

# **BUSINESS VALUATION IN A TEXAS DIVORCE - 2024**

**by Greg Enos**

Some divorces present the challenge of determining the fair market value of a closely held business owned in whole or in part by one or both spouses. A “closely held” corporation is a company whose shares are not publicly traded. Apple, Inc is a publicly traded company. The stock markets set the price for publicly traded corporations. However, for smaller, closely held businesses, an accountant trained in valuing businesses must apply the somewhat vague and uncertain art of the business appraisal. There are several generally accepted methods for placing a value on a business; however, ten “experts” valuing the same company might come up with ten different values and they might use different methods for determining the value.

Valuation has been described as a "study of competing approaches that lead to inconsistent results and of estimates and approximations based on incomplete and sometimes unreliable information." Hamilton, *Fundamentals of Modern Business: A Lawyer's Guide*, p. 354.

In divorces, lawyers, accountants and judges “pretend” that a business will be sold under certain conditions and then try to determine what that sales price would be. Usually, the spouse who runs a business thinks it is valued too high in a divorce and the other spouse often feels the business has not been valued high enough. The truth is that the business will not really be sold and no one will ever really know how much the business could have been sold for.

This article examines how businesses are valued in divorces in Texas. An excellent, more detailed article on this subject written by Aaron Ballard, CPA/ABV is “Business Valuation Disputes: Understanding Differences and Attacking Weaknesses” presented at the State Bar of Texas 2023 Marriage Dissolution Institute.

## **Business Valuation In a Nutshell**

All of the topics in this summary as covered in detail in the paper below.

The easiest way to explain the business valuation process in a divorce is to consider what a reasonable person would do if they were thinking about buying a business. The prospective buyer would want complete and accurate financial records and tax returns on the company. People buy businesses in order to earn income, so it would be vital to accurately determine how much income the business has made and is likely to generate in the future. If the business is paying for the owner’s lawn service and has the owner’s college age son on the payroll even though he does not really work there, that would need to be added to the real income the company generates. Some business owners claim business deductions that really cannot stand up to scrutiny, and so the books must be reviewed and “normalized” to be realistic and fair. A lot of information would be needed about the company, its industry, its competition, its future plans and challenges. A prospective buyer would meet with the owner and the top management team and ask a lot of questions. Buy-Sell agreements and shareholder or partnership agreements that are in place would need to be reviewed to determine if they control or effect how much the sales price would be and whether other co-owners have the right of first refusal before a sale. Lastly, the value of the business would be less if the current owner who is selling is free to compete after the sale and if he or she

brings in a lot of business for the company. Likewise, the value would be decreased if the seller owns less than a majority of the company or the company is not the type that is easily bought or sold.

An accountant with special training and certification in business valuation is usually hired to be an expert witness in a divorce involving a business owned by one or both of the spouses in a divorce. A spouse who is a business owner can testify about the value of the business, but judges are more likely to believe a trained expert over a biased spouse. A business valuation can cost \$7,500 to well over \$100,000, depending on the reputation and charges of the expert and the size and complexity of the business. Sometimes, there are competing experts hired by each spouse who issue reports, run up charges, attend mediation, and testify in depositions or at trial. The process of getting all of the required financial documents to the expert can be time consuming and expensive.

In a Texas divorce, the question to be answered is what is the fair market value of the business? "Fair market value" means the amount that would be paid in cash by a willing buyer who desires to buy, but is not required to buy, to a willing seller who desires to sell, but is under no necessity of selling. *Wendlandt v. Wendlandt*, 596 S.W.2d 323, 325 (Tex. Civ. App. \_Houston [1<sup>st</sup> Dist.] 1980, no writ).

Basic rules of business valuation in a Texas divorce include:

- Do not include the value of personal goodwill but do include the business goodwill. If Sally is selling her business that restores and customizes classic cars, her personal reputation and business connections will go away if she sells and leaves the company. So, the value of the business Sally is selling is discounted because of her personal goodwill. On the other hand, if Juan owns a chain of nine nail salons called "Gulf Coast Classic Nails," there is probably plenty of business goodwill but little personal goodwill because customers do not come to the salons because of Juan personally.
- The value of the business is discounted if the spouse owns less than a majority interest in the company.
- The value of the business is reduced if it is the sort of business that is hard to sell (this is called "lack of marketability").
- A buy-sell agreement may reduce the value of the business if an existing agreement controls what happens in a divorce (especially if the other spouse has signed the agreement).
- The business valuator must determine if the business owner is free to compete if he or she sells the business. The existence of a non-compete agreement should be taken into account because that is what would happen in the real world if the business were sold. However, it seems that if there is no existing non-compete agreement, the business valuator assumes the selling owner could open a competing business down the street (this is basically the personal goodwill discount described above).

The four approaches to valuing a business are:

- **Income Approach** – A prospective buyer wants to know how much income will be derived from buying the business. This approach involves examining the company’s historical income and cash flow, “normalizing” the financial records to reflect proper accounting and adjust for things such as paying the owner’s personal expenses from the business, considering the risks and future competitive environment the company faces, and calculating a present value of projected cash flows.
- **Market Approach** – This approach analyzes sales of comparable businesses, adjusts for differences between the subject business and the comparable businesses, calculates valuation “multiples” used in the comparable sales and apply those to the company’s normalized financial metrics. Some sorts of businesses often are bought and sold, such as dental practices or Subway sandwich franchises and there is available comparable data to use. Many businesses however are the sort that are not commonly bought or sold and often there is not easily available data on those sales that do occur. If a divorce involves a dental practice for example, an expert who regularly consults on the sale and purchase of dental practices might be the best sort of expert to use in a divorce.
- **Asset Approach** – Almost all companies are worth more than their book value. Calculating a value on a company’s assets less liabilities might be of some value if the company is a holding company or only owns land (e.g. – a ranch or six rent houses). This approach may provide a basic floor for a company’s value, but it is seldom used in divorce cases. If the company owns a warehouse on three acres as its only asset, a commercial real estate appraiser may be of more use than a business valuator.
- **The Excess Earnings Method** is very commonly used to value small businesses and professional practices. Based on the 1968 IRS Revenue Ruling 68-609, this method is an income and asset-based method. This method determines an appropriate rate of return for the business' tangible assets, then subtracts that return from the business' historical earnings stream. The remainder is deemed "excess earnings." These excess earnings are "capitalized," then the value of such capitalized earnings are added to the value of the business' tangible assets to arrive at fair market value.

All of these topics are described in detail below.

