VALUATION OF LAW PRACTICE IN DIVORCE

EDWIN J. (TED) TERRY
JIMMY VAUGHT
KARL E. HAYS
Law Offices of
Edwin J. (Ted) Terry, Jr.
805 W. 10th Street, Suite 300
Austin, Texas 78701
Telephone: (512) 476-9597
Fax: (512) 476-6106

KATHERINE A. KINSER
BRIAN W. CLARK
DAVID A. TANNER
McCurley, Kinser, McCurley & Nelson, L.L.P.
5950 Sherry Lane
Dallas, Texas 75225
Telephone: (214) 273-2400
Fax: (214) 273-2470

AMERICAN ACADEMY OF MATRIMONIAL LAWYERS
MIDYEAR MEETING
March 2-9, 2002
Sanibel, Florida

Table of Contents

I. INTRODUCTION.. 1

II. ENTITY THEORY: FORM OF THE PROFESSIONAL PRACTICE.. 1
- A. Sole Proprietorship. 1
- B. Partnership.. 1
  - 1. In General. 1
  - 2. Effect of the Aggregate Theory. 1
  - 3. Partnership Agreement. 2
  - 4 Joint Venture Distinguished. 2
- C. Corporation. 2
  - 1. C-Corp. 3
  - 2. S-Corp.. 3
  - 3. Closely held Corporation. 3
  - 4. Professional Corporation. 3

III. GOODWILL. 3
- A. Definition. 3
- B. Types of Goodwill. 4
  - 1. Professional Goodwill. 4
  - 2. Practice Goodwill. 4
  - 3. "Mixed" Professional and Practice Goodwill.. 5
- C. The Existence of Goodwill: Evidentiary Factors. 5
  - 1. The business name is different from the individual's.. 5
  - 2. The business employs many employees. 6
  - 3. The business contracts with customers.. 6
  - 4. The business supplies competitive prices and services. 6
  - 5. The business serves many clients. 6
  - 6. The business has an established location. 7
- D. The Divisibility of Goodwill. 7
- E. Other Jurisdictions. 7
- F. Goodwill and the Sole Proprietorship. 7
  - 1. *Nail* and Its Progeny. 7
  - 2. How Not to Value a Sole Proprietorship. 8
- G. Goodwill and the Partnership. 9
- H. Goodwill and the Closely Held or Professional Corporation. 10
- I. The Impact of *Salinas v. Rafati*.. 12
- J. Goodwill: Evidentiary and Procedural Considerations.. 13
  - 1. Proof. 13
  - 2. Findings of Fact. 13
  - 3. Exclusion Procedure.. 14

IV. VALUATION THEORY.. 14
- A. Introduction to the Valuation Process. 14
- B. The Definition of "Value". 15
- C. The Measure of Value. 16
  - 1. Market Value.. 16
    - a. Willing Buyer and Willing Seller. 16
    - b. Determining Market Value. 17
    - c. Sales: Comparable and Otherwise.. 18
  - 2. Intrinsic Value.. 19
  - 3. Value to the Owner. 19
  - 4. Book Value. 20
- D. Summary of Valuation Methods.. 20

1. Adjusted Net Assets Method. 20
2. Capitalization of Earnings Method. 20
3. Excess Earnings Method 21
4. Discounted Earnings Method. 21
5. Rule of Thumb Methods. 21
6. Market Based Methods. 22

E. Valuation of Intangible Assets: Discretely or Collectively? 22
F. GAAP 23
G. Capitalization Rates 24
H. Revenue Ruling 59-60 24
I. Discounts and Premiums 25
1. Lack of Marketability Discount. 25
2. Minority Discount. 26
3. Control Premiums. 27

J. Transfer Restrictions 28

V. VALUATION PRACTICE 29
A. Valuing a Professional Practice 29
B. Normalizing Income 29
C. Discovery and Valuation Experts 30
1. Valuation Credentials. 30
   a. ABV: Accredited in Business Valuation. 30
   b. CVA: Certified Valuation Analyst. 30
   c. ASA: Accredited Senior Appraiser. 30
   d. CBA: Certified Business Appraiser. 30
2. Written Report. 30
3. Depose the Expert. 31

D. Documentary Evidence at Trial 32
1. Original Purchase Documents. 32
2. Corporate Minutes. 32
3. Corporate Balance Sheets, Profit and Loss Statements, and Sales Forecasts. 32
4. Representation of Value to Third Parties. 33
5. Tax Returns, Buy-Sell Agreements, Partnership Agreements, and Stock Transfer Ledgers. 33
6. Prior Litigation. 34
7. Loan Applications and Financial Statements. 34
8. Personal Property Tax Rendition Records. 34
9. Business Interruption Insurance Policies and Underwriters' Reports. 35
10. Market Studies. 35
11. Real Estate or Equipment Leases. 35
12. Real Estate Tax Records. 35
13. Trade Association Brochures and Information. 35
14. Offers to Buy/Sell. 36
15. Record Replacement Insurance. 36

E. You Don't Always Need a Hired Gun 36
F. Specific Contract Provisions 37

VI. COMMON PROBLEMS IN VALUING A PROFESSIONAL PRACTICE 37
A. Transfer Restrictions: Binding on Spouse? 37
1. Family Law Context. 37
2. Commercial Context. 38
3. Enforceability Against Non-Employee Spouse. 39
   a. Signature. 39
   b. Legal Representation. 40

c. Fairness of Agreement. . . . 40
d. Sophistication of Non-Employee Spouse. . . . 40
B. The Effect of Buy-Sell Agreements. . . . 40
C. Dirty Tricks. . . . 42
1. Hiding Income. . . . 42
2. Improper Valuation Methods. . . . 42
a. Harnessing Future Earnings. . . . 43
b. "Gross Receipts" v. "Profits". . . . 43
3. Intentional Devaluation. . . . 44
4. Partnership Conspiracy to Defraud. . . . 44

VII. COMMON PROBLEMS IN VALUING A PROFESSIONAL LAW PRACTICE. . . . 45
A. Problems with the Professional Corporation. . . . 45
B. Problems with Personal Injury Practices. . . . 45
1. Percentage of Completion. . . . 45
2. Inception of Title. . . . 46
3. Referral Fees. . . . 46
a. Fees Paid Out. . . . 46
b. Fees Paid In. . . . 46
4. Structured Settlements. . . . 46
5. Advanced Expenses and Costs. . . . 47
6. Partners' or Shareholders' Percentage Interest. . . . 47
7. Shelf Life of Cases. . . . 47
C. Contingent Fees. . . . 47
1. States In Which Contingent Fee is Marital Property. . . . 47
a. Arizona. . . . 47
b. Arkansas. . . . 48
c. California. . . . 48
d. Colorado. . . . 48
e. Louisiana. . . . 48
f. Massachusetts 48
g. New York. . . . 48
h. Washington. . . . 49
i. West Virginia. . . . 49
j. Wisconsin. . . . 49
2. States In Which Contingent Fee is Not Marital Property. . . . 49
a. Florida. . . . 49
b. Georgia. . . . 49
c. Illinois. . . . 49
d. Missouri. . . . 49
e. Oklahoma. . . . 50
f. Pennsylvania. . . . 50
3. When to Divide: Now or Later. . . . 50
D. Problems with Discovery. . . . 50
1. Texas. . . . 50
2. Other Jurisdictions. . . . 52
E. Ethical Considerations. . . . 53
1. Privileges. . . . 53
2. Confidentiality. . . . 54
3. Precautions to Protect Confidentiality. . . . 55

VIII. THE PROFESSIONAL LICENSE. . . . 55
A. Argument. . . . 55
B. Counter-Argument. . . . 56

IX. CONCLUSION 56

APPENDIX A **Are Contingency Fees a Part of the Marital Estate?**
50 States and Washington D.C.

VALUATION OF LAW PRACTICE IN DIVORCE

I. INTRODUCTION

Many contests between divorcing spouses often boil down the trial court's treatment of a business or professional practice, its characterization, and then its valuation. The article will present a general overview of the valuation, for purposes of divorce, of the professional practice and will then discuss some of the common problems in valuing a professional law practice. The Authors will primarily discuss valuation of a professional practice and professional law practice in relation to Texas case law and statutes although significant case law and statutes from other jurisdictions may be mentioned when applicable.

II. ENTITY THEORY: FORM OF THE PROFESSIONAL PRACTICE

The "form" of the particular professional practice is probably the first inquiry to be made in any valuation. Depending on the form of the practice, different issues are at stake, including the often critical issue of "commercial goodwill" versus "personal goodwill," as discussed below. Other significant issues may hang as well on the form of the practice, such as transfer agreements between partners, and the laws controlling ownership interests in professional corporations. In general, the more complex or historically varied the form, the more and varied issues that arise.

All of these factors–and others–affect the value of a spouse's ownership interest in a professional practice.

A. Sole Proprietorship

In a sole proprietorship, an individual owns the business and its assets outright. A sole proprietorship is thereby distinguishable from partnership or corporate entities, in which ownership interests are held by the partners or shareholders of the entity, while the entity itself owns the assets. Thus, in a divorce, the valuation of a sole proprietorship specifically includes will focus on the assets of the practice, whereas a valuation of a partnership or a corporation (in a divorce) will focus on the value of the partner's interest in the partnership, or the value of the shareholder's stock in the corporation (both of which will reflect the value of the underlying assets of the particular entity).

