol. 20, No. 4, Fall 2007, at 10.

WHAT STANDARDS OF VALUE APPLY IN BUSINESS VALUATIONS?

Fair Market or Marital Value and the Question of Discounts When the Close-Held Business Is Not Sold

By Bob Cerceo, Esq.

"I should say something. The Judge and opposing counsel are staring at me and my client just winked at me like I know something. But, that look on my face is really just indigestion from lunch. I wish I knew what they were talking about . . . " This does not have to be you. Following up *Business Valuation Approaches and Methods Boiled Down - The Basics*, Nev. Fam. L. Rep. Vol. 20, No. 1, 2007 at 10,we left off at Standard of Value and the question of Applicable Discounts.[1]

At its core, whether it is referred to as fair value,[2] marital value, investment value,[3] value to the holder,[4] or a like term, in a divorce case when there will not be a sale of the business after the Decree is entered, discounts are suspect and a hot topic for review. The business continues unchanged for the owner-spouse (the party in keeping the business). The basis of value for divorce purposes is, in reality, the value to the marital community in the hands of the owner-spouse under the circumstances existing at the time of the valuation date.

Discounts are relevant only if the business is being sold. If the owner-spouse retains possession of the business, then imposing a discount allows the owner-spouse to take the business at a lower value without paying for the benefit - it is a windfall. This flies in the face of the definition of fair market value, as defined by the ASA, "The amount at which property would change hands between a willing seller and a willing buyer when neither is

(cont'd. on page 18)

STANDARDS OF VALUE:
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acting under compulsion and when both have reasonable knowledge of the relevant facts." *See* Pratt at 28.

In a normal arms-length transaction for the sale of a close held company, there is an actual buyer and an actual seller, and each will take the necessary steps to transition the business, *e.g.*, meeting clients with a "Joe is a good guy"-styled introduction, or extending the original owner as an employee for a year, or more. In a divorce, there is no buyer requiring a transition of knowledge or ramp up period, therefore, applying a discount to fictionally acquire knowledge, like a key man discount, is an unnecessary step. The business simply continues its *status quo* operations.

A key man discount "quantifies" the impact to the value of the business as though the key man is not going to be involved in the business after the divorce. It is not just a question of owner-spouse's fictional unavailability, but how customers will respond to the business if the owner-spouse is no longer involved, how suppliers react or extend credit, who calls to collect accounts receivables, loyalty of the work force, etc. In assessing the key man discount, the Court needs to ask "What does the key man really do?" And if that does not change after entry of the Decree, then there should be no reduction in value. Specific questions to assess the validity of a fictional key man discount include, in part: Will owner-spouse still be the "Boss?" Will owner-spouse still place bids for contracts? Will owner-spouse still hire and fire employees and manage the business? Will owner-spouse still be known to the business community? Will owner-spouse still decide on the number of managers, type of crews to perform work, amount and types of equipment used, and all other facets of the business? In short, if nothing about the business changes after the divorce, the fiction of a key man discount is defeated.

Although Nevada does not have a statute for which "value" to apply, fair market or marital, California takes the position that the standard of value should be the "investment value," rather than fair market value, and investment value is the "value to a particular buyer or seller." In a divorce case, the specific buyer is the owner-spouse. Family Law Act, Civ. Code, §4800, Pratt at 834, 835. Under California case law, this results in the use of the higher of fair market value or investment value, a principle of not penalizing the outgoing spouse for a *status quo* continuation of the business. *In re Marriage of Foster*, 42 Cal. App. 3d 577, 117 Cal. Rptr. 49 (1974), *In re Marriage of Hewitson*, 142 Cal. App. 3d 874, 887, 191 Cal. Rptr. 392 (1983), and *Ronald v. 4C's Electronic Packaging, Inc.*, 168 Cal. App. 3d 290, 298, 214 Cal. Rptr. 225 (1985).

Case law in other sister states eliminates discounts for lack of control and lack of marketability. For example, the Louisiana approach (a community property state) eliminates discounts for lack of marketability where a sale of the business is not contemplated. The value of the stock must be determined without discounts. *See Mexic v. Mexic,* 577 So. 2d. 1046, 1050 (La. App. 4th Cir. 1991). Many other cases can be cited rejecting a discount for lack of marketability. Pratt at 847. "Close corporations by their nature have less value to outsiders, but at the same time their value may be even greater to other shareholders who want to keep the business in the form of a close corporation." *Brown v. Brown*, 348 N.J. Super. 466 (App. Div. 2002).

