

## **BUSINESS VALUATION IN A DIVORCE SETTING**

*Charles A. Wilhoite, CPA/ABV/CFF, CMA, ASA, CFM, CBA, CGMA, CVA  
Managing Director, Willamette Management Associates*

Introduction	2
Valuation Date	3
Standard of Value	4
Fair Market Value	5
Investment Value	6
Fair Value	6
Intrinsic Value	7
Valuation Approaches and Methods	7
Asset Approach	8
Income Approach	12
Market Approach	18
Normalized Economic Earnings	23
Ownership Characteristics	24
Valuation-Based Organizational Agreement Terms/Prior Transactions	25
Intangible Asset Value Considerations	26
Enterprise Goodwill versus Personal Goodwill	26
Implications of <i>Slater V. Slater</i>	27
Addressing “Double- Dipping”	29
Summary and Conclusion	31

## INTRODUCTION

Generally, and for decades, the national divorce rate has been estimated at roughly 50 percent, implying that 50 percent of all marriages end in divorce. However, several factors, including (1) increasing participation rates of women in the workforce, (2) greater control by women over reproductive rights, and (3) a higher average marrying age (and presumed maturity level) of couples are creating expectations that the overall divorce rate eventually will center closer to 33 percent over time. In Oregon, recent statistics indicate that total number of reported divorces has declined annually for the past 5 years, from 15,312 in 2010 to 12,110 (preliminarily) in 2014.

Setting the *estimated rate* of divorce aside, the *actual event* of divorce typically requires the identification and quantification of assets (and liabilities) contained within a marital estate, which typically is deemed to have been created when a divorce filing occurs. The basis for the division of marital property varies among the states, between a standard based on (1) community property—i.e., equal property division, and (2) equitable distribution—i.e., either equal property division, or “equitable” property division based on an allocation process supported by specific facts and circumstances.

Often, a financial expert, and other experts (e.g., real and personal property appraisers and forensic accountants) are required to assist with the identification, valuation and division of a marital estate based on the type, number and/or estimated value of assets contained within a marital estate. From the perspective of a financial expert focused primarily on business valuation and related issues, the following are key considerations that must be addressed to properly identify and estimate the value of relevant property includable within a marital estate:

1. the names of the divorcing parties (and their respective legal counsel)
2. a list identifying owned businesses, business interests, and other investment-based assets (e.g., investment portfolios, income-producing properties, etc.) includable within the marital estate
3. a brief summary regarding each business and/or business interest includable within the marital estate, including: (i) name of company, (ii) description/business focus, (iii) date acquired, (iv) the ownership interest level maintained by the marital estate, and (v) the legal structure of each business in which the marital estate maintains an ownership interest (e.g., regular corporation, S corporation, limited liability company (LLC), partnership)
4. the relevant, effective valuation date (e.g., date of separation, date of divorce, trial date)
5. the relevant standard of value (e.g., fair market value or fair value)
6. the relevant valuation approaches and methods (based on the nature of the subject business operations)

7. normalized economic earnings (based on consideration of key circumstances regarding owners' compensation, nonrecurring and/or discretionary income and/or expense items, related party activity, and seasonal/cyclical operating impacts)
8. ownership characteristics (e.g., controlling versus noncontrolling and marketable versus nonmarketable status)
9. the relevance and impact of shareholder/operating agreement terms and/or historical transactions in the equity of the subject company(ies)
10. intangible asset considerations

The following discussion addresses the 10 factors previously addressed from the perspective of a business valuation expert (hereafter referred to as the expert), and touches on the related interaction between the expert and legal counsel. For purposes of this discussion, it is assumed that items (1) through (3) in the list above have been adequately identified and addressed by the expert. The identification of the parties to a divorce action—including the divorcing parties as well as their respective legal counsel—allows for the identification of conflicts or potential conflicts. Such conflicts might prevent the expert from being deemed to represent an independent party, and therefore being unable (in the eyes of the court) to render an independent opinion.

The specific identification of the valuation subject(s)—including the companies and/or relevant ownership interests includable in the marital estate—provides vital information required for the purpose of establishing a credible and relevant approach to the valuation process. The identification process should include summary descriptions of the business focus for each company includable in the marital estate, as well as the identification of (1) officer/operating positions held by the divorcing parties, (2) all family members/related parties who have received any form of compensation (e.g., cash, company paid expenses, reimbursements), and (3) all business activity between/among related (either through common ownership or board involvement) parties/companies in the five-year period preceding the valuation date.

Items (4) through (10) are discussed below.

## **VALUATION DATE**

Generally, the “valuation date” represents the date on which the conclusion, or opinion, of value rendered by an expert is deemed relevant. Clearly, the valuation date selected in any appraisal process can have a pronounced effect upon the ultimate value of a business or ownership interest therein.

In a divorce setting, the valuation date typically is identified as one of the following dates (depending on the specific circumstances):

1. the date of marriage
2. the date of legal separation
3. the date of divorce (i.e., the current date or date closest to trial)

Typically, the appropriate valuation date is determined by the case law of the specific state/jurisdiction in which the marriage will be dissolved. In some instances, and based on the circumstances, multiple valuation dates may be identified by legal counsel as potentially being relevant, requiring an expert to develop an opinion(s) of value relevant for each date. For these reasons, an expert must rely on guidance provided by legal counsel regarding the appropriate valuation date(s) to assume for the purpose of completing a valuation in a divorce setting.

Some states/jurisdictions establish the date of marriage as one relevant valuation date when a business or ownership interest was brought into a marriage by one of the divorcing parties rather than acquired or developed during the marriage. In these particular states/jurisdictions, equitable distribution typically is the relevant property division standard, and the asset subject to allocation is represented by the increase in the value of the business or ownership interest from the date of marriage to either the (1) date of separation or (2) date of divorce. Different valuation allocation procedures are then applied in order to estimate the marital portion of the asset subject to division.

Generally, the date of separation is the relevant valuation date when the business or business interest subject to division is highly dependent upon the efforts of one of the parties in the divorce action. The valuation of accounting, law, medical and other professional practices are typical examples of situations in which the efforts of the “practicing” spouse typically exert a significant impact upon the continuing operations of the related business, and thus significantly affect the underlying value of the entity.

The date of divorce, or date closest to trial, often is considered the most relevant valuation date when the business interest subject to division represents ownership in an entity whose success is dependent upon the continuing efforts of numerous individuals and an asset base comprised of tangible and intangible assets (discussed below) which are owned by, or related to, the operating entity. The valuation of an ownership interest in large manufacturing or service businesses which are not highly dependent upon the efforts or reputation of one of the divorcing parties are typical examples of situations in which the date of divorce may represent the most relevant valuation date.

## **STANDARD OF VALUE**

The “standard of value” in a business valuation context is best described as the definition of value being sought. However, “value” is a nebulous term, typically determined by circumstances. Although most state

divorce statutes require either equal or equitable division of assets included within a marital estate, the statutes generally are silent with regard to the definition considered most appropriate for estimating value.

The standard, or definition, of value includes an implied response to the question: “value to whom?” Because divorce statutes and judicial precedents vary from state to state, a clear understanding of the following, generally accepted standards of value is required when estimating the value of assets in a divorce setting:

1. fair market value
2. investment value
3. fair value
4. intrinsic value

### **Fair Market Value**

In a divorce setting, *fair market value* typically is the most common standard of value applied. Fair market value is defined as

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms’ length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of relevant facts.<sup>1</sup>

Key within the definition of fair market value is the premise of hypothetical parties dealing at arms’ length. Such a premise necessarily excludes from the estimated value conclusion the impact of any of the following:

1. Special motivations not characteristic of a typical buyer or seller
2. Parties not having the ability or willingness to engage in a transaction
3. Economic and market conditions at a time other than the valuation date

A fair market value conclusion should reflect the economic impact of all rights and benefits inherent in the subject ownership interest(s)—including voting control status—as well as the detrimental economic impact of any limitations. Such limitations typically include (1) a lack of voting control, and (2) limited marketability with regard to an ownership interest(s) in nonpublic companies. These two economic limitations typically are addressed by discounts for lack of control and lack of marketability, respectively.