In a sole proprietorship, the individual assets of the professional practice likely will be community or marital property if acquired during the marriage; such assets are, therefore, subject to division by the court. *See*, *e.g*., *Butler v. Butler*, 975 S.W.2d 765, 786 (Tex.App.–Corpus Christi 1998, no pet.) (the sole proprietorship's furniture, fixtures, machinery, equipment, inventory, cash, accounts, goods, supplies, and all personal property used in connection with the operation of the business, were acquired during the marriage and were therefore community property).

B. Partnership

1. <u>In General</u>

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. TEX.REV.CIV.STAT. art. 6132b, §6. The essential elements of a partnership are (1) an agreement to share profits and losses, (2) a mutual right of control, and (3) a community of interest in the partnership. *See, e.g., MacMorran v. Wood*, 960 S.W.2d 891, 897 (Tex.App.–El Paso 1997, writ denied).

2. <u>Effect of the Aggregate Theory</u>

For purposes of a valuation, a partnership will be treated differently than a sole proprietorship. With the passage of the Uniform Partnership Act in 1961, Texas discarded the aggregate theory of partnership and adopted the entity theory. *Marshall v. Marshall*, 735 S.W.2d 587, 593-594 (Tex.App.–Dallas 1987, writ ref'd n.r.e.). Under the entity theory, the individual assets are owned by the partnership, and not by the individual partners. *Harris v. Harris*, 765 S.W.2d 798, 802 (Tex.App.–Houston [14th Dist] 1989, writ denied). Consequently, partnership property can be characterized neither as community nor separate. *Marshall*, 735 S.W.2d at 594. The only partnership property right possessed by a partner which is subject to a community or separate property characterization is the partner's interest in the partnership. *McKnight v. McKnight*, 543 S.W.2d 863, 867-868 (Tex. 1976); *Farley v. Farley*, 930 S.W.2d 208, 213 (Tex.App.–Eastland 1996, no writ)

(the rights of a divorcing spouse can attach only to the partner"s interest in the partnership, and not specific partnership property).

Thus, in a divorce case, a value must be placed on the partner's ***interest*** in the partnership, which may include the value of the partnership assets. Tangible partnership assets include cash, accounts receivable, work in progress, tangible personalty and realty, etc. Intangible partnership assets include goodwill and going concern value (and should be accounted for in any valuation process). "Intangible property" is commonly defined as property that has no intrinsic and marketable value, but is merely the representative or evidence of value, such as certificates of stock, bonds, promissory notes, and franchises. *Brandes v. Rice Trust, Inc.*, 966 S.W.2d 144, 149 (Tex.App.–Houston [14th Dist.] 1998, pet. denied).

It should be noted that one Texas appellate court has held that, under the entity theory of partnership, undistributed partnership income retained in the partnership is neither the community nor the separate property of any individual partner, but rather remains partnership property, non-divisible upon divorce. *Cleaver v. Cleaver*, 935 S.W.2d 491, 494 (Tex.App.–Tyler 1996, no writ).

3. Partnership Agreement

A valuation of a partnership will usually consider the partnership agreement, if any. *See Salinas v. Rafati*, 948 S.W.2d 286, 289 (Tex. 1997). The partnership agreement, under the law of contracts, governs the rights of the partners. *See, e.g., Dobson v. Dobson,* 594 S.W.2d 177, 180 (Tex.Civ.App.–Houston [1st Dist.] 1980, writ ref'd n.r.e). However, only when a partnership agreement is silent as to particular pertinent issues do the statutory provisions of Texas law come into play. *See, McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex.App.–Dallas 1993, writ denied); *see also*, TEX.REV.CIV.STAT. art. 6132b-1.03(a).

4. Joint Venture Distinguished

A joint venture is a special combination of persons in the nature of a partnership engaged in the joint involvement of a particular transaction for mutual benefit or profit. *Carlyle Joint Venture v. H.B. Zachry Co.*, 802 S.W.2d 814, 816 (Tex.App.–San Antonio 1990, writ denied). A joint venture must possess each of the following characteristics: (1) a community of interest in the venture; (2) an agreement to share profits; (3) an agreement to share losses; and (4) a mutual right of control or management of the enterprise. *See, Coastal Plains Development Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287 (Tex. 1978).

A joint venture is in the nature of a partnership, and is, as a general rule, governed by the same rules as a partnership. *See*, *Truly v. Austin*, 744 S.W.2d 934, 938 (Tex. 1988) (Kilgarlin, J., concurring); *Carlyle Joint Venture*, 802 S.W.2d at 816 (partnerships and joint ventures are so similar in nature that the rights concerning the members of a joint venture are governed by substantially the same rules that govern partnerships).

In contrast to a typical partnership, a joint venture is usually limited to a single transaction. *Harrington v. Harrington*, 742 S.W.2d 722, 724-725 (Tex.App.–Houston [1st Dist.] 1987, no writ). Because a joint venture is normally utilized for only a single transaction, professionals rarely, if ever, engage in joint venture professional practices.

C. Corporation

A corporation is a legal fiction and can act only through its agents. *Maryland Ins. Co. v. Head Indus. Coatings and Servs., Inc.*, 906 S.W.2d 218, 233 (Tex.App.–Texarkana 1995), *rev'd on other grounds*, 938 S.W.2d 27 (Tex. 1996); *In re Marriage of Morris*, 12 S.W.3d 877, 885 (Tex.App.–Texarkana 2000, no pet. history) (a corporation is a separate legal entity that normally insulates its owners or shareholders from personal liability). Ownership of a corporation is evidenced by stock; an individual owns stock in a corporation (thereby an interest in the corporation), while the corporation owns the actual corporate assets. Thus, upon divorce, the trial court can award only shares of stock, and not corporate assets. *See, e.g.,Thomas v. Thomas*, 738 S.W.2d 342, 343 (Tex.App.–Houston [1st Dist.] 1987, writ denied). In other words, the value of an individual's interest

in a corporation is limited to the value of his or her stock, which may include the value of the corporation's tangible and intangible assets; however, the actual assets belong to the corporation and cannot be "partitioned" out of the corporation by a Texas trial court.

The general rule as to the non-divisibility (upon divorce) of corporate assets holds true unless the corporation is a spouse's alter ego. *See, e.g., Siefkas v. Siefkas*, 902 S.W.2d 72, 79 (Tex.App.– El Paso 1995, no writ).

1. C-Corp

A "C-corp" is a regular corporation. Corporate income is taxed at the corporate level; dividends paid to the shareholders are then taxed (a second time) at the shareholder level.

The retained earnings of a C-corp are assets of the corporation, and are not divisible by a trial court upon divorce. *See, e.g., Thomas*, 738 S.W.2d at 344.

2. S-Corp

An "S-corp" is a corporation in which the shareholders have elected "Subchapter S" status, in which corporate income is treated as personal income of the shareholders (like a partnership) for federal income tax purposes; an S-corp does not pay federal income taxes. *See, Id.*; *Suburban Utility Corp. v. Public Utility Commission*, 652 S.W.2d 358, 363 (Tex. 1983) (under Subchapter S, a corporation may elect a tax status which protects the earnings and profits of the corporation from conventional corporate tax rates).

Earnings retained by a S-corp, and not distributed to shareholders, remain corporate assets and cannot be divided upon divorce. *Thomas*, 738 S.W.2d at 345.

3. Closely Held Corporation

A "closely held" corporation is a corporation which is owned by a small number of shareholders, often related. *See, e.g., DeBord v. Circle Y of Yoakum, Inc.*, 951 S.W.2d 127, 131 (Tex.App.–Corpus Christi 1997), *rev'd on juris. grounds sub nom.*, *Stary v. DeBord*, 967 S.W.2d 352 (Tex. 1998) (in a closely held corporation, a small number of shareholders operate more as partners than in strict compliance with the corporate form); *see also, e.g., Dixie Pipe Sales, Inc. v. Perry*, 834 S.W.2d 491, 492 (Tex.App.–Houston [14th Dist.], 1992, writ denied) (the corporation was a closely held corporation, primarily held by members of one family and their spouses).

4. Professional Corporation

The Texas Professional Corporation Act, TEX.REV.CIV.STAT. art. 1528e [the "Act"], authorizes the formation of a "Professional Corporation." A professional corporation ("P.C.") means a corporation organized under the Act for the sole and specific purpose of rendering professional service, and which has as its shareholders only individuals who themselves are duly licensed or otherwise duly authorized within Texas to render the same professional service as the corporation. TEX.REV.CIV.STAT. art. 1528e, Sec. 3(b).

The Act contemplates that professionals such as architects, attorneys, certified public accountants, dentists, public accountants, and veterinarians will form professional corporations. TEX.REV.CIV.STAT. art. 1528e, §3(a). In fact, attorneys must form a professional corporation, rather than professional association, using the Texas Professional Corporation Act. *Welmaker v. Cuellar*, 37 S.W.3d 550, 550 (Tex.App.–Austin 2001, pet. denied).

As with all corporations, the value of an individual's interest in a professional corporation is limited to the value of the stock, rather than the assets. However, it is still the value of the professional practice, including the assets owned by the corporation, that determines the value of the stock ownership interest at stake.