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## How the Valuation Process Drives Business Owners Crazy

Most of the hassle and stress of valuing a business in a divorce case falls on the spouse who owns and operates the business. Business owners often complain about:

- The cost of the valuation, especially if two experts are involved;
- How long the process can take – 2 – 10 months is common;
- The burden of producing so many documents and information and the need to constantly update what has already been provided;
- Concerns about providing confidential data and worries that business partners will not understand why company financial reports are being shared;
- The expert seemingly not understanding the business, the industry, the competition, and the legal/regulatory issues facing the business;
- The incredible high value the expert places on the business (“there is no way I can sell my share of this business for that much!!!!”); and
- For some business owners, the very uncomfortable process of letting outsiders see how the accounting is done, what costs and purchases are called business expenses when they are clearly for personal reasons, and how potentially past tax returns may not be accurate. Small business owners really face little scrutiny over their accounting and the changes of an IRS audit for most are less than the odds of getting struck by lightning. So, a nosy accountant hired by a spouse asking questions about the fishing boat owned by the company, those household bills paid by the business, or that girlfriend being paid as a consultant can make the business owner very nervous.

These issues can be addressed by a variety of measures, including:

- The client who is the business owner must be educated about the business valuation process and the essential need to timely provide financial information. Start by reading this article!
- The lawyers can agree in writing on a valuation date to use in the divorce.
- The parties can agree on one expert to value the business.
- A confidentiality order can be entered which protects the documents and information being produced. **A sample confidentiality agreement is attached to this article as Appendix A.**
- The business owner and his lawyer can spend time organizing and documenting a presentation for the business valuator on the history of the business, the details of how it gets business and how it cooperates, and the challenges facing the business in the future. The more the expert understands about the business, the better.

## **What the Business Valuator Does**

The business valuator, once his or her contract is signed and a retainer is paid, begins work by sending a questionnaire about the company and a long list of documents and information needed. The expert charges by the hour just like the lawyer does. The expert gathers documents, conducts interviews of the business owner and management, asks for more documents and gets even more questions answered. Then, the valuator does research into the industry and perhaps comparable sales, does a lot of calculations and prepares a report. The client and lawyer may suggest changes, clarifications or additions to the report and then the report is shared with the other side in the divorce. The expert may be questioned at a deposition by the opposing lawyer. Often, the other side's expert goes through the same process and issues a competing report. Usually, a rebuttal report is issued to address points raised in the other expert's report. The experts may attend mediation and, if the case does not settle, must prepare for court and attend trial. Divorce litigation can take a long time and if trial is long after the valuator's report was prepared, a supplemental report may have to be issued based on updated financial documents.

## **How the Value of Business Effects the Overall Property Division**

A judge (or sometimes a jury) in a divorce case will decide the fair market value of the business and other community property assets and debts. Then, the judge decides what a "fair and just" division of the community property would be.

Once, the value of the business is determined, the judge has these options:

- Award the business to one spouse and consider the value in the overall property division. This is possible if there are enough other assets to offset the value of the business. If for example, the business is worth \$200,000, but there is \$300,000 in a brokerage account, there should be plenty of cash to give the other spouse enough money to still arrive at an overall 50-50 or 60-40 property division.
- Award a money judgment. *Hanson v. Hanson*, 672 S.W.2d 274, 278 (Tex. App. – Houston [14<sup>th</sup> Dist.] 1984, writ dismissed). A money judgment is usually secured with a lien and can also be secured with a promissory note. For example, if a dentist is awarded her dental practice, her husband might be awarded a judgment against her for \$170,000 secured by a lien on the practice and the building the dentist owns and secured by a promissory note calling for \$3,600 a month payments with interest. A money judgment is usually done when there is not enough other assets to award the other spouse which will offset the value of the business. The monthly payments made by the spouse who is awarded the business are not tax deductible alimony because they are made as part of the property division.
- Split ownership of the business to each spouse. As a practical matter, this almost never happens because most judges assume that if spouses are getting a divorce, they are unlikely to be able to work together as co-owners of a business. However, spouses who are amicable in their divorce and who still get along sometimes agree to continue to co-own a business. In *Braswell v. Braswell*, 476 S.W.2d 444, 445 (Tex. App. – Waco 1972, writ dismissed), the husband

ran a motor freight company and the community estate owned 99% of the shares of the closely held company. At trial, the jury valued the shares at \$9,439,740. The judge awarded properties to Mrs. Braswell of the total value of \$696,400 (including \$613,400 cash), plus one-half of their shares of the stock of the corporation and he awarded the husband half of the shares. On appeal, the wife complained that:

*...trial court abused its discretion by dividing in kind the shares of stock owned by the parties, rather than ordering a sale of the stock and an equal division of the proceeds.*

*In support of her cross point Mrs. Braswell argues, primarily, that Mr. Jones [the employee who owned 1% of the shares] is dominated by Mr. Braswell and will always vote his 38 shares with Mr. Braswell; that she is thereby 'locked in' as a minority stockholder; that no cash dividends have been paid by the corporation since 1951, and she cannot, therefore, anticipate any future income from her 'stock investment'; that she is 'unable to liquidate her minority interest'; that she is 'subject to the whim and caprice of an obviously disgruntled ex-husband who refuses to sell the business yet possesses the control to operate it for his own benefit'; and that she is 'the unwilling victim of lack of adequate management.*

The Court of Appeals rejected the wife's arguments and stated:

*We do not believe these facts raise a presumption that the corporation acting through its dominant officer and stockholders will not now regularly declare and pay reasonable dividends. If they should improperly refuse to do so, then any minority stockholder has his or her legal remedy.*

*The trial court has the duty to determine if the community property is subject to partition in kind. If he determines that it is then he shall equitably divide the community property between the parties. If it is not subject to partition in kind the trial court can appoint a receiver and order so much of the property as is incapable of partition to be sold.*

476 S.W.2d at 477.

- A divorce court can in theory order that a business be sold and the proceeds divided between the parties. This is called partition by sale as opposed to partition in kind. Partition in kind in a divorce means the property is awarded all to one spouse or the other or physically divided. *Forgason v. Forgason*, 911 S.W.2d 893, 896 (Tex. App. - Amarillo 1995, writ denied). This is what the Austin Court of Appeals has said about partition by sale:

*The law favors partition in kind over partition by sale. But partition in kind is only proper if the property is "susceptible of a fair and equitable division." A party seeking partition by sale must show that partition in kind is impractical or unfair. A party is not required to show that partition in kind is physically impossible, but that partition by sale would best serve the parties' interest and restore or preserve the maximum value of the property.*

*Hopkins v. Hopkins*, 03-03-00629-CV (Tex. App. - Austin 4/27/2006, pet. denied)(mem. op.)(citations omitted).

Partition by sale of a closely held business in a divorce is theoretically possible but it is extremely rare and it is hard to imagine a circumstance when ownership of the business could not be divided or awarded 100% to one of the spouses.

It is necessary to determine the value of the business in order to award the business to one spouse and compensate the other spouse with either a large share of the community property or a money judgment (the two options that occur in the vast majority of divorces involving ownership of a closely held business).