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<sup>1</sup> The *International Glossary of Business Valuation Terms*.

## **Investment Value**

Investment value is defined as

The value to a particular investor based on individual investment requirements and expectations.<sup>2</sup>

The definition is deemed relevant whether the subject asset is an entire business or a fractional ownership interest in a business. Generally, the investment value standard is assumed to consider the impact of (1) the specific owner's expectation of risk, (2) the potential synergy associated with ownership of the subject business, (3) the specific earnings expectations resulting from the subject ownership, and, in some cases, (4) the relationship of the spouse/owner to the other owners of the business.<sup>3</sup>

As suggested, the investment value standard is based on the theory that "value" to the marital estate is most appropriately measured from the perspective of how much value a particular asset is expected to generate for its current owner (i.e., a member of the marital estate that will be dissolved upon completion of the divorce). This is contrary to the definition of fair market value, which is based on the premise of value to a hypothetical owner.

## **Fair Value**

Fair value, in a divorce setting, typically is equated with the statutory definition applicable in cases of dissenting stockholders' appraisal rights. In states that have adopted the Uniform Business Corporation Act, the following definition applies:

Fair value, with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.<sup>4</sup>

States that have adopted the fair value standard in a divorce setting can be interpreted as adopting the premise that the divorce is creating a forced, or oppressed, circumstance. Based on the circumstance, one of the divorcing parties—typically the spouse not participating directly in business operations—is deemed to be "forced" into a transactional setting. Comparable to a dissenters' rights circumstance, the "forced" party in a divorce setting is deemed to be entitled to the "fair" value of the subject ownership interest(s). Generally, fair value is often equated with fair market value absent the impact of discounts for lack of control and lack of marketability.

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<sup>2</sup> The *International Glossary of Business Valuation Terms*.

<sup>3</sup> Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5<sup>th</sup> ed., (McGraw-Hill, 2008), p. 945.

<sup>4</sup> Oregon Revised Statutes, Section. 60.551(4).

## **Intrinsic Value**

Intrinsic value—also referred to as fundamental value—is defined as

The value that an investor considers, on the basis of an evaluation of available facts, to be the “true” or “real” value that will become the market value when other investors reach the same conclusion.<sup>5</sup>

Intrinsic value is based upon a fundamental (i.e., analytical) analysis of an investment (e.g., the subject company or subject interest), and assumes, at least temporarily, a higher level of insight and knowledge regarding the investment than the typical investor.

The intrinsic value standard is often considered more relevant than the fair market value standard in many divorce situations because no firm basis for an assumed hypothetical sales transaction can be established with regard to the subject ownership interest. In these particular circumstances, it is arguably more reasonable to estimate value based upon the intrinsic value standard based on the premise that no actual transfer of ownership will occur.

Divorces requiring the valuation of a professional practice for property division purposes are prime examples in which the intrinsic value standard can be applied. When one of the divorcing parties is a 100 percent owner and sole practitioner in, for example, a medical practice, it is generally assumed (barring facts to the contrary) that the party will continue in the practice of medicine subsequent to the divorce. Accordingly, the intrinsic value standard can be applied to estimate the value of the practice to the existing owner/operator. It is important to note that intrinsic value differs from investment value based on the fact that intrinsic value is estimated through the fundamental analysis and judgment of an analyst, ignoring characteristics particular to any one investor (i.e., the owner/operator).

While no sale of the subject practice is assumed, an intrinsic value for the practice is established to the extent that ownership of the practice is expected to provide a monetary return to the investor (i.e., owner/operator) during the period that it is owned.

## **VALUATION APPROACHES AND METHODS**

Family law courts throughout the country typically recognize the three generally accepted valuation approaches: (1) the asset approach (which includes the asset accumulation method and the capitalized excess earnings method), (2) the income approach (which includes the discounted cash flow method and the capitalization of cash flow method), and (3) the market approach (which includes the guideline

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<sup>5</sup> The *International Glossary of Business Valuation Terms*.

publicly traded company method and the guideline merged and acquired method). Each approach, as well as frequently utilized methods categorized within each approach, is discussed in the following sections.

### **Asset Approach**

The asset approach is based upon the economic principle of substitution. The principle serving as the anchor for the asset approach is the premise that an investor will pay no more for an asset (i.e., a business or an interest in a business) than the cost to obtain—either through purchase or construction—an efficiently organized assemblage of assets with equal utility. Although utility can be measured in many ways, generally speaking, the utility measure considered most relevant with regard to the purchase of a business is represented by the level of economic returns (e.g., earnings or cash flow) that the investor expects the investment (i.e., “assembled operating assets”) to generate.

With regard to the valuation of a company or fractional interest in a company based upon the asset-based approach, a business valuation expert typically approaches the engagement from the perspective of viewing the subject company as an organized assemblage of revenue-producing assets—both tangible and, potentially, intangible.

The asset approach can be applied based upon the identification and discrete appraisal of each of the subject company’s assets (i.e., the asset accumulation method), or the collective revaluation of the subject company’s assets (i.e., the capitalized excess earning method). Generally, the assets of a company can be grouped into three broad categories: (1) financial assets, (2) tangible personal property and real estate, and (3) intangible assets.

The summation of the estimated market value of each tangible and intangible asset controlled by the subject company produces the overall asset value of the subject company on a market value basis. Based on the nature of certain assets, specific experts are often required to estimate the market value of the related assets (e.g., professionals specializing in the valuation of real estate, buildings, art and fine jewelry, etc.).

To arrive at the equity value of the subject company, the total value of all liabilities is deducted from the estimated total asset value. Typically, the resulting equity value is assumed to represent a controlling, marketable value indication based on the fact that only a controlling owner would possess the authority to initiate (1) the sale of the assets of the subject company, and (2) the distribution of the related proceeds.

**Typical Subject Company Assets.** Typically, most economically viable operating companies maintain some level of assets that can be classified into one of the three general categories previously identified: (1) financial assets, (2) tangible personal property and real estate, and (3) intangible assets.



Financial assets typically include cash and highly liquid investments, accounts receivable, prepaid expenses, and inventory and supplies.

The tangible personal property and real estate categories typically include office furniture and fixtures, operating equipment, buildings and land, and leasehold improvements.

The existence and value of intangible assets for any company will vary on a case-by-case basis, and typically are determined based on consideration of legal rights and a history/expectation of continuing earnings and cash flow generating capacity. Generally, the intangible assets of a company can be categorized into the following groups:

1. Technology-related (e.g., patents, proprietary technology, technical know-how, systems and procedures, technical manuals and documentation)
2. Customer-related (e.g., customer lists, customer relationships, referral relationships).
3. Contract-related (e.g., purchase contracts, supply contracts)
4. Data processing-related (e.g., computer software, automated databases)
5. Human capital-related (e.g., a trained and assembled workforce, employment/noncompetition agreements)
6. Marketing-related (e.g., copyrights, trademarks/service marks, and trade names)
7. Location-related (e.g., leasehold interests)
8. Goodwill-related (e.g., going-concern value)

While numerous intangible assets within each identified category may exist at a particular company, generally the most significant intangible assets of a company are represented by the economic earnings attributable to customer/client/patient relationships, technology, trade name, and going-concern value (including a trained and assembled workforce).

The valuation of the identified intangible assets of a company typically is based upon the income approach, typically through a variation of the discounted cash flow analysis (which is discussed below). The cost approach is sometimes employed, though companies rarely maintain detailed and readily available cost analysis data regarding internally developed intangible assets. The market approach is also utilized, though it is often challenging to locate market-based data supporting transactions involving specific intangible assets.

The asset accumulation approach is fairly self-explanatory—all assets are identified, valued and summed to arrive at the total asset value of the subject company, with all liabilities deducted to arrive at the indicated equity value of the subject company. The capitalized excess earnings method, which continues to be relied upon by business valuation experts (primarily in a divorce setting and involving smaller companies), is discussed below.