III. GOODWILL

A. Definition

In Texas, "goodwill" has been defined as the advantage or benefits acquired by a business beyond the value of its capital stock, accumulated funds and property, because of the general public patronage and encouragement which it receives from constant and habitual customers on account of its position, or common celebrity, or reputation for skill, or

influence, or punctuality, or from accidental circumstances or necessities, or even from ancient partialities or prejudices. *Peat Marwick Main & Co. v. Haass,* 818 S.W.2d 381, 389 (Tex. 1991), *citing, Taormina v. Culicchia*, 355 S.W.2d 569, 573 (Tex.Civ.App.–El Paso 1962, writ ref'd n.r.e.); *see also, Salinas,* 948 S.W.2d at 290 (the probability that customers would resort to the old place of business may be deemed a valuable right). According to the International Glossary of Business Valuation Terms, goodwill is:

> [t]hat intangible asset arising as a result of name, reputation, customer loyalty, location, products and similar factors not separately identified.

INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (January 2000).

Goodwill is property and, although intangible, is an integral part of a business, the same as its physical assets. *Finn v. Finn*, 658 S.W.2d 735, 749 (Tex.App.–Dallas 1983, writ ref'd n.r.e.) (Stewart, J., dissenting); *see also*, *State v. Rogers*, 772 S.W.2d 559, 560 (Tex.App.–Amarillo 1989, writ denied) (goodwill is intangible, arises from the reputation of a business, and relates to the personality of those conducting the business and the favor, reputation or advantage the business may have).

As a property right, goodwill may be sold or transferred. *Allen v. Allen*, 704 S.W.2d 600, 604-605 (Tex.App.–Fort Worth 1986, no writ). Indeed, the goodwill of a business can be transferred apart from any of its tangible assets. *Airflow Houston, Inc. v. Theriot*, 849 S.W.2d 928, 933 (Tex.App.–Houston [1st Dist.] 1993, no writ).

B. Types of Goodwill

Goodwill may attach to a business, or to a person. *See, Nail v. Nail,* 486 S.W.2d 761, 764 (Tex. 1972). Accordingly, two distinct types of goodwill are identifiable: (1) "professional goodwill" (also referred to as "personal" goodwill); and (2) "practice goodwill" (also referred to as "enterprise" or "business" or "commercial" goodwill). Additionally, a hybrid form of goodwill may exist, in which personal and commercial goodwill are "mixed."

1. Professional Goodwill

"Professional goodwill" is conceptually distinct from goodwill associated with a trade or a business. *Guzman v. Guzman*, 827 S.W.2d 445, 447 (Tex.App.–Corpus Christi 1992, writ denied). Professional goodwill is based on an individual's reputation, experience, training, and ability. *See, e.g., Salinas*, 948 S.W.2d at 286 (the distinction has been drawn that professional goodwill is not so much fixed or as localized as the goodwill of a trade, and attaches to the person of the professional man or woman as a result of confidence in his or her skill and ability). Such qualities are personal to the individual and are probably impossible to separate from the business, making the associated value difficult to transfer. The implication here is that if the professional left his or her current practice and entered another practice, his or her clients would follow. Thus, unless the professional's individual traits can be transferred to a buyer, there is no value to such individual's goodwill for the purposes of division in a divorce.

Incidentally, it should be noted that a person need not be a "professional," like a lawyer or a doctor, in order to develop "professional" goodwill: personality, social contacts, and specialized knowledge of the problems and solutions peculiar to a particular business create, on the part of clients or customers, confidence in the person's skill and ability, *i.e.,* "professional" goodwill." *See, Rathmell v. Morrison,* 732 S.W.2d 6, 18 (Tex.App.–Houston [14th Dist.] 1987, no writ) (key man in several insurance companies possessed professional goodwill).

In Texas, professional goodwill does not possess value, or constitute an asset separate and apart from the person of the professional, or from the professional's ability to practice the profession; it is extinguished in the event of death, or retirement, or disablement, or upon the

sale of the practice or loss of clients. *Nail*, 486 S.W.2d at 764; *see also, Smith v. Smith,* 836 S.W.2d 688, 690 (Tex.App.–Houston [1st Dist.] 1992, no writ). Professional goodwill is not divisible upon divorce in Texas.

2. Practice Goodwill

Practice (or commercial) goodwill refers to an entity's reputation and its ability, as an institution, to attract and hold business, even with a change of ownership. *See, e.g., Peat Marwick Main & Co.,* 818 S.W2d at 389. The key to practice or commercial goodwill is whether customers of the entity will stay with the entity upon the change of ownership. Practice goodwill in Texas is often divisible upon divorce.

3. "Mixed" Professional and Practice Goodwill

Professional and practice goodwill may be "mixed." In other words, a particular individual may accrue professional goodwill, and the business with which the individual is associated may also accrue practice goodwill, a fact Texas courts have repeatedly recognized. *See, e.g., Keith v. Keith,* 763 S.W.2d 950, 952 (Tex.App.–Fort Worth 1989, no writ) (father-son partnership); s*ee also, Welder v. Green*, 985 S.W.2d 170, 178 (Tex.App.–Corpus Christi 1998, pet. denied) (accounting partnership); *Eikenhorst v. Eikenhorst,* 746 S.W.2d 882, 888 (Tex.App.–Houston [1st Dist.] 1988, no writ) (medical partnership); *Rathmell,* 732 S.W.2d at 18 (despite the importance of the owner, the "key man," his insurance companies were not a "one man show" and had goodwill separate and apart from him); *Finn,* 658 S.W.2d at 741 (law firm).

In *Geesbreght v. Geesbreght,* 570 S.W.2d 427, 435-436 (Tex.Civ.App.–Fort Worth 1975, writ dism'd), the Fort Worth Court of Appeals held that a large medical practice corporation could have practice goodwill associated with its name separate from the individual doctors who actually provided the medical services, and discussed such "mixed"goodwill as follows:

> "Goodwill" 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 "goodwill" 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 is attempted to retain the "goodwill" of customer clients of the former operators....the name of the business is a company name as distinguished from the name of an individual. Therein does it have value, plus the value of the opportunity to justify confidence in the new management by the customer/clients of the predecessor owner(s).

With each level of organizational complexity in a professional practice, the segregation of professional goodwill from practice goodwill becomes more difficult. If, for instance, an established, well-known individual lawyer incorporates under a business name, adds associates and partners, and expands into multiple offices, almost invariably the lawyer will have created commercial goodwill in

addition to his or her own professional goodwill. Then, if and when such lawyer gets divorced, up rears the ugly head of the critical distinction between professional and practice goodwill.

C. The Existence of Goodwill: Evidentiary Factors

The existence of goodwill is question of fact. *Guzman,* 827 S.W.2d at 447; *Simpson v. Simpson,* 679 S.W.2d 39, 41 (Tex.App.–Dallas 1984, no writ). In determining whether a trade or business possesses commercial goodwill separate and apart from an associated professional, Texas courts consistently look to several evidentiary factors.

1. The business name is different from the individual's.

Texas courts have been careful to distinguish partnerships that have a generally recognized name, thus prompting patrons to do business with any person or firm using that name, from partnerships the names of which are not generally recognized, composed of, for example, the names of the former (possibly deceased) partners. *See, Welder*, 985 S.W.2d at 179.

When the name of a business is a company name, as distinguished from the name of an individual professional, the business will possess valuable goodwill, in that (a) its reputation for service would survive even a change in management while the new management had an opportunity to presently justify customers' former confidence in the old management, and (b) the existing goodwill presented an opportunity for the new management to enter into the identical field of operations. *Geesbreght,* 570 S.W.2d at 435-436; *see also, Finn,* 658 S.W.2d at 741 (legal professional corporation conducted business under names of founding partners and not current senior partners); *cf., Welder*, 985 S.W.2d at 179 (the accounting partnership had changed its name at various times upon prior dissolutions, and thus there was no goodwill for the continued use of an established, well-recognized name).

On the other hand, as is often the case with a solo professional practice, when the business is a one person professional corporation conducting business in that person's name, any associated goodwill will probably be personal. *Hirsch v. Hirsch,* 770 S.W.2d 924, 927 (Tex.App.–El Paso 1989, no writ).

In general, of course, a well-established business name, in and of itself, generates commercial goodwill. *See, e.g., Rice v. Angell*, 73 Tex. 350, 11 S.W. 338, 340 (1889) (goodwill will survive the dissolution of a partnership when it is attached to a well established name, such as "The Galveston Insurance Agency"); *see also, Pemelton v. Pemelton*, 809 S.W.2d 642, 665 (Tex.App.–Corpus Christi 1991), *rev'd on other grounds, sub nom.*, *Heggen v. Pemelton*, 836 S.W.2d 145 (Tex. 1992) (recognizing the goodwill value of the name "Pemelton Farm and Ranch/Rio Rico Farms").