### **A Business Owner Can Testify About the Value of the Business**

A business owner, including a shareholder of a closely held corporation, can testify as to the company's value and does not have to be designated as an expert witness.

*Red Sea Gaming, Inc. v. Block Investments (Nevada) Co.*, 338 S.W.3d 562 (Tex. App. - El Paso 2010, pet. denied) is an opinion by Justice Anne McClure, which mostly quotes cases from the Houston 14th Court of Appeals and states in part:

*A property owner is qualified to testify to the market value of his property. The testimony must indicate that the owner's assessment is based on the market and not on the intrinsic value of the property to him. Most recently, the 14th Court of Appeals concluded that the property owner rule applies to corporate entities owning property and that a representative of the corporate owner who is familiar with the market value of the property in question may testify under this rule as to the market value of the property, without being designated as an expert witness. That court has also held that the sole shareholder and president of a closely held corporation can testify as to the value of property of a corporation.*

....

*Here, Papachado [a shareholder in the corporation] testified as a lay witness, not as an expert. His testimony was rationally based upon his perception of the partnership's market value and was helpful to a determination of a fact issue. See TEX.R.EVID. 701. We thus disagree with Block's reliance upon Collins [v. Collins], 904 S.W.2d 792 (Tex.App.- Houston [1st Dist.] 1995, writ denied), in which the court focused on expert opinion testimony. Papachado was not required to be designated as an expert in order to give lay opinion testimony of value. We find no error in the admission of his opinions. (Citations omitted).*

*Natural Gas Pipeline Co. of America v. Justiss*, 397 S.W.3d 150 (Tex. 2012), was a nuisance suit for damages, not a divorce. However, the rule articulated by the Texas Supreme Court should apply in divorce cases when a spouse testifies what the family business is valued at. In such a situation, the spouse must also explain what that opinion is based on.

The Supreme Court stated:

*Because property owner testimony is the functional equivalent of expert testimony, it must be judged by the same standards. Thus, as with expert testimony, property valuations may not be*

*based solely on a property owner's ipse dixit [bare assertion]. An owner may not simply echo the phrase "market value" and state a number to substantiate his diminished value claim; he must provide the factual basis on which his opinion rests. This burden is not onerous, particularly in light of the resources available today. Evidence of price paid, nearby sales, tax valuations, appraisals, online resources, and any other relevant factors may be offered to support the claim. But the valuation must be substantiated; a naked assertion of "market value" is not enough. Of course, the owner's testimony may be challenged on cross-examination or refuted with independent evidence. But even if unchallenged, the testimony must support a verdict, and conclusory or speculative statements do not.*

The Houston First Court of Appeals further explained the limitations imposed on an owner testifying about the value of his or her company:

*An owner's testimony about market value is, however, subject to some limitations.*

*One limitation is that the owner-witness must testify about the property's market value, not some other valuation method.*

*Another limitation is that the owner-witness must present evidence of their "personal familiarity with both the property and its value." This is because the Property Owner Rule "falls within the ambit of Rule 701" and therefore is based on the presumption that property owners ordinarily have personal knowledge of their property and its market value. In other words, the rule is premised on the assumption that property owners will "have a sound basis for testifying as to its value." While the Property Owner Rule permits either spouse to opine on the value of a community asset, the rule applies only if the owner demonstrates familiarity with both the asset and its market value. A property owner demonstrates the requisite qualifications to testify as to a property's value if the owner's testimony includes factors relevant to the market value, versus what might be better considered intrinsic or personal value.*

*If the property owner cannot satisfy these requirements, the owner's opinion on the asset's value is conclusory and no evidence.*

*Mathis v. Mathis*, No. 01-17-00449-CV, 2018 WL 6613864, at \*4 (Tex. App.—Houston [1st Dist.] Dec. 18, 2018, no pet.) (mem. op.) (citations omitted).

Thus, the spouse who testifies his auto repair business is worth \$200,000 should base his opinion on what he could sell the company for (market value) and he should be asked what that opinion is based on and he should say he checked with a business broker, his banker and owners of several other similar businesses. The spouse cannot simply just say his business is worth \$200,000 without an explanation.

## **A Company Is Almost Always Worth More Than Book Value**

Book value carries very little weight in determining the present value of closely held corporate stock. The Texas Supreme Court has stated, "Book value is entitled to little, if any, weight in determining the value of corporate stock, and many other factors must be taken into consideration..." *Bendalin v. Delgado*, 406 S.W.2d 897, 900 (Tex. 1966). In *Chaffe v. Murray*, 492 S.W.2d 680, 685 (Tex. Civ. App. – Corpus Christi 1983, writ ref'd n.r.e.), the court stated that book value should rarely, if ever, be used to value a company.

Adjusted book value is a better indicator of a company's real worth. The tangible assets of a business are appraised and reflected at market value, then the business' liabilities are subtracted to arrive at adjusted book value. Despite this adjustment to book value, adjusted book value still reflects a relatively low value for a business interest. A typical service-oriented business has a low adjusted book value because tangible assets are usually insignificant. The value of such a business is in its earning capacity which is not an element of adjusted book value.

## **Documents and Information the Appraiser Needs**

If you were thinking of buying a business, there would be basic information and documentation that you, your accountant and your banker would require before making a decision on how much to offer for the businesses. Those same items are needed to value a business in a divorce:

1. A detailed description of the business: its history, what the business does, its market, its competitors, its key employees, customers and suppliers
2. Balance sheet for each quarter for the past three to five years (depending on how long the company has been in existence)
3. Income statements (profit and loss reports) for each quarter for the past three to five years (depending on how long the company has been in existence)
4. Company tax returns for the last 5 years
5. Discussion of any IRS scrutiny or audits of the company and the results of those audits
6. Detailed general ledger report for the current and prior year
7. Financial forecasts, if available
8. The company's legal type and ownership structure, including owners and percentages of ownership
9. Important contracts binding the company or owners, such as franchise agreements or buy-sell agreements between the owners
10. Information on recent sales of ownership interest in the company

11. If a professional license is required to own or work in the business
12. All pending litigation and claims by or against the company
13. Current monthly payroll data - number of employees and their functions
14. Information on how many hours the business owner who is selling works on the company, his or her pay, whether his or her personal expenses are being paid through the company and what benefits he or she receives from the company (e.g. - company car, health insurance, etc.)
15. A summary of product inventory amounts for each product (from physical inventory) for the past three years
16. Payment history of customers, including an accounts receivable aging report, for the past three years
17. Information on employee benefit plans and costs
18. Information on contracts with top executives and managers
19. Information on obligations for retirement plans, profit sharing, stock options and bonuses
20. Listing of all intellectual property - patents, copyrights, trademarks/service marks - and all license agreements
21. A listing of all business advisers - attorney, CPA, consultants and any contracts or retainers.