**Capitalized Excess Earnings Method.** The capitalized excess earnings method (CEEM) is an asset-based approach. However, it is considered a hybrid valuation approach since it is based on the

combination of (1) an asset approach (i.e., asset accumulation method), and (2) an income approach (i.e., earnings capitalization) to estimate the intangible asset value, and total value, of the subject company.

The current version of the CEEM is defined in Revenue Ruling 68-609. The foundation for Revenue Ruling 68-609 is the U.S. Treasury Department Appeals and Review Memorandum Number 34 (ARM 34). The “Treasury Method,” as it was called, was initially adopted to estimate the value of goodwill that breweries and distilleries lost because of Prohibition.

While there are several variations to the method, the typical steps in the CEEM are as follows:

1. Estimate the fair market value of the subject company’s net tangible assets (i.e., the asset accumulation aspect of the analysis).
2. Estimate a normalized level of long-term economic earnings (e.g., cash flow) for the subject company based on consideration of the most likely level of future economic earnings achievable over a long-term (i.e., 20-plus year) operating horizon.
3. Estimate an appropriate required rate of return for the subject company’s net tangible assets.
4. Multiply the estimated fair market value of the subject company’s net tangible assets by the appropriate required rate of return (estimated in Step 3).
5. Subtract the estimated, fair return on net tangible assets (the product of Step 4) from the estimated level of normalized, long-term economic earnings (the earnings level established in Step 2).
6. Divide the indicated level of “excess” earnings (the result of Step 5) by the risk-adjusted rate of return considered appropriate based upon the specific operating characteristics of the subject company (as pertaining to earnings attributable to intangible assets). In selecting the relevant rate of return, consider the operating history of the subject company, the industry in which the subject company operates, and the subject company's size, market position and reputation.
7. Add the estimated value of the subject company’s net tangible assets to the indicated value of the subject company’s intangible assets.

With regard to the CEEM, a potential acquirer of the subject company is assumed to contemplate the acquisition of the subject company based on an expected ability to earn a fair return on investment after recognizing all necessary expenses. The fair return on the overall investment is bifurcated between (1) a reasonable return on net tangible assets, and (2) a reasonable return on intangible assets.

The present and future earning power of the subject company is of primary importance to a potential acquirer. If the net tangible assets of the subject company do not generate returns in excess of those reasonably expected in the market based on the nature of the assets, the buyer usually will not be willing to pay more than the estimated value of the net tangible assets to acquire the related business (i.e., no “excess” earnings are expected, so no material intangible assets are deemed to exist).

For reference, an estimated excess earnings capitalization rate of 25 percent implies that an acquirer would be willing to pay for approximately 4 years (i.e.,  $1 \div .25 = 4$ ) of expected future excess

earnings. Generally, and based on the fact that earnings attributable to intangible assets have a higher risk profile (i.e., are subject to greater variability with no tangible asset support), the excess earnings capitalization rate typically is at least equal to the estimate cost of equity capital for the subject company.

A simplified model of the CEEM is presented below.

**Exhibit 1:  
Capitalized Excess Earnings Method  
Calculation of Equity Value on a Controlling Basis**

After-tax, normalized net cash flow to total invested capital		\$1,300,000
Fair market value of net tangible assets	\$500,000	
x Required return on net tangible assets	5.0%	
= Fair return on net tangible assets		(\$25,000)
Indicated excess earnings		\$1,275,000
÷ Estimated excess earnings capitalization rate		25%
= Indicated intangible asset value		\$5,100,000
+ Fair market value of net tangible assets		\$500,000
= Indicated asset value		\$5,600,000
- Reported interest-bearing debt		(\$1,300,000)
= Indicated market value of equity		\$4,300,000

**Key Considerations Regarding the Asset Approach.** In summary, the asset approach can be equated to recasting the historical, cost-based balance sheet of the subject company to a market value-based balance sheet as of the relevant valuation date. As a result, the following are key questions that require rational, well-supported responses from an expert in order to gain the necessary comfort that the valuation conclusion produced by the asset approach is reasonable and reliable:

1. Have all material assets and liabilities been identified—including assets and liabilities of a contingent nature?
2. Have all material assets and liabilities been adjusted, appropriately, to market value?
3. Has appropriate consideration been paid to the existence of potential intangible assets?
4. If the CEEM has been utilized, does the level of normalized economic earnings reflect an achievable level over the assumed, forward-looking operating period?
5. If the CEEM has been utilized, has an appropriate required rate of return on net tangible assets been applied?
6. If the CEEM has been utilized, does the risk-adjusted rate of return used to capitalize indicated excess earnings appropriately reflect the risk inherent in the subject company's ability to continue to generate the excess earnings over the assumed, forward-looking operating period?
7. Is the indicated valuation conclusion consistent with—within a reasonable range of—the valuation conclusions produced by other valuation approaches considered?

8. Has the implied equity value conclusion been adjusted appropriately for consideration of control/lack of control and marketability/lack of marketability considerations relevant for the subject ownership interest (e.g., a noncontrolling equity interest in a privately held company)?

### **Income Approach**

The income approach to valuation is based upon the premise that the value of a company is represented by the present value of all estimated future economic income (e.g., earnings or cash flow) expected to be realized by the individuals possessing ownership interests in the company. Ownership interests are understood to represent both equity investments (e.g., various classes of shareholders) and debt investments (e.g., bondholders or other interest-charging lenders).

**Discounted Net Cash Flow Method.** An example of an income approach method is the discounted net cash flow (DCF) method, also referred to as yield capitalization. This method requires the following analyses: (1) revenue analysis, (2) expense analysis, (3) investment analysis, (4) capital structure analysis, and (5) residual value analysis. Each analysis, including related considerations, is discussed briefly below.

*Revenue Analysis.* Revenue analysis involves a projection of prospective revenues from the provision of goods and/or services by the subject company. This analysis generally includes consideration of the following microeconomic factors: primary goods/services provided; pricing and price elasticity; market dynamics, including competition; regulatory factors; geographic markets served and demographic factors; and technological influences.

*Expense Analysis.* The expense analysis requires consideration of the following operating factors: cost of goods/services provided; fixed versus variable costs; product/service versus period-based costs; cash versus noncash costs; direct versus indirect costs; cost absorption/allocation practices; cost/efficiency relationships; and cost/volume/profit relationships.

*Investment Analysis.* The investment analysis requires consideration of the following factors: required minimum cash balances and working capital needs; accounts receivable/payable turnover; facilities utilization and related constraints; and capital expenditure requirements and related financing implications.

*Capital Structure Analysis.* The capital structure analysis requires consideration of the following factors: current capital structure; market-based/optimal capital structure; cost of debt and equity capital components; the marginal cost of capital; systematic and nonsystematic risk factors; and the weighted-average cost of capital (WACC).

*Residual Value Analysis.* The residual value analysis results in an estimation of the value of the prospective cash flow generated by the subject company after the conclusion of a discrete projection

period. The residual value can be estimated by various methods—for example, a price/earnings multiple or, typically, the Gordon growth model (i.e., the capitalization of normalized, expected earnings).

Based on the results of the above-mentioned analyses, a projection of after-tax, debt-free net cash flow from operations can be developed for a reasonable, discrete projection period (e.g., three years or five years). The projected cash flow is discounted at an appropriate after-tax, present value discount rate, resulting in an indication of the present value of each year's cash flow.

The residual value of the subject company is estimated at the end of the discrete projection period. This residual value is also discounted to a present value. The present value of the discrete net after-tax, debt-free cash flow projection is added to the present value of the residual value. This summation results in the estimated value of the subject company—representing the total value of all invested capital (i.e., all interest-bearing debt capital and all equity capital).

*Present Value Discount Rate.* If the cash flow being discounted is projected on an after-tax, debt-free basis, the appropriate discount rate must represent a combination of risk applicable to both equity investors and debt investors. This rate is typically referred to as the weighted-average cost of capital (WACC).