The principle to be drawn from the cases on discounts (whether it is a key man discount, lack of marketability, lack of control, or otherwise), is that without an actual sale of the business, the business continues as a going concern unchanged for the owner-spouse, and the basis of value for divorce purposes is the value to the marital community in the hands of the owner-spouse under the circumstances existing at the time of the valuation date.

Exceptions exist and there will be instances when applying discounts is appropriate. Get friendly with your expert and ask questions. Now the look on your face when everyone is staring can be one of a wise and learned counsel, and not just the indigestion from lunch.

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FOOTNOTES:

1 As mentioned before, it is widely acknowledged that one of the leading authorities on business valuation is Dr. Shannon P. Pratt, and his most recent authoritative text on the subject is *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, Fourth Ed., Shannon P. Pratt, Robert F. Reilly and Robert P. Schweihs, McGraw Hill (2000), ISBN 0-07-135615-0. A condensed "handbook" style overview is published by the American Bar Association, the *Lawyer's Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony,* Shannon P. Pratt ABA Section of Family law (2000), ISBN 1-57073-829-7.

2 "Fair Value is not the same as, or shorthand for, 'fair market value.' 'Fair Value' carries with it statutory purpose that shareholders be fairly compensated, which may not equate with the market's judgment about the stock's value." *Brown v. Brown*, 348 N.J. Super. 466 (App. Div. 2002).

3 "The specific value of an investment to a particular investor or class of investors, based on individual investment requirements; distinguished from market value, which is impersonal." The Dictionary of Real Estate Appraisal, 3rd ed. (Chicago Appraisal Institute, 1193) pg. 190. In other words, it is the value to a specific buyer (a subjective consideration), not a hypothetical buyer (an objective consideration).

4 What the investment is worth to one of the marital litigants as opposed to the general population of fair market value buyers.

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Nev. Fam. L. Rep., Vol. 20, No. 3, Summer 2007, at 5.

WHAT FINANCIAL EXPERTS EXPECT FROM ATTORNEYS

by Richard M. Teichner, CPA/ABV, CVA, CDFA™

Numerous articles have been written for CPAs and other financial specialists rendering advice about what is expected of them when they provide litigation consulting services and expert witness testimony. Also, I have seen articles for attorneys on what they should consider in selecting an expert. However, I have not seen any articles about an expert's expectations of attorneys (although I cannot say for certain that no such articles exist). Therefore, I wanted to at least express my views on what I believe financial experts and forensic accountants expect of litigators, including family law attorneys, of course (and what experts in other fields most likely expect as well), which I have attempted to do in this article.

In the articles that I have seen directed at financial experts and forensic accountants, there have been some common themes. For example, for trial testimony, we are told that, besides needing to remain composed during the rigors of cross-examination, we are to be well prepared; have a supportable basis for our conclusions or opinions (cases such as *Daubert* and *Kumho Tire Co.*); be completely truthful; do not guess; maintain independence and objectivity - not be an advocate for the client; be clear and concise; use visual aids when possible; use analogies to explain complex concepts; frequently look at the trier(s) of fact when responding to questions; admit when we have made a mistake; try to anticipate opposing counsel's questions before trial; pause before answering so that we can formulate our response, and so that, when questions are coming from opposing counsel, our client's counsel can have time to object.

The discussion below probably does not contain anything that is especially new or revealing to an attorney whose practice includes litigation, but at least some of the points revisited may serve to heighten his/her awareness of what is already known from experience and study. Furthermore, probably as to most of these points, the attorney might want to use them to express what he/she expects of the expert. So, in situations where the roles could be reversed, the attorney might say to the expert, "Make sure that you . . . " or "Make sure that you remind me to . . . "