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

**Practice Tip: if you represent the spouse who does not control or run the business, subpoena loan applications and loan renewal applications for the business and the business owner from the bank. Business owners almost always place a high value on their business when they apply for loans, just as they usually try to put a low value on their companies when they find themselves in a divorce. In my experience, the business owner will seldom produce such documents in discovery, so it is best to go directly to the bank with a request for production to a non-party and a subpoena duces tecum.**

Often, the business appraiser will want to visit the business and meet with the business owner and management. These management interviews are very important to the valuation process. The business owners needs to cooperate in scheduling and attending these interviews, but a lawyer

needs to be present and the owner needs to meet with his or her attorney to prepare for these meetings.

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

### **The Management Interview**

A very important step in the business valuation process involves the valuator interviewing the spouse who owns the business and also possibly other co-owners and top management of the company. A prospective buyer of a business would insist on doing the same thing. There is a lot of information about a business that is obtained via these interviews because financial reports, while important, do not tell the entire story. The business owner (and her partners and employees) need to be prepared for this interview and the spouse's attorney should be present. Usually, these interviews are recorded. **Appendix B to this agreement lists some of the topics usually covered at these management interviews.** Many valutors want to visit the business and see it for themselves. It is important that the business owner cooperate in scheduling and participating in the interview and the on-site business visit, if that is requested.

### **Primary Areas of Dispute in Business Valuation**

Reasonable experts may provide values for a business that vary by up to 20%. Experts may differ in the values they place on the same business because of:

- Valuation date - Is Expert A valuing the company as of 9/30/24 and Expert B as of 12/31/23?
- Application of expert judgment on discounts – the experts may apply different discounts for lack of control, lack of marketability, and personal goodwill.
- Different adjustments to “normalize” the company books (see detailed discussion below)
- Industry data – Experts commonly rely on industry data for important assumptions, such as growth rates, profit margins and working capital requirements. The company that is being valued might fall under several different industries and experts might use different sources of industry data.
- Lack of information or different information about the business and its prospects
- Discount rate to account for risk – different experts may use different discount rates in the valuation of the same company, resulting in big differences in valuation.
- Differences in calculating cash flow

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

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

### 1. Do Not Include the Value of Personal Goodwill But Do Include the Business Goodwill

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

*"Good will" is sometimes difficult to define. In a personal service enterprise such as that of a professional person or firm, there is a difference in what it means as applied to "John Doe" and as applied to "The Doe Corporation" or "The Doe Company". If "John Doe" builds up a reputation for service it is personal to him. If "The Doe Company" builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business but the sale of such business naturally involves the right to continue in business as "The Doe Company". The "good will" built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the "good will" of customer clients of the former operators.*

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

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

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

*Read together, Nail and Geesbreght indicate a two-pronged test to determine whether the goodwill attached to a professional practice is subject to division upon divorce. First, goodwill must be determined to exist independently of the personal ability of the professional spouse. Second, if such goodwill is found to exist, then it must be determined whether that goodwill has a commercial value in which the community estate is entitled to share.*

*Evidence in the present case indicates that the husband's law firm has goodwill independent of his professional ability. Like the professional corporation in Geesbreght, the firm does not conduct business under the names of the senior partners, but rather operates under the names of two founding partners no longer practicing with the firm. The record reflects that at the time of trial the law firm consisted of twenty senior partners, twenty-two*

*junior partners and forty-three associates. The husband has been practicing law with the firm for over twenty-five years; however, the firm has been providing legal services to the public for more than ninety years. A large part of the firm's reputation for providing services was built upon the professional abilities of the husband's predecessors in the firm as well as the abilities of his present partners and professional employees. Under these circumstances we recognize that the firm has goodwill independent and apart from the professional ability of the husband.*

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

Attorneys and judges must look at the business being valued and the case law in light of current practices. The Texas cases cited above on personal and professional goodwill for professional practices were all decided over 30 years ago. A lot has changed since then, especially in the field of medicine. Now, medical practices are bought and sold frequently. Larger clinics and national chains buy up local medical practices regularly. Dental practices in particular are commonly bought and sold.

## **2. The Value of the Ownership Interest in the Company Must Be Discounted if the Spouse Owns a Minority Interest in the Company and Also Discounted for Lack of Marketability**

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

A case from the Dallas Court of Appeals explained the range of discounts for lack of control and lack of marketability:

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

*Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App. – Dallas 2011), rev'd on other grounds, 443 S.W.3d 856 (Tex. 2014).

These discounts can significantly reduce the value of a company. Assume that Jose owns a 25% interest in a business and the accountant values the total business at \$200,000. Jose's 25% would

be \$50,000, but a 30% reduction for marketability and another 30% reduction for owning a minority interest would reduce the value of Jose's interest to \$22,197.

Every business appraiser will admit that there is a lot of subjectivity involved in calculating a marketability or minority interest discount.

### **3. A Buy-Sell Agreement Can Effect or Even Determine the Value of a Business**

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

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

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

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

The Court of Appeals affirmed and said:

*...Susan also contends that she is not bound by the "buy-sell" provision in the Shareholders Agreement setting the stock's value at \$.50 per share because she never signed the Shareholders Agreement and that, accordingly, the trial court abused its discretion by determining that as a matter of law Lance's 22,000 shares of the Association were valued at \$11,000. It is undisputed that every shareholder of the Association paid \$11,000 for their 22,000 shares of stock when the stock was issued to them and that every shareholder that left the Association was paid \$11,000 for the Association to repurchase their 22,000 shares of stock. It is undisputed that Lance and Susan's community estate paid \$11,000 to the Association for the issuance of Lance's 22,000 shares of stock. And finally, it is undisputed that Lance can never sell his 22,000 shares of stock for more than \$11,000; the stock's value in the closely held Association is contractually set at \$11,000. Nonetheless, Susan claims the*

*stock should be valued at either \$794,000 (book value under GAAP); \$1,100,100 (fair market value considering Association equity as a stand-alone business); or \$943,000 (fair market value considering Association equity as a component of Matrix). **But Susan cites no authority for the proposition that a community asset (22,000 shares of the Association's stock) which is to be divided in a divorce, may have one monetary value as to one spouse (\$11,000 as to Lance) and a wholly different value to the other spouse ( \$794,000, \$1,100,100, or \$943,400 as to Susan). Nor have we located any such authority.** Because the evidence establishes the "comparable sales value" for Lance's 22,000 shares of the Association's stock was \$11,000 based on prior sales by former physician-shareholders and because \$11,000 is the only price that Lance's stock may be sold at, the trial court did not abuse its discretion by valuing the stock at \$11,000 under a comparable sales valuation and as mandated by the Shareholders Agreement even though Susan did not sign it.*