To estimate the WACC, the analyst must estimate: (1) the relevant, required rate of return on equity capital, (2) the relevant, required rate of return on debt capital, and (3) the proportions of debt capital and equity capital comprising the relevant capital structure of the subject company.

*Return on Equity.* The required rate of return on equity typically is developed based on the analysis of empirical market evidence and recognition of the subject company's investment risk.

Developing a required rate of return on equity begins with estimating a risk-free rate of return that incorporates investors' expectations for the real rate of interest on money and the impact of inflation, or loss of purchasing power, over time. Because we are interested in concluding a required rate of return for an equity investment, equity risk premiums (i.e., incremental risk components) relative to the risk-free rate of return must also be researched.

The relevant required rate of return on equity generally is developed based upon the capital asset pricing model. Using this model, the return on equity is estimated by adding to the risk-free rate of return an equity risk premium(s) based on an analysis of the risk characteristics of the subject company relative to similar characteristics for the relevant industry and/or a relevant group of guideline publicly traded companies within the industry.

Beta, which represents the relative risk of a company in relation to general market risk, is used to estimate some portion of the incremental risk premium relevant for the subject company. The appropriate

beta factor is applied to the estimated equity risk premium in order to estimate the relevant equity risk premium for the subject company.

When dealing with smaller companies, financial experts are often required to make subjective determinations regarding any incremental, or reduced, equity premiums warranted for the subject company, based on consideration of factors and characteristics specific to the subject company.

Based on the limited nature of direct comparable information that can be relied upon to estimate the required rate of return on equity for smaller, closely held companies, valuation analysts often employ a “build-up” equity method. In this method, analysts start with a risk-free rate and add relevant equity risk premiums to estimate the appropriate required rate of return on an equity investment in the subject company. A frequently utilized source of equity premium components is Ibbotson Associates *Stocks, Bonds, Bills and Inflation Yearbook*.

The following table presents a simple application of the estimation of a required rate of return on equity based on the build-up method (assuming a relatively small—i.e., annual revenue between \$10 million and \$20 million—subject company):

<u>Equity Component</u>	<u>Rate (%)</u>
Risk-free rate (20-year Treasury bond)	2.5[a]
Long-horizon equity risk premium	7.0[b]
Small stock equity risk premium	3.9[c]
Company-specific equity risk premium	<u>4.5[d]</u>
Estimated required rate of return on equity, rounded	<u>18.0</u>

- a. Represents the yield on a 20-year U.S. government bond, as quoted in the *Wall Street Journal* on March 31, 2015.
- b. Represents the large company stock total returns minus long-term government bond income returns, as presented in the Duff & Phelps *2014 Valuation Handbook—Guide to Cost of Capital*.
- c. Represents the “micro-cap” decile premium, as presented in the Duff & Phelps *2014 Valuation Handbook—Guide to Cost of Capital*.
- d. Estimated based on consideration of company-specific factors, including size, key person/key customer dependence, geographic market concentration, and relatively short operating history of the company.

As indicated, the summation of the risk-free rate of return and the estimated equity risk premiums represents the estimated required rate of return on equity.

*Return on Debt.* The required return on debt for the subject company typically is estimated based on consideration of the subject company’s (1) current weighted-average cost of debt (i.e., total interest expense in the most recent 12-month period divided by average interest-bearing debt outstanding) and (2) marginal cost of borrowing (i.e., estimated current borrowing rate). Because the discounted cash flow

method is performed on an after-tax basis, the relevant borrowing rate is reflected after the impact of effective taxes, or as follows: borrowing rate  $\times$  (1 – effective income tax rate).

*Cost of Capital Weightings.* The overall required rate of return, or WACC, for the subject company can now be estimated based on consideration of the estimated cost of each capital component and the relevant weight of each capital component in the overall capital structure for the subject company.

The relevant capital structure typically is estimated based upon consideration of the subject company’s historical/expected capital structure and an analysis of the capital structures of the relevant industry/selected guideline publicly traded companies within the relevant industry.

*Weighted Average Cost of Capital.* Assume that a reasonable weighting of debt and equity components comprising the subject company’s capital structure as of the valuation date is 20 percent and 80 percent, respectively. Further, assume that the estimated, after-tax required rate of return on equity and debt is 18 percent and 3 percent, respectively.

Applying this capital structure weighting to the subject company’s estimated cost of debt and equity capital results in the estimated WACC presented below.

<u>Required Rate of Return on Capital Components</u>		<u>% of Total Capital Structure</u>		<u>Weighted Cost of Capital (%)</u>
Debt capital @ 3%	×	0.20	=	0.60
Equity capital @ 18%	×	0.80	=	<u>14.40</u>
Present value WACC discount rate (rounded)				<u>15.00</u>

**Capitalization of Cash Flow Method.** Another example of an income approach method is the capitalization of economic earnings, or cash flow, method, also referred to as the direct capitalization method.

Unlike the DCF method, which produces an indication of the value of a company based on discounting a series of projected future cash flow to a present value, the capitalization of cash flow (CCF) method produces an indication of the total value of a company based on the conversion of a single cash flow amount into an indication of value. The indication of value resulting from the CCF method represents the value of the entire subject company, with no distinction between tangible and intangible assets.

In a divorce setting, the CCF method typically is employed more frequently than the DCF method. This is based primarily on the fact that smaller companies subject to valuation in a divorce setting often do not prepare the long-term operating projections required to complete the DCF method.

The following steps identify a typical process implemented to complete the CCF method:

1. **Estimate normalized earnings and cash flow for the subject company.** Normalized earnings typically are estimated for the subject company based on consideration of a historical average (straight or weighted) covering a period of time deemed relevant for purpose of estimating the most likely level of long-term future earnings. All non-recurring items—both revenue and expense—should be removed from historical earnings to estimate a normalized earnings base. Depending on the duration and operating stage of the subject company, and based on consideration of economic and industry conditions as of the valuation date, normalized earnings are sometimes, and rationally, based on the subject company’s most recent operating results.

Adjustments are then made to convert normalized earnings to free cash flow, or cash flow that can be distributed to stakeholders (i.e., debt and equity investors) without affecting the future operations of the subject company.

Typical adjustments required to convert normalized earnings to free cash flow available to stakeholders include the add back of reported interest expense, the addition of depreciation and amortization (i.e., “non-cash”) charges, and the deduction of annual required capital expenditures and working capital requirements.

2. **Estimate a long-term growth rate.** The long-term growth rate represents growth expected over a 20-plus year operating horizon. Therefore, the growth rate must be achievable given the subject company’s planned capital expenditure capacity and working capital limits. Generally, the estimated long-term growth rate will be developed based upon an analysis of historical growth, as well as consideration of long-term inflation, expected population increases, and projected industry and economic conditions.
3. **Estimate the required rate of return on capital for the subject company.** Normalized earnings and estimated free cash flow calculated in Step 1 above represent earnings and cash flow available to all investors. Therefore, the appropriate required rate of return should reflect the risks inherent in a weighted investment in the subject company’s debt and equity. The relevant weights are represented by the proportion of debt and equity in the subject company’s expected long-term, or optimal, capital structure.

Typically, the prospective capital structure is altered from the historical capital structure only when a control level of value is being sought. In such instances, the capital structure often is assumed to be optimized at a level represented by the industry average capital structure.

Factors generally considered in estimating the appropriate required rate of return on equity for the subject company include: the duration of the company, the company’s position within its market and industry, the size of the company, the threat of existing competitors and new competitors, the level of historical returns provided by the company and the variability in the returns, the financial structure and operating structure of the company, the degree of reliance on key personnel and significant customers, management depth and experience, and exposure to uncontrollable operating risks, such as the regulatory environment.

Factors generally considered in estimating the relevant cost of debt include: the subject company’s current cost of debt, the subject company’s existing debt level and capacity for additional debt, and the subject company’s historical debt servicing patterns and relevant coverage ratios.