The expectations that I believe an expert has of an attorney are relatively simple and straightforward. Certainly, some of the expectations differ when the expert is engaged by the attorney as a consultant rather than as someone who is expected to testify. In either event, the expert does not welcome being contacted about a matter within only a few days before a conclusion or opinion is needed. Virtually all experts, at one time or another, have received an initial call from an attorney who says, "The trial is next week and I need you to testify" (although this has been thwarted in many jurisdictions), or "I need to designate an expert by noon tomorrow." Obviously, the lead time given to the expert depends on the nature and complexity of the case, but there must be enough leeway for the expert to be able to assess and analyze all pertinent documentation, and then arrive at a conclusion or opinion that is supportable and will withstand challenges. What if the attorney waits until close to the last minute, and the circumstances are such that the expert is in fact able to arrive at a conclusion, which happens to be unfavorable to the case? The attorney may then first realize that the chances of "winning" the case are poor and, if so, the client has been done a great disservice.

In situations where the expert is going to testify, the attorney should not withhold any information that is relevant to any part of the case that could possibly affect the expert's conclusions. The more the expert knows about the entire case, the more reliable the work product will be and the better he or she will be prepared for any contingencies at deposition or trial. When the expert is engaged as a consultant, the attorney may not want to reveal certain aspects of the case, which is generally not an issue from the expert's perspective. However, the attorney must realize that the conclusions of that expert could very well be different (and more favorable) than from the conclusions of the expert who may later be designated as a witness, as he or she will undoubtedly have obtained more information from which to formulate conclusions and opinions.

Testifying experts need to become familiar with the evidentiary and procedural rules to which they will be subject. In non-Federal cases, experts should be informed about the rules of the jurisdiction in which they will be testifying and to what extent, if any, the courts follow or parallel Federal Rules of Evidence and cases such as *Daubert* and *Kumho Tire Co.*, referred to above. (Some states may still follow the likes of *Frye*). Also, the expert needs to know what documents are discoverable (e.g., preliminary drafts of schedules or reports, emails, handwritten or electronically produced notes) and what may be considered spoliation of evidence, see *Trigon Insurance Co. v. United States*. Some other particulars that the expert needs to or should know are the cut-off date

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FINANCIAL EXPERTS: *cont'd. from page 19*

for discovery, opposing counsel's background and courtroom methods, the jury instructions relative to testimony, the make-up of the jury and how the judge normally runs his courtroom.

Of course the expert should take the initiative to ask the attorney or otherwise learn about many issues mentioned in the preceding paragraph. However, there are certain specifics and legal issues about which the expert will not be aware or that are best interpreted and imparted by the attorney. Thus, the attorney should ascertain that the expert is informed about these issues.

Also, as alluded above, the attorney needs to keep the expert informed about all the aspects of the case that in any way could be germane to the expert's work product, opinions or testimony. Ongoing communication is very important. The attorney and the expert each need to let the other know the weak points as well as the strong points of the case. Strategizing together can benefit everyone. The attorney, however, must not lose sight of the fact that the opinions of the expert are his or her own, and that expert is an advocate of such opinions and not an advocate for the litigant.

Allowing the expert to review and comment on an opposing expert's report is almost always essential. Also, whenever appropriate and possible, the expert should be asked to sit in on the opposing expert's (and often on other witnesses') testimony at deposition and at trial. When indicated, the attorney should seek the expert's assistance in formulating deposition and trial questions, interrogatories and requests for production of documents for the opposing parties and witnesses. Experts who testify expect the attorney to prepare them for trial, and this includes going over questions that will be asked on direct examination. Many of these questions should be prepared jointly by the attorney and expert.

Lastly, when you determine that a matter warrants having an expert (or consultant), please communicate the reasons for your decision or recommendation so that the client understands the importance of the expert's role in the case. With this understanding, given the expert's function, the client will be inclined to be more receptive to the need for the expert. Also, if the client recognizes the value of the expert's role, then the client will normally be more accepting of the fees charged by the expert. An important point in this regard is that an expert who is owed a considerable amount of unpaid fees may have to overcome the burden of being perceived as an advocate for the client or for the case. This expert may very well be subject to rigorous questioning by opposing counsel in an attempt to convince the trier of fact that the expert is not independent and cannot be objective, as the payment of his/her fees could depend on the outcome of the trial.

The bottom line is that attorneys and experts work most effectively together and best serve the client when each knows and is willing to regard the other's expectations.

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