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

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

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

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

This is basically intrinsic value, which is, "the actual monetary value of the property's use to the owner." *Crisp v. Security Nat'l Ins. Co.*, 369 S.W.2d 326, 328 (Tex.1963). Evidence of a property's intrinsic value can be presented when the property has no fair market value. *City of Austin v. Canizzo*, 267 S.W.2d 808, 812 (Tex.1954). The Texas Pattern Jury Charge 2010, Family, PJC 203.1 instructs the jury:

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

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

*Finn v. Finn*, 658 S.W.2d 735 (Tex. App. - Dallas 1983, writ ref'd n.r.e.) involved a law firm partnership and a partnership agreement that said how much the husband would get if he died or withdrew from the firm. The majority decision in *Finn* held that the only way the husband could realize the value of accrued goodwill would be to keep practicing with the firm since the partnership agreement did not include good will in the valuation formula. Thus, the majority concluded that the husband's future work for the firm after divorce and the resulting goodwill was not community property. *Finn* at 742. The *Finn* decision was an en banc ruling that involved four justices joining the majority opinion, two justices concurring and five justices dissenting. Justice Stewart wrote a concurring decision that has since been followed by other courts and almost universally praised by seminar authors for the last 40 years. Justice Stewart wrote:

*The partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. The formula in the partnership agreement may represent the present value of the husband's interest, but it should not preclude a consideration of other facts. The value of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any. Goodwill is property and, although intangible, it is an integral part of a business, the same as its physical assets. Whether the law firm possessed goodwill, and, if so, its value are fact questions for the trier of facts.*

*Finn* at 749 (citations omitted).

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

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

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

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

*shareholder's divorce and does restrict who may own and purchase the Association's stock as well as the price at which the stock may be sold, Von Hohn, Keith, and Finn are not controlling.*

*Mandell at 540.*

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

Hill v. Hill, No. 02-12-00332 (Tex. App. – Fort Worth, 2014)(mem. op.) reviewed the holdings in Mandell, VonHohn, Keith, and Finn and concluded that the partnership agreement, which did not have any provision addressing stock ownership and value in the event of divorce, was “only a factor to consider in the present value of the partnership interest...” Hill is an example of how an expert should not value a business. The wife’s expert said the husband’s one tenth of one percent interest in a multinational accounting firm was worth \$2.4 million but the judge found the partnership interest was worth only \$14,000, (and the trial ruling was upheld on appeal). The wife’s expert’s report said it was not a complete valuation report. The expert admitted his report did not mention the partnership agreement and he had never talked to the husband. The expert did not apply any discount for lack of control or lack of marketability. His report did not use the words “good will” and he did distinguish between commercial goodwill and personal goodwill.

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

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

But, can you assume that the spouse who is selling his or her interest in the business is free to set up a competing business? This is a huge question regarding the value of a small business or professional practice. If Dr. Aguilar is selling his dental practice but is free to set up shop across the street, the young dentist considering buying the practice will pay a lot less. On the other hand, if Dr. Aguilar signs a non-compete agreement, his current practice will likely be sold for a higher price. In some professions, such as law, non-compete agreements are not allowed.

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

**Reader Beware:** the cases discussed below are all 20 years or older and a lot has changed in the last two decades in the business world, particularly in the sale of medical and dental practices (which is now common place). The sale of almost all businesses and professional practices now

involve a non-compete agreement. The case law described below should be considered in light of the current business realities.

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

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

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

***We hold that in finding the value of the Rathmell companies the trial court should have excluded value attributable to the factors listed. If the value found by the court did exclude such factors, the court should have so stated in additional findings of fact. Without such additional findings it is impossible to determine whether the trial court included or excluded them. In making this ruling we are not saying that the trial court should find a value including the above-listed factors and then make separate findings of what portion of such value is attributable to each factor. It is only necessary that the trial court's findings show clearly that the value found by the court excluded such factors. Had the second portion of this bill of review been tried to a jury, appellant would have been entitled to an instruction to the jury that in determining the value of the Rathmell companies the jury should exclude value attributable to such listed factors.***

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

In response to the *Rathmell* case, the instruction regarding the fair market value of a business was changed in Texas Pattern Jury Charge:

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

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

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

million, the husband and Mr. Hickson testified the company was worth \$2.2 million, and the jury found the company was worth \$2,189,482.90.

The court of appeals held:

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

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

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

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

.....

*In determining the value of Acme Partners, LLC, you are not to include the value of personal goodwill or the value of time and labor to be expended after the divorce. However, you may consider the commercial goodwill, if any, of Acme Partners, LLC that is separate and apart from personal goodwill.*

Texas Pattern Jury Charges 2024, Family, PJC 203.2.

However, the comment to PJC 203.2 points out:

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

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

The courts of other states which, like Texas, distinguish between personal goodwill and business goodwill, have held that if there is no actual non-compete agreement in place, then the business evaluator and the divorce court can assume that the spouse who owns the business interest is free

to compete if she sells. *Held v. Held*, 912 So.2d 637 (Fla. 4<sup>th</sup> Dist. App. 2005); *Gaskill v. Robbins*, 282 S.W.3d 306 (Ky. 2009); *Slater v. Slater*, 2010 WL 5356556 (Or. App.)(Dec. 29, 2010).

A 45-year-old Texas case says that a trial court cannot order a covenant not to compete provision as a part of its divorce decree. *Ulmer v. Ulmer*, 717 S.W.2d 665 (Tex. App. – Texarkana 1968, no writ)(husband ordered not to compete with janitorial business awarded wife for one year). One could cite *Ulmer* to argue that if a trial court cannot order a party not to compete with a business awarded the other spouse, then it should not be able to assume the spouse will not compete if he sells his business interest. However, the majority of states which have addressed the issue in the last two decades have allowed a divorce court to order a non-compete agreement in a divorce. See e.g. *In re Marriage of Fischer* (Colo.Ct.App.1992) 834 P.2d 270; *Lord v. Lord* (Me.1983) 454 A.2d 830; *Holland v. Holland* (Wyo.2001) 35 P.3d 409; *Cesar v. Sundelin* (2012) 81 Mass.App.Ct. 721, 967 N.E.2d 171; *Carr v. Carr* (1985) 108 Idaho 684, 701 P.2d 304.

A 2014 case from California explained why a trial court should be able to order a non-compete agreement when awarding a family business to one spouse:

*It therefore follows that, if an ongoing marital business is being awarded to one spouse, and if the value of that business includes goodwill, a family court should have the power, ... to issue a noncompetition order so that the value of that asset is preserved, just as a noncompetition clause in a business purchase and sale agreement is designed to protect the value of the asset purchased.*

....