4. **Deduct long-term growth estimated in Step 2 from the required rate of return on invested capital estimated in Step 3.** Deducting estimated long-term growth from the estimated required rate of return on invested capital results in the capitalization rate applicable to the economic earnings estimated in Step 1. The capitalization rate, or divisor, can be converted into an economic earnings multiple by dividing the indicated capitalization rate into one. For example, a capitalization rate of 20 percent converts to an earnings multiple of 5.0 as follows:  $(1 \div .20) = 5.0$ .
5. **Capitalize economic earnings by the indicated capitalization rate.** Economic earnings estimated in Step 1 can be divided by the indicated capitalization rate or multiplied by the implied economic earnings multiple estimated in Step 4 to estimate the value of the subject company.

A simplified model of the CCF method is presented below:

**Exhibit 2:**

**Capitalization of Debt-Free Cash Flow**

**Calculation of Equity Value on a Controlling Basis**

After-tax, normalized net cash flow to total invested capital	\$500,000
x (1 + expected long-term growth rate of 3%)	1.03
= Long-term, normalized cash flow to total invested capital	\$515,000
÷ WACC direct capitalization rate (15% - 3%)	12%
= Indicated MVIC (rounded)	\$4,300,000
- Interest-bearing debt	(\$1,300,000)
= Market value of equity	\$3,000,000

**Key Considerations Regarding the Income Approach.** The income approach can be equated to the present value summation of all economic returns (i.e., cash flow) expected to be received during the period that an asset (i.e., company or interest in a company) is owned. As a result, the following are key questions that require rational, well-supported responses from an expert in order to gain the necessary comfort that the valuation conclusion produced by the income approach is reasonable and reliable:

1. If the DCF method has been utilized, were the projected operating statements incorporated in the analysis developed by management in the normal course of operations, or were they developed by the expert (and therefore subject to greater challenge)?
2. Do the projected operating statements and related cash flows reflect growth, margins, and investment levels (i.e., capital improvements and working capital requirements) that are consistent with historical results and industry norms?
3. Has the present value discount rate been developed in a manner consistent with the cash flow stream that is being converted to a present value? (e.g., Projected, after-tax cash flow available to equity investors should be discounted using an after-tax, equity-based discount rate, while projected, after-tax cash flow available to debt and equity investors should be discounted using an after-tax WACC discount rate.)
4. Is the estimated, long-term terminal growth rate consistent with historical growth and supported by expected economic and industry growth?
5. If the CCF method has been utilized, has the level of cash flow incorporated in the model appropriately been “normalized” to reflect a reasonable level of long-term, expected cash flow that is consistent with historical and expected operating results given the development stage of the subject company and expected economic and industry conditions?

6. Was the capitalization rate—i.e., the estimated discount rate reduced by expected, long-term growth—developed in a manner consistent with the cash flow being capitalized (as discussed above regarding the DCF discount rate), and does the capitalization rate appropriately reflect the risks inherent in the expected cash flow? (i.e., Have industry risk, size risk, and company-specific risk—including product/service and key person risk—factors appropriately been considered?)
7. Is the estimated, long-term growth rate reasonable based on consideration of (i) how the long-term, normalized cash flow was estimated, (ii) historical operating results, (iii) cyclical/seasonal impacts, and (iv) economic and industry expectations.
8. Is the indicated valuation conclusion consistent with—within a reasonable range of—the valuation conclusions produced by other valuation approaches considered?
9. Does the value conclusion consider the impact of nonoperating assets (e.g., excess cash, nonoperating investments)?
10. Has the implied equity value conclusion been adjusted appropriately for consideration of control/lack of control and marketability/lack of marketability considerations relevant for the subject ownership interest? (e.g., A noncontrolling equity interest in a privately held company should reflect appropriate adjustments to value for noncontrolling, nonmarketable status.)

### **Market Approach**

The third approach that often is utilized to estimate the value in a divorce setting is the market approach. The market approach is based on the premise that the value of a company can be estimated based on consideration of the price investors are willing to pay for similar companies (or ownership interests) with comparable risk profiles and offering comparable economic returns.

Two methods typically are utilized when the market approach is deemed relevant for the purpose of estimating value in a divorce setting: (1) the guideline publicly traded company (GPTC) method, and (2) the guideline merged and acquired company (GMAC) method. The GPTC method is based on the analysis of pricing (i.e., trading volume and “per share” value), operating and financial data relating to the stock of publicly traded companies. The GMAC method is based on the analysis of pricing (i.e., total, or controlling, sale value), operating and financial data relating to completed transactions involving transfers of publicly traded and private companies.

Because the pricing data incorporated in the GPTC method relates to transfers of minority interests (i.e., noncontrolling shares) in the related companies, the initial indication of value resulting from the GPTC method typically is interpreted as representing a noncontrolling indication of value. Because the pricing data incorporated in the GMAC method relates to transfers of controlling interests (i.e., mergers and acquisitions) involving the related companies, the initial indication of value resulting from the GMAC method typically is interpreted as representing a controlling indication of value.

**Guideline Publicly Traded Company Method.** The first step in the GPTC method is to search for publicly traded companies deemed reasonably comparable to the subject company by identifying the most appropriate Standard Industrial Classification (SIC) or North American Industrial Classification (NAIC) code. Sources typically reviewed for information on publicly traded companies include:

- S&P Capital IQ—[www.capitaliq.com](http://www.capitaliq.com) (information regarding 79,000 publicly traded companies—domestic and foreign)
- MergentOnLine—[www.mergentonline.com](http://www.mergentonline.com) (information regarding 15,000 domestic companies and 20,000 international companies)
- Bloomberg—[www.bloomberg.com/professional/](http://www.bloomberg.com/professional/) (information regarding nearly all active and inactive domestic/international companies)
- Thompson ONE—[www.thompsonreuters.com](http://www.thompsonreuters.com) (information regarding 52,000 public companies and 1million private companies)
- FactSet—[www.factset.com](http://www.factset.com) (information regarding 73,000 companies worldwide)
- Pitchbook/BVR Guideline Public Company Comps—[www.bvmarketdata.com](http://www.bvmarketdata.com) (information regarding nearly all publicly traded domestic companies)

The next step is to narrow the list of potential guideline publicly traded companies to arrive at a list of relevant guideline publicly traded companies. Key factors considered for the purpose of narrowing the list of potential guideline publicly traded companies to the group considered most representative of the risk, return and pricing characteristics relevant for the purpose of valuing the subject company typically include:

1. Comparability of business description/operating focus
2. Reasonable size comparability
3. Domestic companies
4. Relative financial and operating comparability
5. Absence of financial/operating distress
6. Pricing and trading activity

After a list of guideline publicly traded companies has been selected, typically five years of historical financial statement data (and projected data, if available) is used by the expert to calculate various pricing multiples, which are applied, after any necessary adjustments, to the subject company's appropriate fundamentals.

Pricing multiples that often are considered for the purpose of completing the GPTC method typically include:

1. Equity pricing multiples:
  - Price per share/earnings per share
  - Price per share/cash flow per share
  - Price per share/book value per share
  - Price per share/revenue per share
2. Invested capital pricing multiples:
  - Market value of invested capital (MVIC—total debt and equity)/earnings before interest and taxes (EBIT)
  - MVIC/earnings before depreciation, interest, and taxes (EBDIT)
  - MVIC/debt-free net income (DFNI)

- MVIC/debt-free cash flow (DFCF)
- MVIC/revenues
- MVIC/tangible book value of invested capital (TBVIC)

Depending on the specific circumstances regarding the subject company as of the valuation date, each of the pricing multiples deemed relevant may be calculated based on consideration of (1) latest twelve-month (LTM), last fiscal year (LFY), average, weighted-average, or projected fundamentals.

The next step in the application of the GPTC method is to select the appropriate pricing multiples to apply to the relevant financial fundamentals of the subject company. Adjustments to the indicated pricing multiples of the guideline publicly traded companies generally are required to reflect differences in the risk profiles between the subject company and the publicly traded companies, based primarily on consideration of: size (e.g., assets, revenues, customers/clients, products/services), geographic diversity and differences in the demographics of markets served, market position, depth of management, capital and access to capital, profitability, expected growth, and variability of earnings and cash flow.