2. The business employs many employees.

A business that employs competent employees, who handle day-to-day business affairs, will likely possess goodwill apart from the personal goodwill of the owner, even if the owner is a critical "key man" in the business. *See, Rathmell,* 732 S.W.2d at 18; *see also, Geesbreght,* 570 S.W.2d at 435 (10 full-time employees, and 50-100 part-time employees); *Finch v. Finch,* 825 S.W.2d 218, 224-225 (Tex.App.–Houston [1st Dist.] 1992, no writ) (business goodwill existed because the owner employed men to work on cars at his shop, and did not personally perform all of the work on the vehicles; thus, had the owner retired, died, or been disabled, the goodwill would not have been extinguished, since persons other than the owner performed some of the work at the shop); *Finn,* 658 S.W.2d at 741 (law firm had over forty partners and over forty associates).

3. The business contracts with customers.

A business that contracts directly with customers, as opposed to the principals contracting with customers, accrues goodwill apart from the goodwill of the principals. *Eikenhorst,* 746 S.W.2d at 888; *cf., Simpson,* 679 S.W.2d at 41 (contracts with customers did not even mention corporation, but instead recited names of owners); *see also and cf., Salinas,* 948 S.W.2d at 292 (because hospital would only agree to contract with an individual

physician, even though the contracting physician shared the benefits of the contract with his partners, the contract was personal to the contracting physician and was not a partnership asset).

4. The business supplies competitive prices and services.

Competitive pricing and product selection also create goodwill in a business, regardless of the personal goodwill attached to a principal. *Rathmell,* 732 S.W.2d at 18. Competitive pricing and products are seldom features of a professional practice.

5. The business serves many clients.

A business that serves many clients, particularly in the absence of direct participation by the principal or principals of the business, creates goodwill with those clients apart from the personal goodwill attached to the principal(s). *See, Geesbreght,* 570 S.W.2d at 435; *Eikenhorst,* 746 S.W.2d at 888 (medical partnership provided radiological services to four hospitals).

6. The business has an established location.

A business with an established location, such as the "corner store," may have commercial goodwill simply by virtue of such location. *See, e.g., Rice*, 11 S.W. at 340; *see also, Nail*, 486 S.W.2d at 763 (goodwill can exist as an incident of a continuing business having locality or name); *Taormina,* 355 S.W.2d at 573-74 (goodwill could exist when former partners continued their business, among other things, in the same place and with the same name).

D. The Divisibility of Goodwill

In Texas, only goodwill that exists separate and apart from an individual's personal skills, abilities, and reputation is divisible upon divorce. *Rathmell*, 732 S.W.2d at 17. In *Finn,* the Dallas Court of Appeals enunciated the two-pronged test, acknowledged by Texas courts as determinative, for whether goodwill is divisible upon divorce: (1) the goodwill must exist independently of the personal goodwill of the professional; and (2) such goodwill must have a commercial value in which the community is entitled to share. *Finn*, 658 S.W.2d at 740. Put another way, goodwill in a professional business is not considered part of the community estate unless it exists independently of the professional spouse's skills, and the community estate is otherwise entitled to share in the asset. *Guzman*, 827 S.W.2d at 447

From an accounting standpoint, *Finn's* two-pronged test isolates the excess profits which are separate from the income of the individual professional.

E. Other Jurisdictions

Not all jurisdictions recognize that the goodwill in a law practice is or may be subject to distribution upon divorce. *See, e.g., Richmond v. Richmond*, 779 P.2d 1211 (Alaska 1989); *Beasley v. Beasley*, 518 A.2d 545 (Pa. Super. Ct. 1986); *Smith v. Smith*, 709 S.W.2d 588 (Tenn. Ct. App, 1985); *Holbrook v. Holbrook*, 309 N.W.2d 343 (Wis. App. 1981). However, the majority of jurisdictions recognize that the goodwill in a law practice is or may be subject to distribution upon divorce. *See, e.g., Molloy v. Molloy*, 761 P.2d 138 (Ariz. Ct. App. 1988); *Fenton v. Fenton*, 184 Cal. Rptr. 597, 184 Cal. App.3d 541 (1982); *In Re Marriage of Huff*, 834 P.2d 244 (Colo. 1992); *E.E.C. v. E.J.C.*, 457 A.2d 688 (Del. Super. Ct. 1983); *McDiarmid v. McDiarmid*, 649 A.2d 810 (D.C. 1994); *Thompson v. Thompson*, 576 So.2d 267 (Fla. 1991); *Dugan v Dugan*, 457 A.2d 1 (N.J. 1983); *McLean v. McLean*, 374 S.E.2d 376 (N.C. 1988); *In Re Marriage of Brooks*, 756 P.2d 161 (Wash. Ct. App. 1988).

F. Goodwill and the Sole Proprietorship

1. *Nail* and Its Progeny

The leading Texas case regarding the valuation of the goodwill of a professional practice operated in the form of a sole proprietorship is probably *Nail,* 486 S.W.2d 761. The husband was an ophthalmologist who had been operating as a sole proprietor for about fifteen years. In the party's divorce, the trial court found:

> [t]hat the value of the assets of the medical practice of [the husband] is $131,759.64, including all fixtures,

> furniture, equipments, and the value of the goodwill that has accrued thereto during the marriage....That the approximate value of [the husband's] office equipment and office furniture is $735.47.

Id. at 762.

On appeal, the Texas Supreme Court deduced that the trial court had valued the goodwill of the husband's medical practice at $131,024.17 ($131,759.64 - $735.47). The Texas Supreme Court then held:

> ...it cannot be said that the accrued goodwill in the medical practice of [the husband] was an earned or vested property right at the time of the divorce or that it qualifies as property subject to division by decree of the court. It did not possess or constitute an asset separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in an event of his death, or retirement, or disablement as well as in the event of the sale of his practice or the loss of his patients, whatever the cause....That it would have value in the future, is no more than an expectancy wholly dependent upon the continuation of existing circumstances.

Id. at 764 (citations omitted). The Texas Supreme Court expressly left open in *Nail* the question of whether goodwill could be considered in evaluating a professional partnership or corporation, and also said that it was "not concerned with goodwill as an asset incident to the sale of a professional practice." *Id.* at 764. However, as will be discussed below, in *Salinas*, the Texas Supreme Court apparently answered the question of the application of *Nail* to professional partnerships and corporations in the affirmative.

In *Austin v. Austin*, 619 S.W.2d 290 (Tex.Civ.App.–Austin 1981, no writ), the Austin Court of Appeals considered the valuation of a solo professional practice of a certified public accountant. Following *Nail*, the Austin appellate court stated:

> The goodwill of an ongoing non-corporate, professional practice is not the type of property that is divisible as community property in a divorce proceeding....Once a professional practice is sold, the goodwill is no longer attached to the person of the professional man or woman. The seller's actions will no longer have significant effect on the goodwill. The value of the goodwill is fixed and it is now property that may be divided as community property.

Id. at 292 (citations omitted); s*ee also, Guzman,* 827 S.W.2d at 448 (goodwill, if any, of the solo CPA firm did not exist independently from the husband); *Hirsch,* 770 S.W.2d at 927 (no evidence that goodwill existed apart from the personal abilities of the husband, a solo lawyer).

Nail does not establish an absolute rule. *Salinas,* 948 S.W.2d at 291. Thus, whether a sole proprietorship has goodwill should be a case-by-case determination. The existence of goodwill, after all, is a question of fact. Since goodwill is oftentimes the most valuable asset in a service-oriented business, *Nail* must not deter the effort to place goodwill among the business' assets in the valuation process. *Nail* should be limited to cases in which the goodwill of the sole proprietorship is totally indistinguishable from the sole proprietor. If goodwill exists separate and apart from the person of the sole proprietor, its value should be considered.

2. <u>How Not to Value a Sole Proprietorship</u>

In *Smith,* 836 S.W.2d. 688, the husband was a licensed, certified respiratory therapist and the wife worked primarily as a homemaker. The husband operated his business as a sole proprietorship. No independent income tax returns were filed for the business; business income was reported on a profit and loss statement (Schedule C) filed as part of the parties' joint income tax return.

At the trial of the divorce, both the wife and the husband testified that in 1988 he told the wife

that if anything happened to him, she should sell the business to another individual for $72,000, to be paid over a period of three years, or let an employee run it for one-half of the profits. *Id.* at 691.

Also at trial, the wife called an accounting expert to provide the court with a valuation of the husband's business. The expert reviewed three years of their personal income tax returns and financial records. To arrive at the valuation for the business, the expert determined the income from the business for four years, from which he subtracted the tax liability to reach that year's after tax income. He then added the after tax income for the four years, and divided that figure by four, to arrive at an average after-tax income of $68,846. Finally, the expert multiplied the average after tax income by a factor of 9.818 (the present value of an annuity of $1 for 20 years at 8% return) to calculate the present value of the business at $675,930. The expert explained his assumptions for the formula: he assumed the husband was 40 years old and would work until he is 60, and that 8% was a conservative rate of return. The expert described his method as an estimate of the present value of average annual earnings on an annuity basis. The expert testified that he was not familiar with the husband's type of business and did not have any comparable sales of similar businesses. He said he did not interview the husband, did not inspect the facilities, and did not see the equipment. In determining the value of the business, he said he assumed the assets were not of any consequence and the entire value of the business was based on the earning capacity of the husband. The expert admitted on cross-examination that his valuation was merely an evaluation of the income generated by the husband. *Id.* at 690-691.

The trial court valued the husband's business, excluding goodwill, at $100,000. *Id.* at 690.