*To be sure, all post-separation earnings are separate property under California law, and "the expectancy of future earnings is not synonymous with and should not be the basis for determining the value of goodwill in a community property business." But that is not what occurs when a marital asset is transferred for value with a concomitant non-competition order. So, for example, where the sale of a community asset to a third party includes the imposition on one spouse of a covenant not to compete, and that covenant gives value to the community asset, the cost of any detriment suffered by the spouse due to the noncompetition restrictions is properly treated as part of the valuation and division process. Because the future effects of a noncompetition clause imposed in connection with the sale or assignment of a community asset are part of the equation for determining the value of the community asset upon dissolution, it does not constitute a division of future earning capacity.*

*In re Marriage of Greaux and Mermin*, 223 Cal. App. 4th 1242, 1252-3, 167 Cal. Rptr.3d 881 (Feb. 14, 2014)(citations omitted).

In some industries, businesses are simply not sold without a non-compete agreement. It would seem that valuation of a business should be based on real world conditions.

### **Methods for Valuing a Business**

The generally accepted methods for valuing a business would better be described in a book or very long article and are best understood by accountants or folks who majored in math. In general, all of the accepted valuation methods are basically mathematical hocus-pocus akin to forecasting the

national debt ten years from now – experts can debate endlessly on the proper method to use and regardless of the method utilized, the answer is completely different depending on the method and assumptions applied. For example, most of the business valuation methods require the expert to select a capitalization rate and discount rate and there are several methods for determining both and no sure answer on which to use, particularly in the current times when the rate of return on investments is so very low. As noted above, the discount for minority ownership and for lack of marketability can also vary widely. In summary, ten different valuation experts can examine the same business, and not agreeing on the method to use, can come up with ten different answers for the company's value.

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

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

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

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

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

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

1. **Adjusted book value** - The tangible assets of a business are appraised and reflected at market value, then the business' liabilities are subtracted to arrive at adjusted book value. Adjusted book value still reflects a relatively low value for a business interest because for most small businesses, the tangible assets are relatively insignificant. The value of such a business is in

its earning capacity, which is not an element of adjusted book value. A typical service-oriented business has a low adjusted book value because tangible assets are usually insignificant. The value of such a business is in its earning capacity which is not an element of adjusted book value.

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

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

At least one court has approved the use of an income method in the valuation of a closely-held corporation. In *Morgan v. Morgan*, 657 S.W.2d 484 (Tex. App. \_Houston [1st Dist.] 1983, writ dismissed), the trial court's decision relied, in part, on the testimony of a CPA who evaluated a machine shop business using the "capitalization of earnings" method. The wife's expert chose a capitalization rate of 15% to arrive at \$567,000 as the fair market value of the corporation. The husband offered no expert testimony, but testified that the business was worth nothing or \$75,000, at most. The \$75,000 appears to have been the adjusted book value of the corporation. The Court of Appeals approved this capitalization of earnings approach as one of the acceptable methods of valuing a closely-held corporation and affirmed the trial court's judgment.

- B. Discounted Future Returns Method. This income method is based on the theory that the value of the business is the present value of its future income. The business appraiser must forecast the future earnings stream that will be available to a hypothetical purchaser, then apply an appropriate discount rate to arrive at the business' present value. This method employs the use of two subjective variables. One is the discount rate at which the income stream is adjusted to its present value. There is also some subjectivity and speculation in regard to the business' future earnings. One court found that this method was inappropriate in the context of a particular divorce because value was based on post-divorce earnings and profits. *Smith v. Smith*, 836 S.W.2d 688 (Tex. App. \_Houston [1st Dist.] 1992, no writ). The business involved in *Smith* was a sole proprietorship. The Court stated that the expert's findings reflected the husband's personal future earning capacity and not the value of the business. Therefore, this method generally should not be used in a divorce case since future earnings are not divisible in a dissolution of the marriage because they are post-divorce earnings and therefore are the separate property of the divorced professional or business owner.
3. **The Market Approach**, which looks at recent sales of shares in the same company but also often looks at comparable sales of similar businesses.
  4. **The Excess Earnings Method** takes pages to describe in detail but is very commonly used to value small businesses and professional practices. Based on the 1968 IRS Revenue Ruling 68-

609, this method is an income and asset-based method. This method determines an appropriate rate of return for the business' tangible assets, then subtracts that return from the business' historical earnings stream. The remainder is deemed "excess earnings." These excess earnings are "capitalized," then the value of such capitalized earnings are simply added to the value of the business' tangible assets to arrive at fair market value.

The excess earnings method involves these steps:

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

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

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

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

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

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

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

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

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

The weakness of this method is the relatively arbitrary use of an "appropriate rate of return" with respect to the net tangible assets, and the equally arbitrary capitalization rate with respect to the "excess earnings." These two subjective decisions by the business appraiser can change substantially the result of the "formula" approach.

### **“Normalizing” Business Financial Records and Non-Operating Assets**

Many small businesses are not paragons of accounting accuracy or 100% pure when it comes to reporting business expenses and avoiding taxes. The financial records of some companies are deliberately misleading or have not been kept correctly. If the corporation pays for the owner’s personal auto, home, boat and RV insurance and records those payments as business expenses, that creates a misleading image of the firm’s expenses and profit. Not every CPA who prepares corporate tax returns challenges the underlying data provided by clients and very few financial records of small businesses are every audited. Some business owners are shady and some business owners just do not know what they are doing when it comes to bookkeeping and accounting. For these reasons, the business valuator will carefully review the details of the company’s financial records, ask a lot of questions and frequently make adjustments to accurately show the business’ true income, expenses and profit. This process of adjusting the company’s financial records is called “normalizing.” Common issues with corporate financial records that are adjusted in the “normalizing” process include:

- Unusual, non-repeating items – Government payments received because of COVID or a temporary loss of income because of a hurricane are not expected to happen every year and probably should not be included if the valuator is trying to make a reasonable projection of future profits.
- Non-operating assets – See discussion below.
- Officer compensation, perks and distributions – If the owner is paid a salary that is too small or too large compared to what would be paid to an outsider hired for that role, an adjustment needs to be made. Is a company truck for the owner reasonable if the business is a hair salon? Are company cars for the owner’s wife and mother-in-law reasonable? Are profit distributions avoided in favor of salary because the company is C corporation and double taxation is being avoided or is there little or no salary paid and all profits are taken out in the form of distributions?
- Related party transactions – Does the advertising company being valued pay excessive rent for its offices to a separate company the owner of the advertising company also owns? Are family members on the company payroll? Are “loans” to or from the company owner really loans and are the terms commercially reasonable?
- Accounting issues – Are the bank statements reconciled? Are financial entries properly coded?

Non-operating assets are assets owned by a business which are not necessary for the normal operations of the business. For example, if the husband's commercial painting and drywall business owns a very expensive fishing boat and a RV, the boat and RV are not necessary to the operation of the company. It may be that the owner found it easier to buy his big toys through the company, but those assets of the company are not necessary for it to run. Non-operating assets are considered separately and their value is typically added back to the value of the company at the end of the valuation process. Common types of non-operating assets are:

- Assets used by the owner personally
- Vacant land not being used by the business
- Investments unrelated to the company's operations
- Receivables owed to the company by the owner or his/her family

Valuation experts will sometimes disagree about whether to include idle machinery or equipment not being used by the company as non-operating assets, as well as excess cash or marketable securities beyond what is needed to fund the business's normal operations.