After estimating the appropriate pricing multiples, the analyst applies the selected multiples to the relevant fundamentals—as appropriately normalized—of the subject company.

The indications of value resulting from the application of the various pricing multiples are then reconciled and weighted, typically to produce a single, “point-estimate,” of value. (Recognized valuation standards allow for the valuation conclusion to be presented as a “range of values” in certain, agreed-upon circumstances.)

MVIC-derived multiples are most useful when comparing the subject company to guideline publicly traded companies that have substantially different capital structures. Applying invested capital multiples to the fundamentals of the subject company results in an estimate of MVIC for the subject company. To estimate the value of the equity, the market value of the interest-bearing debt for the subject company as of the valuation date must be subtracted from the indicated MVIC.

In some states/jurisdictions, and based on the belief that the GPTC method is not appropriate for the purpose of estimating the value of smaller, nonpublic companies, the GPTC method generally is limited to the analysis of larger private companies. As a result, the GMAC method often is considered more relevant regarding the valuation of smaller, nonpublic companies.

**Guideline Merged and Acquired Company Method.** Based on the GMAC method, the value of a subject company can be estimated by analyzing completed transactions involving companies deemed reasonably comparable. To search for mergers and acquisitions, the expert focuses on the appropriate SIC/NAICS codes, as previously discussed in the GPTC method.

Commonly used sources for identifying relevant merger and acquisition data include:

- Capital IQ
- Thompson ONE
- Pratt's Stats
- Bizcomps
- FactSet Mergetstat
- Merger & Acquisition Sourcebook
- SDC OnLine
- Mergerstat Review

In addition, there are also publications that summarize completed transactions for specific categories of healthcare organizations (e.g., hospitals, HMOs, and physician practices), such as Irving Levin Associates, Inc., *The Health Care M&A Report*.

Further, with regard to certain medical and dental practices, *The Goodwill Registry* publishes data regarding the estimated price paid for intangible assets of the selected professional practices (as a percentage of gross revenue). This data, published annually, is sorted by year of the transaction and by medical/dental specialty.

Implementing the GMAC requires that the terms of each relevant transaction be reviewed to determine the actual price paid, and whether the transaction involved the sale of equity or assets. If the transaction involved the sale of assets, it is important to determine the exact assets purchased and the treatment of any liabilities.

After identifying and selecting a group of guideline transactions and determining the purchase price for each transaction, various pricing multiples are calculated. As in the GPTC method, after estimating the appropriate pricing multiples, the expert applies the relevant, selected pricing multiples to the normalized fundamentals of the subject company.

An example of the guideline merged and acquired company data is presented in Exhibit 3. This example presents pricing multiples resulting from the analysis of 11 acquired<sup>6</sup> multi-specialty practices for the valuation of Medical Clinic, Inc. (MCI), which operates as a 100-physician multi-specialty practice with five sites in a metropolitan area.

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<sup>6</sup> Based on data presented in Irving Levin Associates, Inc., *The Health Care M&A Report*.

### Exhibit 3 – Multispecialty Merged and Acquired Company Analysis Medical Clinic, Inc.

Acquired Practice	Location	Physicians	Revenue (\$)	Price/Physician (\$)	Price/Revenue(\$)
Riverside Medical Clinic	Riverside, CA	90	50,000,000	355,556	.64
Lexington Clinic	Lexington, KY	125	51,000,000	512,000	1.25
Arnett Clinic	Lafayette, IN	109	87,438,000	660,528	.82
Diagnostic Clinic	Largo, FL	93	49,000,000	395,699	.75
Glen Ellyn Clinic	Glen Ellyn, IL	89	60,000,000	707,865	1.05
Cardinal Healthcare, PA	Raleigh-Durham, NC	75	34,170,500	573,333	1.26
Summit Medical Group	Summit, NJ	75	47,000,000	736,087	1.17
Lewis-Gale Clinic, Inc.	Roanoke, VA	106	68,200,000	410,377	.64
Clinical Associates	Baltimore, MD	71	35,870,000	245,070	.49
Meridian Medical Group	Marietta, GA	67	63,950,000	419,597	.44
Berkshire Physicians	Pittsfield, MA	93	43,683,000	317,204	.68

Based on the information provided by the analysis of the merged and acquired physician practices, an expert faced with the challenge of appraising MCI should consider and analyze the following factors, among others, for the purpose of making appropriate pricing multiple selections:

- The dates of the guideline transactions relative to the valuation date of MCI.
- Market conditions at the date of the GMAC transactions relative to market conditions existing at the valuation date of MCI.
- Size of MCI (based on assets, revenues, and number of physicians) relative to the GMACs.
- Physician mix (i.e., primary care versus specialty care) of MCI relative to the GMACs.
- Payer mix (i.e., fee-for-service, HMO, PPO, Medicare, Medicaid) of MCI relative to the payer mix of the GMACs.
- Profitability—measured by consideration of operating income and total physician compensation and benefits—of MCI relative to that of the GMACs.
- Historical growth—in assets, revenues, physician compensation and profits—of MCI relative to that of the GMACs.
- Diversity of practice (i.e., level of ancillary services) of MCI relative to that of the GMACs.
- Location of MCI (i.e., rural, urban, suburban) relative to the locations of the GMACs.
- Market position of MCI relative to the market position of the GMACs in their respective catchment areas.

While all of the above information may not be readily available with regard to the identified acquired companies, an analysis of all pertinent and available information is an important step in the selection of relevant and supportable market-derived pricing multiples.

Upon selecting the appropriate pricing multiples and applying them to the relevant fundamentals of the subject company, the GMAC method is completed in the same fashion as the GPTC method.

**Key Considerations Regarding the Market Approach.** The market approach can be equated to a relative value process—in essence, estimating the value of a company based on comparability with other, similar companies that either (1) are publicly traded, or (2) recently have been acquired. As a result, the following are key questions that require rational, well-supported responses from an expert in order to

gain the necessary comfort that the valuation conclusion produced by the market approach is reasonable and reliable:

1. Based on consideration of relative (i) business focus, (ii) size, (iii) diversity of product/service offerings, (iv) markets served, and (v) growth and profitability, has a relevant and adequate pool of GPTC or GMAC been identified (i.e., considering both comparability and number of companies)?
2. Based on consideration of the business focus of the subject company and the industry in which it operates, have the appropriate pricing ratios (e.g., price/asset, price/book value, price/revenue, price/earnings, price/cash flow) been emphasized?
3. Based on consideration of the stage of operations for the subject company and the industry in which it operates, have the pricing ratios been developed with appropriate emphasis on the most relevant operating periods (e.g., LTM, LFY, 3-year average or 3-year weighted-average, 5-year average or 5-year weighted-average)?
4. Are the selected pricing ratios reasonable in the context of the indicated pricing ratio ranges and comparative analysis between the subject company and the GPTC/GMAC?
5. Is the weight attributed to each indication of value reasonable based on consideration of the stage of operations for the subject company and the industry in which it operates?
6. Is the indicated valuation conclusion consistent with—within a reasonable range of—the valuation conclusions produced by other valuation approaches considered?
7. Does the value conclusion consider the impact of nonoperating assets (e.g., excess cash, nonoperating investments)?
8. Has the implied equity value conclusion been adjusted appropriately for consideration of control/lack of control and marketability/lack of marketability considerations relevant for the subject ownership interest? (e.g., A noncontrolling equity interest in a privately held company should reflect appropriate adjustments to value for nonmarketable status when using the GPTC method.)

## **NORMALIZED ECONOMIC EARNINGS**

As previously discussed, normalized earnings are intended to represent an earnings level for the subject company that reflects financial performance under “normal” operating circumstances. In essence, normalized earnings should represent a true indication of the historical and expected financial operating results for the subject company that an investor reasonably could rely upon for the purpose of making an investment decision.