On appeal, the Houston First Court of Appeals held that the wife's expert presented only evidence of the husband's personal future earning capacity, as opposed to the value of the business. *Id.* at 692. His testimony was based on matters personal to the husband (his life expectancy; the amount earned in past years projected over his work lifetime), and did not include any consideration of the business (its assets, receivables, or comparable sales of similar businesses). *Id.* Since a spouse is not entitled to a percentage of his or her spouse's future income, but rather is only entitled to a division of property that the community owns at the time of the divorce, the Houston appellate court held that the only admissible evidence of value of the business was the parties' identical testimony that the husband valued it at $72,000 in 1988. *Id.* Consequently, such evidence was both legally and factually insufficient to support the trial court's finding of a valuation of $100,000. *Id.*

G. Goodwill and the Partnership

There may be goodwill in a professional partnership that is separate from the skills or attributes of an individual partner, just as a mercantile partnership can have goodwill beyond the individual contributions or the partners. *Welder*, 985 S.W.2d at 178. In *Salinas*, the Texas Supreme Court stated: "*[t]o the extent* that the valuation of the dissolved [professional] partnership was based on the goodwill attributable to the personal skills and talents of the former partners, it improperly took into account intangibles that were not partnership assets." *Salinas,* 948 S.W.2d at 290 (emphasis added). Thus, there may be *divisible* practice goodwill in a professional partnership, as well as non-divisible professional goodwill.

Many Texas practitioners believe that the leading case regarding the valuation incident to divorce of the goodwill of a professional practice operated in the form of a partnership is *Finn,* 658 S.W.2d 735. During the parties' entire twenty year marriage, the husband practiced law with a prominent Dallas law firm, of which he was a senior partner.

Under the terms of the firm's partnership agreement, if the husband died or withdrew from the partnership, he was only entitled to (1) the amount contributed in his capital account, (2) any earned income which had not been distributed, and (3) his interest in the firm's reserve account less 10% of his proportionate share in the accounts receivable for client's disbursement. The agreement did not provide for compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill.

The trial court instructed the jury to exclude the goodwill of the law firm and its future earning capacity from the valuation of the community

interest in the husband's law practice. On appeal, the wife contended that the trial court's instruction was erroneous.

Applying its new two-pronged test, *i.e.*, (1) the goodwill must exist independently of the personal goodwill of the professional and (2) such goodwill must have a commercial value in which the community is entitled to share, the majority of the Dallas appellate court found that the restrictions in the husband's partnership agreement deprived him of any legal entitlement to the value of the firm's goodwill. *Id.* The *Finn* majority opinion is premised directly on the fact that the partnership agreement provided no recovery for goodwill on the husband's death or withdrawal from the professional practice. According to the majority, the husband could not realize the value of the firm's goodwill and therefore it had no commercial value. *Id.* at 740. Thus, the goodwill attributable to the husband's partnership interest was not divisible upon divorce. *Id* at 741.

It should be noted that the *Finn* opinion was the result of an *en banc* rehearing (11 Justices sitting) with 4 of the Justices joining the majority, 2 concurring, and 5 joining in the dissent.

In a well-reasoned concurring opinion, Justice Annette Stewart strongly disagreed with the *Finn* majority opinion:

> 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.

Id. at 749 (Citations omitted).

Further, Justice Stewart asserted that the *Finn* majority was concerned with "future contingencies," but noted that, under Texas law, the assets of a community estate are valued as of the time of dissolution of the marriage. *Id.* Consequently, argued Justice Stewart, there was no valid reason to exclude a professional partnership interest from the basic rule as to valuation at the time of dissolution, when the partner, whose interest was being valued, intended to continue as a member of the firm. *Id.* at 741-742.

The Texas Supreme Court's refusal to find reversible error in the *Finn* decision may *not* have been an implicit approval of the opinion of the Dallas Court of Appeals on partnership goodwill. The Court of Appeals reversed the trial court, but on grounds unrelated to the question of partnership goodwill. Thus, it is at least arguable that the *Finn* opinion on partnership goodwill was *dicta*.

Fairly recently, the San Antonio Court of Appeals stated that, in *Salinas*, 948 S.W.2d at 291, the Texas Supreme Court recognized that goodwill may exist in a professional partnership that *must* be considered in dividing a community estate upon divorce. *See*, *Southwest Texas Pathology Associates, L.L.P. v. Roosth*, 27 S.W.3d 204, 209 (Tex.App.–San Antonio 2000, pet. dism'd) (emphasis added). However, in *Salinas*, the Texas Supreme Court actually stated: "[n]evertheless, there may be goodwill in a professional partnership that is separate from the skills or attributes of an individual member." *Salinas,* 948 S.W.2d at 291, *citing*, *Nail*, 486 S.W.2d at 764. Thus, contrary to the implication of the San Antonio appellate court in *Southwest Texas Pathology*, in *Salinas*, the Texas Supreme Court did not address the issue of the *divisibility*, under *Finn*, of partnership goodwill, but rather only the existence of potentially divisible commercial goodwill. Even so, the San Antonio appellate court's misstatement notwithstanding, it is true that there may be goodwill in a professional partnership that must be considered upon divorce, as the Texas Supreme

Court implicitly (but not explicitly) recognized in *Salinas*.

H. Goodwill and the Closely Held or Professional Corporation

Goodwill in a professional corporation which exists independently of a professional's personal skills may be subject to division. *Guzman*, 827 S.W.2d at 447.

The leading Texas case with regard to the valuation of the goodwill of a professional practice operated as a closely held corporation is *Geesbreght*, 570 S.W.2d 427, mentioned earlier. In 1975, the husband and his partner, both doctors, formed a professional corporation, which, ultimately, supplied hospital emergency room services by other physicians in its employ to hospitals at eight different locations, and was grossing more than $1 million annually.

In 1976, the husband filed for divorce, and the value of his interest in the professional corporation was contested. After a trial before the court, the trial court found that the $16,000 book value of the husband's 500 shares of stock to be the value of the stock for purposes of the parties' property division. The wife appealed, contending the trial court erred in not considering the goodwill of the professional corporation.

After distinguishing the circumstances present in *Nail* from those of the husband, the Fort Worth Court of Appeals in *Geesbreght* held that the value of the corporate stock was enhanced by goodwill separate and apart from the person of the husband. *Id.* at 435.

In *Rathmell*, 732 S.W.2d 6, the Houston Fourteenth Court of Appeals expanded upon the traditional concept of professional goodwill in a corporation. In 1975, after more than twenty years of marriage, the husband and wife entered into a property settlement agreement, approved by the court and incorporated in the parties' divorce decree, which awarded to the husband the Rathmell companies, insurance agencies in which the husband was the key man.

In 1977, the husband sold the Rathmell companies for substantially more than the value represented to the wife in their prior settlement negotiations. The wife filed a bill of review alleging, among other things, that the husband had misrepresented the value of the Rathmell companies. After a trial before the court, the trial court made a fact finding that the value of the Rathmell companies was $4,857,000 on the date of the parties' divorce.

The Houston Fourteenth Court of Appeals reversed the trial court and remanded the case for a new trial. *Id.* at 20. The Houston appellate court compared the personal goodwill of the husband with the professionals in *Nail, Geesbreght*, and *Finn*:

> [The husband] is not a lawyer or a doctor, as were the professionals in *Nail, Geesbreght,* and *Finn*. Nevertheless, it is clear that appellant did develop professional goodwill as the term is used in *Nail.* The Rathmell companies specialized in providing insurance to large businesses and associations. Several witnesses testified that the key to financial success of the Rathmell companies was [the husband's] personality, social contact, and specialized knowledge of the problems and solutions peculiar to insuring businesses and associations. Personality and social contacts are important in business because they help "get a foot in the door." Specialized knowledge is needed to get customers the right kind of insurance for a good price. It is undisputed that [the husband] was the major "producer" in the companies, meaning he brought in most of the customers. The goodwill that arose because of these attributes in [the husband] attached as a result of confidence in his skill and ability, and did not possess value or constitute an asset separate and apart from [the husband's] person or his individual ability to practice his profession, and would be extinguished if he died, or retired, or was disabled.
>
> *Id*. at 18.

The husband argued that all goodwill associated with his companies was his professional goodwill. *Id.* However, the Houston appellate court did not agree, but rather found that his companies were not a "one man show." *Id.* Thus, the Rathmell companies also had goodwill separate and apart from the husband. *Id.*

Hirsch, 770 S.W.2d 924, sheds additional light upon the valuation of goodwill in a professional corporation. In *Hirsch,* the husband had practiced law since the mid-1960's and had formed a professional corporation in 1976. The wife filed for divorce, and the value of the incorporated one-person law practice was at issue. In the ensuing jury trial, the wife's expert testified that the law practice had a present value of $444,774, arriving at that figure by multiplying a 5-year average of the law practice's annual gross receipts by 1.5. The jury charge submitted by the trial court did not instruct the jury to exclude the husband's personal goodwill from the valuation of the professional corporation. The husband appealed, claiming, among other things, that the trial court improperly permitted the jury to consider his personal goodwill.