## **Standards for Business Valuation**

Texas accountants are required to follow the Statements on Standards for Accounting and Review Services (SSARS) issued by the American Institute of Certified Public Accountants. 22 T.A.C. §501.62. This very detailed standard (70+ pages) addresses issues such as the scope of the valuation assignment and the methods for valuing a business and can be a useful resource for preparing to cross-examine a business valuator. A complete copy of the current June 2022 SSARS standard can be downloaded in PDF format at <https://www.aicpa-cima.com/resources/download/aicpa-ssars-currently-effective>

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

## **Qualifications of the Forensic Accountant**

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

1. Use a Certified Public Accountant licensed by the State of Texas who has real world practical experience serving business clients in valuing businesses outside of the courtroom.
2. Check with other attorneys to find an expert who is respected, diligent, not overly expensive, not too busy for your case and most importantly, who can explain these complicated accounting principles in friendly layman's terms while still coming across as authoritative.

3. Check on the judge who will hear your case and see if there are accounting experts that judge particularly likes or dislikes.
4. Check with the expert and find out what he or she charges and how available he or she is to promptly do the job.
5. Check the expert's resume and see what training he or she has in business valuation. Look for special credentials in business valuation:
  - A. The American Institute of Certified Public Accountants certifies CPA's who are **Accredited in Business Valuation (ABV)**.
  - B. National Association of Certified Valuators and Analysts (NACVA) - NACVA is a global, professional association supporting the business valuation, litigation consulting and fraud deterrence disciplines within the CPA and professional business advisory communities and provides the following certification programs:
    1. **Accredited Valuation Analyst (AVA):** professionally trained to perform business valuations as a service to both the consulting community and the users of their services; requires training as a prerequisite to certification; must hold a business degree from an accredited institution of higher education and demonstrate substantial business valuation experience among other requirements.
    2. **Certified Valuation Analyst (CVA):** professionally trained to perform business valuations as a service to both the consulting community and the users of their services; requires training as a prerequisite to certification; must hold a valid license as a Certified Public Accountant.
    3. **Certified Financial Forensic Analyst (CFFA):** this credential is designed to demonstrate to the legal community that the designee possesses a level of experience and knowledge deemed acceptable by the National Association of Certified Valuation Analysts (NACVA) and the Forensic Institute for Financial Experts (FI) to provide competent and professional forensic financial litigation support; the training includes economics, statistics and calculating damages, followed by a five-day practicum in which participants learn about commercial damages and participate in a damages study which takes them through the processes of deposition, mediation and jury trial.
  - C. American Society of Appraisers (ASA) - The ASA is a self-supporting and independent organization of appraisal professionals and others interested in the appraisal profession. The ASA originated in 1936 and is the oldest and only major appraisal organization representing all of the disciplines of appraisal specialists. The ASA has a mandatory re-accreditation process whereby designated members must regularly submit evidence of professional growth through participation in professional activities and continuing education. The ASA provides the following certification programs:
    1. **Accredited Member (AM):** each accredited member of the American Society of Appraisers has earned a professional designation in one or more specialized areas

of appraisal; must complete intensive course work and pass written examinations, including an examination on the Uniform Standards of Professional Appraisal Practice (USPAP); must submit representative appraisal reports and an appraisal experience log for at least two years; requires a college degree or its equivalent.

2. **Accredited Senior Appraiser (ASA):** in addition to the qualifications set forth for an accredited member, the ASA designation demonstrates a minimum of 5 years of full-time equivalent appraisal experience and a college degree or its equivalent.
3. **Fellow of the American Society of Appraisers (FASA):** to achieve the Fellow, an Accredited Senior Appraiser must be recognized by ASA's International Board of Governors for outstanding services to the appraisal profession and/or the society.

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

1. Accredited by IBA (AIBA): must possess a 4-year college degree or equivalent; successfully complete an 8-day workshop in valuing closely held businesses, or hold a journeyman level designation in business valuation from organizations recognized by the Institute of Business Appraisers; pass a comprehensive written examination on current business valuation theory and practice.
2. **Certified Business Appraiser (CBA):** available to those members of The Institute of Business Appraisers, Inc. who are able to demonstrate that they have attained a high level of professional competence and conduct; requires a 4-year college degree or equivalent; in addition to the 4-year college degree, the applicant must have successfully completed at least 90 classroom hours of upper level course work; at least 24 hours of this coursework must have been in courses offered by the Institute of Business Appraisers; in lieu of the 90 classroom-hour requirement, the applicant may demonstrate 10,000 hours active experience as a business appraiser; experience must include valuation of a variety of business types and appraisals for a variety of purposes; complete a 6 hour, proctored, CBA written examination covering the theory and practice of business appraisal.
3. **Master Certified Business Appraiser Accreditation (MCBA):** the Master Certified Business Appraiser is the highest professional designation awarded in the business valuation industry; requires a 4-year college degree and a 2-year post-graduate degree; must have held the Certified Business Appraiser designation for not less than 10 years, and must have 15 years full-time experience as a business appraiser: experience must include valuation of a variety of business types and appraisals for a variety of purposes; must hold a professional designation awarded by one or more compeer professional business appraisal societies such as those issued by the American Society of Appraisers, the National Association of Certified Valuation Analysts, and the American Institute of Certified Public Accountants.

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

Appendix A – Confidentiality Order

Appendix B – Common Questions at a Management Interview

## Appendix A – Confidentiality Order

NO. \_\_\_\_\_

IN THE MATTER OF  
THE MARRIAGE OF

\_\_\_\_\_ AND

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§  
§  
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IN THE DISTRICT COURT

\_\_\_\_\_ JUDICIAL DISTRICT

\_\_\_\_\_ COUNTY, TEXAS

### CONFIDENTIALITY ORDER

The parties to this order seek the entry of a protective order governing the documents produced in this action and other documents, information, or testimony provided in connection with pretrial proceedings or the trial of this action. A protective order in the form set forth below is necessary because discovery in this action and the trial of this action are likely to involve sensitive personal, financial, and business information, the disclosure of which could cause injury to the producing party. The Court finds that good cause has been shown, and IT IS ORDERED THAT:

#### *Definitions*

The following definitions apply in this order:

"Document," whether used in the singular or the plural, means any kind of written, graphic, or recorded matter, however produced or reproduced, of any kind or description, including originals, copies, and drafts, and both sides thereof.