In a divorce setting, the process of normalizing earnings often proves to be one of the most challenging aspects of an engagement that an expert must address when valuing the subject company. Some level of forensic, or investigative, analysis is required in most divorce circumstances. The following are key areas of interest that typically must be addressed when normalizing the earnings of a subject company:

1. The reasonableness of owner/operator compensation and benefits (i.e., are compensation and benefit levels in line with industry norms based on related responsibilities and commitment level)

2. The existence, significance, and reasonableness of related party activity (e.g., does income recognized/expense reported as a result of related party dealings reflect market-based levels)
3. The impact of unusual/nonrecurring income and expense items (e.g., litigation awards/settlements, regulatory fines/penalties, unique/discontinued business lines, theft losses/write-offs, loss recoveries/insurance proceeds, significant gains/losses on asset sales, discretionary/nonbusiness-related income/expense, etc.)
4. The impact of seasonal/cyclical influences on reported operating results (e.g., cyclical industries such as forest products and real estate, or seasonal considerations such as retail and agriculture)

A well-reasoned valuation analysis prepared in a divorce setting will identify and appropriately address those items deemed material and included within the categories identified above. In some instances, doubts regarding the persistence and/or materiality of required normalizing adjustments may be so significant that a formal forensic analysis may be required. Such an analysis will not only enable an expert and legal counsel to gain the comfort necessary to develop a reasonable level of normalized earnings for the subject company, but may also result in the identification of undisclosed assets that should be included in the marital estate..

### **OWNERSHIP CHARACTERISTICS**

The valuation subject in a divorce setting can be represented by any level of ownership, ranging from 1 percent to 100 percent of the equity in a subject company. The nature of the ownership interest can range from highly liquid, publicly traded stock, to an equity interest represented by stock or membership units in a privately owned, (1) regular corporation, (2) subchapter S corporation, (3) limited liability company, or (4) partnership.

Of key significance with regard to the analysis and valuation of an equity interest includable in a marital estate is a clear understanding of the economic rights and benefits inherent in the subject ownership interest. A controlling equity position in a nonpublic company typically would require the concluded value to incorporate the impact of (1) a reasonable adjustment for controlling ownership status (i.e., a control premium), and, possibly, (2) some consideration for the estimated cost to convert the position to cash (i.e., illiquidity discount). Similarly, a noncontrolling equity position in a nonpublic company typically would require the concluded value to incorporate the impact of (1) a reasonable adjustment for noncontrolling status (i.e., a discount for lack of control), and (2) a reasonable adjustment for nonpublic status (i.e., a discount for lack of marketability).

Control (or lack of control) and marketability (or lack of marketability) adjustments regularly are addressed in valuations completed for divorce purposes. Further, there are numerous authoritative valuation standards, texts, articles, and judicial precedents that provide guidance regarding the identification and treatment of control and marketability considerations, a more detailed presentation of



which is beyond the scope of this discussion. However, it is worth noting that a combined discount for lack of control and lack of marketability status can often approach 50 percent of an otherwise controlling-level value, emphasizing the importance of these considerations.

In addition to adjustments relating to control and marketability characteristics inherent in an ownership interest, a thorough valuation completed in a divorce context should also address and indicate how the following factors—when relevant—were considered in arriving at the opinion of value presented:

1. Key person dependency (i.e., whether a direct discount was applied, or whether an “implied” discount is reflected in the calculation of the discount/capitalization rate in the income approach, and/or the multiple selection process in the market approach)
2. Key customer dependency (i.e., whether a direct reduction was applied when normalizing earnings, or whether an “implied” discount is reflected the manner previously identified with regard to key person dependency)
3. S corporation status (i.e., whether a direct premium was applied, or whether an “implied” premium is reflected in the form of a reduced discount for lack of liquidity or marketability)

#### **VALUATION-BASED ORGANIZATIONAL AGREEMENT TERMS/PRIOR TRANSACTIONS**

Shareholder, operating, and partnership agreements, and related documents, often include provisions intended to address the question of “value” with regard to the underlying equity of the subject company. Often, the related provisions provide very specific definitions of “value,” and/or detailed processes for estimating value.

While the provisions often included in the organizational documents related to above may be precise with regard to the definition of value and the process for estimating the value of the underlying equity of the subject company, the definition of value provided may not be consistent with the standard of value required in the relevant state/jurisdiction in a particular divorce setting. This, however, does not mean that the valuation-related provisions incorporated in organizational documents should be ignored.

Prudent valuation practice requires that the valuation-related provisions in organizational documents are thoroughly reviewed (if available) and considered. When appropriate and possible, “value” should be estimated (i.e., “calculated” when formulas are presented) pursuant to the terms established by the relevant provisions. At this point, the expert can then reconcile the value indication resulting from the related provisions with his/her independently estimated value indication. The reconciliation process will enable the expert to establish whether the provision-based value indication is relevant for consideration (i.e., given any weight) when rendering a final opinion of value.

Similarly, prior transactions in the equity of the subject company should be reviewed and analyzed. Of key consideration when analyzing prior transactions in the equity of the subject company are

(1) the date of the transaction(s), (2) the size of the interest(s) involved, (3) the parties involved, and (4) the terms of the transaction(s)—including price and payment terms. Clearly, arms'-length transactions involving unrelated parties that occurred within a reasonably recent period relative to the valuation date and that reflected cash-equivalent consideration would provide the best evidence of value regarding the equity of the subject company. Such transactions may provide meaningful indications of value that are relevant to the expert and that should be considered for the purpose of rendering a final opinion of value.

## **INTANGIBLE ASSET VALUE CONSIDERATIONS**

The intangible asset value of the subject company in a divorce setting routinely is referred to as “goodwill.” As previously discussed, and from an economic perspective, the potential intangible asset value, or goodwill, of a company is based primarily on the expectation of continued earnings and cash flow in excess of normal returns on the tangible operating assets of the company.

In many instances, the intangible asset value inherent in a company can significantly exceed the tangible asset value of the company. This is often the case when a professional practice (i.e., service-based firm) is the subject company in a divorce setting, and why the identification and evaluation of intangible asset value is a key property division consideration in many divorce matters.

In a broad sense, goodwill is defined as

that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.<sup>7</sup>

The treatment of goodwill (i.e., the inclusion or exclusion of goodwill as divisible property) in a divorce setting varies from state to state. The classification of goodwill for property division purposes appears to be dependent primarily on whether the related intangible value is attributable to the subject company (i.e., “enterprise,” or “entity,” goodwill), or attributable to—and inseparable from—an individual (i.e., “personal”) goodwill.

Generally, the state of Oregon recognizes enterprise goodwill as a divisible marital asset, but typically excludes personal goodwill.

### **Enterprise Goodwill versus Personal Goodwill**

Enterprise goodwill generally is interpreted as representing intangible asset value that is owned and/or that has been created by a commercial enterprise and that can be transferred. Identifiable intangible assets typically classified within the enterprise goodwill category include:

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<sup>7</sup> The *International Glossary of Business Valuation Terms*.

1. Trademarks and trade names
2. Patented and unpatented technology
3. Copyrights
4. Customer lists and relationships
5. Contracts, including employment agreements and noncompetition agreements
6. Phone number
7. Leasehold
8. Trained and assembled workforce

These assets possess certain attributes that provide a foundation for their existence, including:

1. They can be identified and described
2. They can be substantiated legally, and defended
3. They can be owned
4. They can be documented
5. They can be purchased or created
6. Generally, they have defined lives, or their existence can be intentionally terminated

Personal goodwill generally is interpreted as representing intangible asset value, or, more appropriately, attributes, that are unique to, and inseparable from, an individual. Attributes typically classified within the personal goodwill category include:

1. Personality
2. Reputation
3. Personal skill, expertise and knowledge
4. Personal relationships

In essence, personal goodwill is represented by certain attributes that are deemed to be incorporated into the very being of an individual, and therefore are unable able to be sold or transferred to another individual.

Valuations in a divorce setting involving a subject company that is very large, or the continuing economic viability of which is not highly dependent on the personal goodwill of a divorcing party, typically do not create significant challenges regarding the divisibility of intangible asset value. In such circumstances, and depending on the subject ownership interest, the primary challenge is developing a reasonable conclusion regarding the value of the subject interest, rather than allocating estimated intangible asset value between enterprise goodwill and personal goodwill.