The El Paso Court of Appeals reversed the judgment of the trial court. *Id.* at 928. In its holding, the Court cited *Nail* and *Geesbreght,* but focused primarily on the two-pronged test established by *Finn*:

> ...it has become relatively clear that goodwill is not to be included or considered when placing a value on a professional corporation unless it can be determined first, that the goodwill exists independently of the personal ability of the professional person, and second, that if such goodwill does exist, it has a commercial value in which the community estate is entitled to share....Where the entity is a one person professional corporation conducting business in that person's name, it would be difficult to get past the first prong of the test. In this case, there is no evidence that goodwill existed independently of the personal ability of [the husband].

Id. at 927.

I. The Impact of *Salinas v. Rafati*

In *Salinas*, upon the dissolution of a professional partnership of radiologists, and the formation of a new partnership by two of the former partners, the plaintiff (the third of the ex-partners) sued his former partners, alleging a breach of fiduciary duty, wrongful dissolution, and that he had not been fully paid for his share of the partnership. The issue before the jury was whether the plaintiff partner had been fully compensated for his interest in the partnership.

Under the plaintiff's theory of the case, the future earning capacities of the former partners could be considered in valuing the professional partnership upon dissolution. *Salinas*, 948 S.W.2d at 289. In other words, the plaintiff argued that the value of the dissolved partnership should include the ability the partnership would have had to produce income in the future. *Id.* at 290. At trial, although the plaintiff's expert purported to remove any personal goodwill from his valuation of the partnership, he testified unequivocally that his valuation was based on what the two former partners could earn over time if they and their employees continued the practice of radiology in the same location and in the same manner as they had done in the past. *Id.*

However, the Texas Supreme Court noted that the plaintiff treated the partnership upon dissolution as if it were a salable, going concern, when, by definition, the partnership ceased to exist after the period of time necessary to wind up outstanding matters. *Id.* Thus, according to the Texas Supreme Court, the value that the plaintiff attributed to the partnership was largely based on the talents and abilities of the individual physicians and their ability to generate income in the future. *Id.* Therefore, to the extent that the valuation of the dissolved partnership was based on the goodwill attributable to the personal skills and talents of the former partners, the Texas Supreme Court held that the valuation improperly took into account intangibles that were not partnership assets. *Id.* The Texas Supreme Court then stated that the plaintiff's attempt to harness the future earning capacity of the former partners highlighted the incongruity of a rule of law that would allow a partner to recover a share

of a former partner's ability to generate income *under the guise of goodwill*. *Id.* at 291.

Salinas raises a number of important issues. For example, *Salinas* appears to extend the Texas Supreme Court's reasoning in *Nail* to partnerships and corporations (Justice Owen, writing for a unanimous court, commented favorable upon *Geesbreght*), two entities that had not been addressed earlier by the Texas Supreme Court. *See,* George P. Roach, *The Texas Supreme Court Revisits Professional Goodwill,* STATE BAR SECTION REPORT FAMILY LAW, Vol. 1998-1, p. 20 (Spring 1998); *see also, Salinas,* 948 S.W.2d at 291. Additionally, since a partner should not be able to recover a share of a former partner's ability to generate income under the guise of goodwill, *Salinas* stands for the proposition that the personal *professional goodwill of all the partners must be excluded* in valuing commercial goodwill. *See,* Roach at 21. Logically, then, *Salinas* appears to require that, in the valuation of the commercial goodwill of a corporation, the professional goodwill of shareholders must be excluded.

In a divorce case, "goodwill" is a tempting prize, capable of dramatically inflating the balance sheet of a professional spouse. As a result, it is not unusual to find a non-professional spouse attempting to "harness the future earning capacity" of the professional spouse under the "guise of goodwill." *Salinas* mandates that such an attempt should not be permitted to succeed.

J. Goodwill: Evidentiary and Procedural Considerations

1. Proof

Since the existence of goodwill is question of fact, the trial lawyer must develop sufficient facts to support his or her position, whether for or against the existence of divisible goodwill in any particular case.

Critical elements of the proof should include evidence that personal goodwill existed (or didn't) and the amount of such personal goodwill. *See, e.g., Welder*, 985 S.W.2d at 179. In *Welder*, after a partnership dissolution, one partner continued the business at the same location used prior to the breakup, and, on appeal, the Corpus Christi Court of Appeals acknowledged that such fact might create goodwill value. *Id.* at 179. However, while the record was replete with references to valuation practices employed by accountants in determining goodwill, and there was evidence of how the various precursor partnerships had determined the value owed to a departing partner or due from new partners buying their way into the partnership, there was no evidence of clients who had remained with the one partner, or of their value, based solely on the partner's continued use of the old location, and so there was not even a scintilla of evidence showing or tending to show that any goodwill attached to his business was attributable to its location. *Id.*; *see also*, *Parker v. Parker*, 897 S.W.2d 918, 933 (Tex.App.–Fort Worth 1995, no writ) (husband failed to sufficiently brief point of error so that appellate court could determine whether the trial court considered the two types of goodwill in determining the value of the corporations).

2. Findings of Fact

It is also important that the trial court's findings of fact and conclusions of law indicate whether the trial court considered goodwill in the valuation of any business for the purposes of dividing the marital estate. *See, Finch*, 825 S.W.2d at 224*; Parker*, 897 S.W.2d at 933.

In *Cherokee Water Co. v. Gregg County Appraisal Dist*., 801 S.W.2d 872, 876 (Tex. 1990), the Texas Supreme Court stated that, since it did not know the specific method that the trial court used in arriving at its determination of property value, the plaintiff could not dispute the trial court's determination, based on the valuation methodology used by the opposing party's expert. In a footnote to its opinion, the Texas Supreme Court explained that, in its initial findings of fact and conclusions of law, the trial court did not specify the method of appraisal used to arrive at its determination of property value, and that the plaintiff filed a request for additional findings of fact and conclusions of law but did not request the trial court to specify its method of appraisal; as a result, there was no evidence that the trial court used an improper method to arrive at fair market value of plaintiff's property. *Id.* at n.4.

Additionally, in another footnote, the Texas Supreme Court added that there was evidence before

the trial court that various recognized methods of property appraisal were used in determining market value. *Id*. at 877, n. 5. In the same footnote, the Texas Supreme Court stated: "[w]hile we do not condone a trial court's use of an unrecognized method in determining property values, without findings of fact and conclusions of law regarding the specific method used by the trial court, we cannot say the valuations were improper."

Clearly, in *Cherokee Water*, the Texas Supreme Court took the position that if a litigant wants to complain about the valuation methodology adopted by the trial court, the litigant better obtain findings of fact identifying the actual methodology utilized by the trial court. The Texas Supreme Court's position would therefore seem to logically imply that such a litigant has a right to such findings. There is, however, a remarkable conflict among Texas courts of appeals on the issue of the availability of findings with respect to valuation issues.

Generally, a trial court must make findings on each material issue raised by the pleadings and evidence, but not on evidentiary issues; findings are required only when they relate to ultimate or controlling issues. *See, e.g.*, *Roberts v. Roberts*, 999 S.W.2d 424, 434 (Tex.App.–El Paso 1999, no pet.).

There is substantial Texas authority holding that the trial court is not required to make specific valuation findings in divorces. *See, e.g.*, *Lettieri v. Lettieri*, 654 S.W.2d 554, 557 (Tex.App.–Fort Worth 1983, writ dism'd) (the trial court is not required to set out its theories or the legal basis upon which it grounded the division of property; *Finch v. Finch*, 825 S.W.2d 218, 221 (Tex.App.–Houston [1st Dist.] 1992, no writ) (the value of specific property is not an ultimate issue, and therefore need not be set out in findings of fact); *see also*, *Wallace v. Wallace*, 623 S.W.2d 723, 725 (Tex.App.–Houston [1st Dist.] 1992, no writ). Other Texas appellate courts, however, have taken a contrary position and hold that findings are necessary in valuation cases. *Roberts v. Roberts*, 999 S.W.2d at 435; *see also*, *Joseph v. Joseph*, 731 S.W.2d 597, 598 (Tex.App.–Houston [14th Dist.] 1987, no writ) (the trial court's failure to file findings placed the appellant in an unjust and harmful position of guessing at the valuation methods used when attacking the property division, requiring that the case be reversed and remanded for a new trial); *In re Marriage of Morris*, 12 S.W.3d 877, 886 (Tex.App.–Texarkana 2000, no pet.).

However, in 2001, the Legislature enacted Section 6.711 of the Family Code which provides that in a suit for dissolution of a marriage in which the court has rendered a judgment dividing the estate of the parties, on request by a party, the court shall state in writing its findings of fact and conclusions of law concerning: (1) the characterization of each party's assets, liabilities, claims, and offsets on which disputed evidence has been presented; and (2) the value or amount of the community estate's assets, liabilities, claims, and offsets on which disputed evidence has been presented. In addition, a request for findings of fact and conclusions of law under this section must conform to the Texas Rules of Civil Procedure. Section 6.711 became effective September 1, 2001, and applies to a suit for dissolution of a marriage pending on that date or filed on or after that date.

c. Exclusion Procedure

The Texas practitioner should also be aware of the proper procedure to exclude expert testimony regarding valuation on the grounds of incorrectly valuing *divisible* goodwill. The expert witness should be taken on voir dire, and asked whether he or she can put a value on the business entity that does not include personal or professional goodwill; if the expert cannot do so, his or her testimony should be excluded upon proper motion. *See, Hirsch,* 770 S.W.2d at 927; *see also, Smith,* 836 S.W.2d. at 690 (the expert's appraisal was not admissible because the expert had failed to exclude the husband's personal goodwill from his evaluation.