"Business information" means information or any document which relates to any of the following businesses: \_\_\_\_\_

"Business information" includes company governing documents such as, but not limited to, formation documents, company agreements, minutes and amendments; financial reports and data; financial or loan or credit card statements or agreements; agreements between business owners; records or agreements relating to compensation or benefits of non-parties; documents relating to business plans or structure; business tax returns; and customer, client or vendor information.

"Producing party" means any party to this order who responds to a discovery request or otherwise provides information to a party to this action or to the Court in connection with this action.

"Producing third party" means any person or entity not a party to this suit who responds to a discovery request or otherwise provides business information to a party to this action or to the Court in connection with this action.

"Requesting party" means any party to this action other than the producing party.

"Termination of the action" means the final termination of this action by any means including without limitation entry of a final judgment or dismissal. If an appeal is taken from any judgment or order entered in this action, the "termination of the action" shall not occur until all appellate proceedings have been finally concluded, as well as any proceeding in connection with any remand.

"Party" means any person who is a party to this action.

#### *Limitations on the Disclosure and Use of Business Information*

No Business information produced in this action shall be disclosed in any manner except to (1) a party to this action; (2) counsel involved in this action and their paralegal, computer, clerical, secretarial, and other employees and contract workers engaged in the preparation for the trial of this action; (3) consultants or experts retained by a party to this action or its counsel to whom disclosure is necessary for the preparation of this action for trial; (4) a witness whose testimony is being taken either during deposition or at trial; and/or (5) as evidence in a trial or hearing in this action.

Prior to any Party or their counsel disclosing Business information to any third party authorized under this Order, such third party must agree to be bound by the terms of this Confidentiality Order prior to receiving any Business information.

Business information shall be used solely for the purpose of conducting this action and not for any other purpose whatsoever. This order not only prohibits disclosure of Business information or testimony but also prohibits the discussion of Business information with any person not specifically authorized to receive such information under this order.

Counsel shall advise their paralegal, computer, secretarial, clerical, and other employees and contract workers of the requirements imposed by this order.

#### *Filing of Business Information*

Any motions, pleadings, affidavits, briefs, or other documents submitted to or filed with the Court that contain, reproduce, quote, paraphrase, or otherwise reveal any Business information shall be marked as "This document contains sensitive data" on each page.

*Use of Business Information at Hearings or at Trial*

The parties shall undertake in good faith to negotiate mutually acceptable procedures to present to the Court to protect against the disclosure of Business information in connection with any hearing regarding this action or the trial of this action. By agreeing to do so, no party waives its right to demand a trial by jury.

*Duration*

This order shall remain in full force and effect and survive the termination of this litigation unless modified by an order of this Court or by the written stipulation of all parties and any affected third party filed with the Court.

*Independently Obtained Information*

Nothing in this order shall in any way restrict the right of a party to use or disclose information obtained from any source other than from a producing party or producing third party during the litigation of this action, whether or not such independently obtained information is identical to information designated as confidential by the producing party or producing third party.

*Cumulative Provisions*

The procedures established by this order are intended to be cumulative and in addition to any party's right to seek any further or different protection from the Court for any document or information deemed to be confidential.

This order is without prejudice to the right of any party to apply to the Court at any time, on reasonable notice to the other parties and the affected third party, to request that the Court for good cause modify the provisions of this order.

*Successors and Assigns*

This Confidentiality Order shall be binding on and inure to the benefit of all successors and assigns of the parties to the order.

SIGNED on \_\_\_\_\_.

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JUDGE PRESIDING

APPROVED:

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Petitioner

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Respondent

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Counsel for Petitioner

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Counsel for Respondent

## Appendix B – The Management Interview

The management interview will vary from business to business. The goal of the interview is to gain information about the major factors that impact the value of the business, especially those that cannot be ascertained from the financial documents provided. Questions often arise from the review of the financial documents, such as “what exactly is this expense” and “why the sudden change of income for the 2<sup>nd</sup> quarter of 2023?”

The most common topics addressed in the management interview include:

- Company history: when and how was the company formed; in what ways has the company changed since formation; have there been any mergers, acquisitions, or divestitures since formation; have there been any changes in ownership
- Owners and management team: who are the owners and what are their percentages of ownership and roles with the company? Is there a buy-sell or shareholder agreement?
- Products/service: what does the company do; explain the different lines of services or products offered; are there any plans to expand into new product/service offerings or get rid of existing offerings; what is the breakdown of revenue and margins among different products/services; does the company experience any cyclicity or seasonality in revenue; who are the major suppliers/vendors
- Customers: describe the company’s target market; how many customers does the company have; who are the company’s top five customers; what percentage of revenue do the top customers make up; does the company have any long-term contracts with any of its customers; how does the company attain new customers; what marketing does the company do
- Competition: how significant of a role does competition play in the company; who are the company’s primary competitors; how does the company set itself apart from its competition; what are the company’s competitive strengths and weaknesses
- Economic and industry conditions: what are the primary economic factors that impact the company; are there any major trends in the company’s industry that are relevant
- Locations/facilities: how long has the company operated out of its current location(s); what real properties does the company own, if any; for any properties that are leased, are they leased from a third party or related parties; what are the lease terms; is rent at market rates or under/over market
- Fixed assets: what are the company’s primary fixed assets; what condition are they in; what is their current value; are there any significant capital expenditures planned/needed; what is the amount of annual capital expenditures expected on an ongoing basis
- Workforce: how many employees does the company have; what is the breakdown between full-time vs. part-time and employees vs. independent contractors; is the company

overstaffed or understaffed; who are the key personnel and what are their roles; are there any family members or related parties on the payroll

- Role of owners: what is the day-to-day role of the company's owners; how is the company managed; number of hours a week the owners work; how much do the owners receive in compensation; how much would the company have to pay third parties to perform the functions that the owners perform; what other perks/benefits are received by the owners; how are distributions determined
- Current financial position: does the company have sufficient liquidity as of the valuation date; is there any excess working capital as of the valuation date; are there any accounts receivable that are not expected to be collected; does the company have access to liquidity; what are the terms of the company's long-term debt; do any off-balance sheet liabilities exist
- Historical financial performance: explain the company's revenue trajectory over the last five years; explain historical profit margins and any changes experienced over the last five years; are there any non-business or personal expenses on the company's books; are there any non-recurring income or expense items
- Outlook for the future: what are the company's plans for the future; how much revenue is expected any budgets or forecasts; what is the expectation for margins going forward; does the company have exit/succession plans or strategies.
- Valuation issues: has the company ever been valued before; has the company ever received any offers to buy/sell; has the company ever explored potential sales; what valuation multiples are common in the industry; have there been any prior transactions of ownership interests in the company?

Credit for much of the information in Appendix B is given to Aaron Ballard, CPA/ABV is "Business Valuation Disputes: Understanding Differences and Attacking Weaknesses" presented at the State Bar of Texas 2023 Marriage Dissolution Institute. This is an excellent article that every divorce attorney should read and keep for future reference.