### **Implications of *Slater V. Slater***

In the Matter of the *Marriage of Shelly A. Slater, Petitioner-Respondent, and Paul J. Slater, Respondent-Appellant* (Crook County Circuit Court, 06DS0016, A137465, filed December 29, 2010), the Oregon Appellate Court ruled that the trial court erred in including the value of a hypothetical noncompetition

covenant when it valued Slater Chiropractic (the Practice) and, consequently, erred in determining the value of the business.

The opinions of the fair market value of the Practice offered by the experts—\$610,000 by Wife’s expert and \$504,152 by Husband’s expert—were within a reasonable range. However, Wife’s expert concluded that all of the indicated Practice value above the estimated net tangible asset value of \$160,902—i.e., \$449,098—was independent of Husband (the sole owner and primary practitioner) and attributable to “entity goodwill.”

Conversely, Husband’s expert concluded that only \$30,373 of an estimated \$303,730 in total intangible asset value for the Practice was attributable to a noncompetition agreement between the Practice and the associate (i.e., employee) chiropractor, Dr. Miller. Husband’s expert further concluded that the remaining \$273,357 in estimated intangible asset value for the Practice was attributable to the “ongoing personal services of Husband,” and, as personal goodwill, should be excluded from the estimated total practice value for property division purposes.

In agreeing with Husband’s expert, the Appellate Court concluded that the fair market value of the Practice was \$230,795 (i.e., the \$504,152 estimated total Practice value less “personal goodwill” estimated at \$273,357), rather than the \$500,000 conclusion presented by the trial court. Key reasoning offered by the Appellate Court in rendering its decision (i.e., that the preponderance of the indicated goodwill was personal to Husband) and remanding the matter to the trial court included:

1. husband was the sole owner of the Practice
2. the Practice bore Husband’s name
3. half of the Practice’s business (i.e., revenue) originated from Husband’s status as a preferred provider (with no evidence that such status could be transferred to the Practice or a new owner)
4. when Husband purchased the Practice in an arm’s-length transaction (10 years prior to the divorce), payment for his predecessor’s noncompetition covenant (in essence, personal goodwill) was substantially more than payment for the business goodwill

Of particular significance in the Appellate Court’s opinion is emphasis of the fact that Wife made no attempt to present a valuation of the business differentiating between enhanced earnings attributable to the entity and enhanced earnings attributable to Husband individually. While Wife’s expert testified that *none* of the enhanced value of the Practice was attributable to Husband personally, Wife’s expert agreed that, if husband were to sell his business, it would be necessary for him to execute a noncompetition covenant.

As stated by the Appellate Court:

*That acknowledgement is irreconcilable with the position that Husband's personal skills, services, and continued presence are immaterial to the business's enhanced earnings. If that were so, the assumption of a noncompetition covenant would be inapposite to valuation.* (Emphasis added.)

While the facts and circumstances regarding *Slater v. Slater* are specific to that matter, the Appellate Court's ruling and related foundation are instructive when valuation in a divorce setting in Oregon involves a professional practice or service-based entity that is highly dependent on the continued presence and participation of a single individual. It is worth noting that the Appellate Court provided "hints" regarding how the Wife could have presented rational evidence segregating the indicated goodwill between Husband (i.e., personal) and the Practice (i.e., entity):

- Was the "preferred provider" status specific to Husband, or general with regard to the Practice? The record indicates that Husband underwent back surgery shortly before trial, and was expected to be in recovery and unable to work for three to six months. Husband wrote a letter to his patients encouraging them to seek treatment from Dr. Miller in his absence. Such a circumstance implies some level of transferability with regard to goodwill that would otherwise be deemed personal to Husband. Further, such a circumstance suggests that the Practice, rather than Husband, maintained the "preferred provider" status that was credited with generating over half of the Practice's business.
- Of the remaining 40 percent of the Practice's business—attributable to word-of-mouth referrals and advertising in the Yellow Pages—what percentage of patient services were attributable to Dr. Miller? The record indicates that Husband's expert determined that 10 percent of total goodwill, based on the percentage of collected revenues, was attributable to Dr. Miller's practice.
- What portion of the Practice's business was attributable to insurance that was contracted with the Practice, as a qualified provider, rather than Husband, as a specific provider?

### **Addressing "Double- Dipping"**

In a divorce setting "double dipping" is the term often ascribed to the inappropriate inclusion, or "double counting," of the same economic value in both property division and marital support determinations. The rationale supporting the inappropriateness of double dipping is premised on the concept that earnings that are capitalized or otherwise incorporated into the valuation process for the purpose of estimating the value of marital property must be excluded from earnings that serve as the basis for establishing marital support.

A simple example clarifies the point, and the significant impact that double dipping can exert with regard to the division of a marital estate.

Assume the following facts:

- Wife owns and operates 100% of a closely held company
- Wife's total compensation from the business has averaged \$750,000 annually, with little variability, in the 5 years preceding the valuation date
- average company earnings, after taxes, averaged \$2 million annually, with little variability, in the 5 years preceding the valuation date
- a very qualified, rational, and diligent expert has concluded, using the capitalization of earnings method, that market-based, total compensation for wife is stated reasonably at \$450,000, and that a reasonable capitalization rate for the company is 15%

A potential "double dip" would occur if (1) for support purposes, Wife's total gross income is based on assumed, continuing compensation of \$750,000 annually, and (2) the company is valued based on a "normalization" of earnings for the company including an assumption that Wife's annual compensation should be restated to \$450,000. The normalization process would result in annual, expected earnings for the company increasing by \$300,000, or the difference between Wife's actual compensation of \$750,000 and reasonable, market-based compensation of \$450,000. The incremental earnings level attributed to the company as a result of the normalization of compensation equals \$180,000 on an after-tax basis (i.e., \$300,000 in incremental earnings reduced by a 40% effective income tax rate).

Based on a 15% capitalization rate (or an implied earnings multiple of 6.7 times—i.e.,  $1 \div .15 = 6.666$ , or 6.7), the normalization process results in an increase in the value of the company of approximately \$1.2 million:  $\$180,000 \div .15 = \$1,200,000$ . It is clear that the \$300,000 reduction in compensation for valuation purposes results in a higher business valuation and should therefore not also be included in the assumed, continuing gross income for Wife, which would result in a higher level of marital support.

Avoiding the "double dip" would require either (1) estimating support based on the normalized compensation level of \$450,000 incorporated in the valuation process, or (2) estimating support based on the historical compensation level of \$750,000 and excluding the compensation adjustment from the valuation process. From the expert's perspective, and barring unusual circumstances, it would be inappropriate to complete the valuation ignoring market-based evidence indicating that an adjustment to owner's compensation was (1) relevant and appropriate, based on generally accepted valuation practice, (2) supportable, and (3) quantifiable.

## **SUMMARY AND CONCLUSION**

A thorough and defensible business valuation requires strict adherence to generally accepted business valuation practice. Such adherence is achievable only through the consistent application of relevant business valuation standards, and consideration of authoritative financial, economic and valuation theory (as embodied in authoritative literature and court precedents).

Business valuation in a divorce setting often is complicated by challenges relating to the completeness and accuracy of data, and access to data. Further, the nature of a divorce circumstance often creates a less-than-optimal environment for experts to deliver services due to what is generally deemed emotionally driven behavior on the part of one, or both, of the divorcing parties.

This chapter discussed the some of the key considerations that qualified business valuation experts and legal counsel must address when faced with the task of placing “value” on business-related assets includable within a marital estate. This chapter also identified several key issues that should be addressed during the valuation process in order to ensure that a relevant and defensible opinion of value is developed.

*Charles Wilhoite is a managing director at Willamette Management Associates and national director of the tax-exempt entity and health care services practice. Charles has been with the firm for 25 years and has testified extensively throughout the country in divorce and other litigated matters. Charles can be reached at (503) 243-7500, or at [cawilhoite@willamette.com](mailto:cawilhoite@willamette.com).*