IV. VALUATION THEORY

A. Introduction to the Valuation Process

In any divorce, valuation issues are resolved by an interplay between the parties, lawyers, experts, and judges. With regard to the valuation of a professional practice upon divorce, into such mix must be added many complicated economic and accounting principles. Consequently, it may be worthwhile to keep in mind the following cynical explanation, offered by one unknown author:

> Experts are people who know a great deal about very little, and who go along learning more and more about less and less until they know practically everything about nothing.
>
> Lawyers, on the other hand, are people who know very little about many things, and who keep learning less and less about more and more until they know practically nothing about everything.
>
> Judges are people who start out knowing everything about everything, but end up knowing nothing about anything, due to their constant association with experts and lawyers.

See, Crum & Forster, Inc. v. Monsanto Co., 887 S.W.2d 103, 134 n. 26 (Tex.App.–Texarkana 1994, no writ).

It should be recalled that, in a valuation case, the finder of fact is not required to accept the opinions of the experts on either side of the controversy, but can determine the value to be somewhere in the range between the high and low values offered in evidence. *InterFirst Bank Dallas, N.A. v. Risser,* 739 S.W.2d 882, 890 (Tex.App.–Texarkana 1987, no writ). Of course, the fact finder's determination must fall between the high and low values offered in evidence, since there must be an evidentiary basis for the finding. *Salinas*, 948 S.W.2d at 289 (no evidence supported jury's finding that a medical partnership's value was $4,284,000, when the expert testimony placed the value of the partnership at between $756,821 and $2,940,000); *see also, Moore v. Bank Midwest, N.A.,* 39 S.W.3d 395, 401 (Tex.App.–Houston [1st Dist.] 2001, pet. denied) (the jury's finding of fair market value was within the range of values supported by the evidence, and therefore should not be overturned on appeal).

Ultimately, the valuation of a professional practice is an estimate of what the practice is worth. An estimate of value is based upon various assumptions, many of which will be discussed in this paper.

The valuation of a business, including a professional practice, generally looks toward the future earnings potential of the business. However, for purposes of divorce, valuation should be predicated upon historical data, since future earnings after divorce are not divisible by a Texas trial court. *See, e.g., Berry v. Berry*, 647 S.W.2d 945, 947 (Tex. 1983) (retirement benefits accruing as compensation for services rendered after divorce are the employee spouse's separate property, which cannot be divested and given to the non-employee spouse). Moreover, historical data is most often used and relied upon in valuing small closely held businesses and professional practices, particularly when the analyst acts in the capacity of an expert witness, because such data is based on fact and is not easily disputed.

Additionally, it should also be noted that, strictly speaking, a "valuation" and an "appraisal" are two distinctly different animals. In a "valuation," the valuator seeks

> [t]o establish a value for an entire or partial interest in a closely held business or professional practice, taking into account both quantitative and qualitative tangible and intangible factors associated with the specific business being valued.

Black & Isom Associates, BUSINESS VALUATIONS: FUNDAMENTALS, TECHNIQUES & THEORY, Chapter Two - 1 (1995). On the other hand, in an "appraisal," the appraiser seeks

> [t]o establish the value of certain specific tangible assets, based upon special market knowledge, education, and vocational training possessed by the appraiser.

Id. at Chapter Two - 2. Accordingly, a "valuation" may utilize "appraisals" of specific tangible assets in the determination of the overall value of the business.

B. The Definition of "Value"

According to TEXAS PATTERN JURY CHARGES - FAMILY, PJC 203.1 (2000), value is defined as:

> The value of an asset is its market value unless it has no market value.
>
> "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.
>
> If an asset has no market value, its value is the value of its current ownership as determined from the evidence.
>
> In valuing an asset to be received in the future, you are to find its present value as determined from the evidence.

The foregoing definition represents the yardstick by which *all evidence* must be measured in a divorce trial involving a valuation of any professional practice (actually, of any asset). But it must be emphasized that "fair market value" is not a singular figure valid for a variety of purposes; rather, every valuation must begin with an answer to the question: "value of what, to whom, and for what purpose?" Maxson, *Valuation of Closely Held Securities–Avoiding Common Pitfalls and Misconceptions,* VALUATION NOTES (Deloitte & Touche, June 1991), *quoted in* Brenda Keen Schwartz, *Complex Business Valuation Issues: Presentation and Impeachment*, EE-1, 22nd ANNUAL ADVANCED FAMILY LAW COURSE (1996).

One commentator has identified four basic tenets of valuation practice:

1. value is forward looking;
2. all value is the expectation of future performance;
3. the best indicator of future performance is usually the performance of the immediate past; and
4. historical accounting and other data are useful primarily as a road map to the future.

Robert James Cimasi, *Medical Practice Valuation and Transactions in a Changing Market*, p. 15, INSTITUTE OF CERTIFIED BUSINESS COUNSELORS 21ST ANNUAL MEETING**.**

C. The Measure of Value

Texas jurisprudence has produced several measures of value. These common law notions of value arise primarily from non-divorce situations and are difficult, at best, to reconcile. One seminal, instructive opinion with respect to the various measures of value is *Taylor County v. Olds*, 67 S.W.2d 1102 (Tex.Civ.App.–Eastland 1934, writ dism'd). *Taylor County,* an often cited condemnation case, establishes four grades of evidence which may be produced to prove value: (1) market value; (2) intrinsic value; (3) cost of replacement; and (4) value to the owner. *Id.* at 1105. Only certain of these "grades" of evidence establishing value are relevant to the valuation of a professional practice ("cost of replacement," for example, is an irrelevant concern).

Furthermore, *Taylor County* creates a loose "hierarchy"of value. Thus, a party offering evidence of value other than market value should lay a predicate therefor by a *prima facie* showing that there exists no market value at the time and place in question; if the party fails to do so, the opposing party has the right to object to the admission of any other evidence of value until such showing is made. *Id.* at 1104; *see also, Bryant v. Stohn,* 260 S.W.2d 77 (Tex.Civ.App.–Dallas 1952, writ ref'd n.r.e.).

In many instances involving the valuation of a professional practice, laying the predicate for establishing a measure of value that is not market based may be relatively easy, since there will be no readily ascertainable market. Historically, documented, bona fide bid and asked prices for closely held businesses have rarely existed. *See, e.g.,* Schwartz at EE-3. However, over the past several years, more data bases reporting sales of closely held companies have been generated, and such information is increasingly available to business valuators.

1. <u>Market Value</u>

a. Willing Buyer and Willing Seller

Market value has been defined by the Texas Supreme Court as:

> [t]he price the property will bring when offered for sale by one who desires to sell, is not obligated to sell, and is bought by one who desires to buy, but is under no necessity of buying.

City of Pearland v. Alexander, 483 S.W.2d 244, 247 (Tex. 1972).

According to the Internal Revenue Service, and the International Glossary of Business Valuation Terms, fair market value is:

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

Rev. Rul. 59-60, 1959-1 C.B. 237; *see also,* INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (January 2000). Clearly, *City of Pearland* and Rev.Rul. 59-60 articulate the classic definition of "fair market value." As a practical matter, however, whether the "classic" definition is of any use is far less clear.

For example, the valuation of a business, for the purposes of divorce, often *assumes* a hypothetical, as opposed to a specific, identified, "willing" buyer and seller. Further, in such hypothetical valuation, it must be *assumed* that "willing" means "willing to do anything in order to complete the sale"; in other words, it must be assumed that the "willing" seller has no actual participation in the negotiations culminating in an eventual sale of his or her business.

However, *sellers do participate*: in actual arms-length sales transactions; covenants not to compete (often included in the overall consideration of an actual sale, and the value of which is "carved out" of the actual sales price), although usually demanded, are sometimes refused. Thus, the assumption of a "willing" buyer and seller often conflicts with the realities of a given valuation situation. Realistically, it simply *cannot* be assumed that a "willing" buyer will do *anything* to consummate a sale. *Cf.*, *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177, 185 (Tex. 2001) (in a condemnation proceeding, the condemnee's expert oversimplified the problem of finding market value in one crucial respect: he assumed that a willing buyer would value the land at the highest possible price that would still allow a reasonable return upon the investment; however, a competitive market does not ordinarily guarantee that willing buyers will pay the highest price they can afford, since they often have the option of purchasing comparable property for less money elsewhere).

In the marketplace, "actual value" is most often the result of arms-length negotiated transactions. Yet, in most divorce valuations there has been no arms-length negotiated transaction. Further, with the exception of *City of Harlingen*, there appear to be no reported Texas cases articulating the extent to which a seller must be "willing" to sell for the classic definition of value to be applicable. Is it defensible, either in theory or in practice, for a court to assume that any specific, identified seller will agree to a covenant not to compete, particularly if that seller has unequivocally expressed his unwillingness to do so?

b. Determining Market Value

Texas courts have recognized three general approaches to determining market value: (1) the market data (or comparable sales) approach [or guideline company approach]; (2) the cost approach; and (3) the income (or income-capitalization [or discounting]) approach. *Travis Cent. Appraisal Dist. v. FM Properties Operating Co.*, 947 S.W.2d 724, 730 (Tex.App.–Austin 1997, pet. denied). In addition, when circumstances dictate, the Texas Supreme Court has not hesitated to recognize alternative methods of valuation. *Id.*, *citing*, *Missouri-Kansas-Texas R.R. v. City of Dallas*, 623 S.W.2d 296, 299-301 (Tex. 1981). The three different approaches are not different definitions of market value, but rather are simply different ways of arriving at an estimate of what a willing buyer would pay a willing seller. *Travis Cent. Appraisal Dist.*, 947 S.W.2d at 730.

An interesting example of the application of the "willing buyer and seller" standard in the

determination of market value occurred in *Morgan v. Morgan*, 657 S.W.2d 484, 487 (Tex.App.–Houston [1st Dist.] 1983, writ dism'd), in which the husband unsuccessfully argued that the trial court erred by placing an excessive valuation of $450,000 on the couple's business.

In *Morgan*, the wife's expert accountant testified that, since the business income tax returns were inadequate to give a "picture of the company's performance," he evaluated the earnings history and historical growth rate, and capitalized the annual earnings of the business on an after-tax basis. *Id.* Concluding that the business generated a pretax cash flow of $119,961 for 1981, the expert determined the after-tax cash flow by assuming an amount of $36,550 as compensation the husband would pay himself, and factoring in a 30% tax rate, a rate he termed conservative. *Id.* at 489. Finally, the expert chose a capitalization rate of 15% as a yield an investor in the current market would expect from his investment and divided the after-tax cash flow by 15% to arrive at a total of $567,000 as the fair market value of the property. *Id.*

The Houston appellate court noted that, while it was true that the accountant never specifically testified that he took the classic "fair market value" definition into consideration, it was nonetheless "obvious" that the expert did consider the willing buyer/willing seller standard, since the whole purpose of his analysis by income capitalization was to arrive at the amount of money a willing investor would pay for the business. *Id.* In other words, the valuation of $567,000 was, in the expert's opinion, what a willing buyer would pay a willing seller in order to gain a 15% return on his investment. *Id.* Accordingly, the Houston appellate court found that the expert's opinion was well-supported and that there was sufficient evidence to support the trial court's ultimate valuation of $450,000. *Id.* at 490.

c. Sales: Comparable and Otherwise

The concept of market value assumes an existing, established market. *See, e.g., Wendlandt v. Wendlandt*, 596 S.W.2d 323, 235 (Tex.Civ.App.–Houston [1st Dist.] 1980, no writ). In theory, the marketplace is the most reliable indication of value. Therefore, in theory, sales of comparable closely held businesses or professional practices should be helpful in the determination of value.

However, as a practical matter, there is often little or no actual market for a closely held business or professional practice. Therefore, other measures of value must be utilized. *See, e.g., Religious of Sacred Heart of Texas v. City of Houston*, 836 S.W.2d 606, 615-617 (Tex. 1992) (recognizing that when the most common method of determining market value–the market data approach–cannot be successfully utilized, resort to additional methods of determining market value is necessary); *InterFirst Bank Dallas, N.A.,* 739 S.W.2d at 890 n. 7 (when sales of stock had been infrequent, had consistently been in small blocks, and had been to buyers who were generally members of the controlling family, the expert witnesses properly sought other methods for arriving at a fair market value).

In actual practice, comparable sales present many difficulties in the valuation of an existing business. As expressed by several valuation experts:

> Useful comparative sales data are much harder to obtain for sales of businesses than for sales of real estate. The problem of obtaining comparative transaction data is greater for small businesses and professional practices than for large businesses.

Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, VALUING SMALL BUSINESS AND PROFESSIONAL PRACTICES, 67 (2nd Ed. Irwin) [hereinafter referred to as "Pratt"]. If comparable sales of a small business are indeed discovered, the actual negotiated terms of the sales are usually not known. The demands for, as well as the offers and rejections of, such sales terms as covenants not to compete, long term payouts, and requirements for the seller to remain in the employ of the subject practice, are difficult to determine. The unique motivations of the particular buyers and sellers can be impossible to ascertain, yet they significantly affect fair market value.

Another considerable problem with the use of comparable sales data for the valuation of a

professional practice is the uniqueness of every practice:

> [e]ach parcel of real estate is also unique, of course; but the large number of variables, many of which are impossible to measure numerically, usually make the matter of comparability a greater problem when using comparable sales transaction data [for the sale of a small business] than when using comparative real estate transaction data.

Pratt at 67-68. Simply put, if comparable sales are utilized in a valuation of a specific business, then the businesses sold must be truly comparable. In the jargon of valuation experts: if comparable sales data is utilized, the translations used to postulate value should be comparable in terms of (1) size of practice (volume); (2) location (urban vs. suburban vs. rural); and (3) time of the transaction. Robert L. Brown, Ed., VALUING PROFESSIONAL PRACTICES AND LICENSES: A GUIDE FOR THE MATRIMONIAL PRACTITIONER, §7.02[b][2] (1997 Supp. 2nd Edition).

With respect to the notion of "comparable sales," Shannon Pratt has pointed out that it is common, although erroneous, to think of "comparable" only in the sense of similar products. Shannon Pratt, *Business Valuation Body of Knowledge*, p. 127 (John Wiley 1998). However, according to Dr. Pratt, the term "comparable" actually refers to companies with similar risk characteristics, *e.g.,* similar supply and demand forces and other economic risk factors. *Id*. It is common, for instance, in the U.S. Tax Court to compare companies that have similar consumer brand recognition and distribution, even though the products of such companies may be very different. *Id*.

Consequently, if "comparables" are to be used in a valuation, Dr. Pratt further notes that Revenue Ruling 59-60 advocates the use of the public companies that are the same or similar to the subject company, and that "similar" has been generally interpreted to allow wide latitude in guideline company selection, since the object is to identify companies with similar risk characteristics. *Id*. at 128.

Comparable or guideline company valuation methods are gaining in popularity, because the data bases for obtaining the necessary "comparable" information about such companies is becoming increasingly broad and available.

2. Intrinsic Value

According to *Taylor County,* in the absence of market value, the next best evidence of value is intrinsic value. 67 S.W.2d at 1105*; Howell v. Bowden*, 368 S.W.2d 842, 848 (Tex.Civ.App.–Dallas 1963, writ ref'd n.r.e.). Thus, intrinsic value is considered a proper basis for valuation only when there is evidence that the property has no market value. *Whelan v. State*, 282 S.W.2d 378, 380 (Tex. 1955).

Intrinsic value has been defined as: "[t]he true, inherent and essential value of a thing, not depending upon accident, place or person, but the same everywhere and to everyone." *Rosenfield v. White*, 267 S.W.2d 596 (Tex.Civ.App.–Dallas 1954, writ ref'd n.r.e.). Intrinsic value is "[w]orth based upon such factors as costs, depreciation, present usefulness, past return on investment, etc...." *City of Austin v. Cannizzo*, 267 S.W.2d 808, 812 (Tex. 1954). The term "intrinsic value" is often used interchangeably with the term "actual value." *See, e.g., Religious of Sacred Heart of Texas,* 836 S.W.2d at 616 ("[r]eal, actual or intrinsic value...).

The concept of intrinsic value is less well-defined than market value. Consequently, intrinsic value is seldom utilized in business valuations. *See, e.g.*, Edwin J. (Ted) Terry, Kristin K. Proctor, Ken Huff, and James LaRue, *Dealing with Special Problems Relevant to Evaluation & Division of Professional Practices,* B-20, 22nd ANNUAL NEW FRONTIERS IN MARITAL PROPERTY LAW (1997) [hereinafter referred to as "Terry and Proctor"].

3. Value to the Owner

The concept of "value to the owner" appears to be very similar to what is often expressed as "going concern value." A "going concern" is "an operating business enterprise." INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (January 2000). "Going concern value" is the intangible value of an enterprise that has the necessary work force, systems, procedures,

operating assets, and organizational structure in place. *See, Id.*; *see also*, *State v. Rogers*, 772 S.W.2d at 560 (it has been suggested that a "going concern value" is predicated upon an estimate of future profits and relates to the productiveness of a well-operated, successful business and its sound future potential). A trained and assembled work force is a particularly valuable intangible asset for many businesses, because of the significant "start-up" cost necessarily involved with developing a new work force.

"Value to the owner" has been recognized as a legitimate measure of value in the context of a divorce. In *Beavers v. Beavers,* 675 S.W.2d 296, 299 (Tex.App.–Dallas 1984, no writ), the community estate owned a one-third interest in the stock of a closely held corporation. The sale of the shares of stock was restricted by an agreement that they be offered first to the other shareholders at book value. Thus, it was acknowledged by all concerned that the market value of the stock was zero. Nevertheless, the trial court found the value of the community stock to be $170,000. The Dallas Court of Appeals affirmed the trial court's finding and held:

> [w]hile market value is usually the best evidence of the value of the personal property, in the absence of a market value, the actual value of the property to the owner may be shown.

Id. at 299.

It has been argued that the definition of value from *City of Pearland,* and further expanded by *Beavers*, opens the door to the introduction of all sorts of evidence bearing on the value of the ownership of a closely held business to the owner (provided that it has been established that no market value exists). *See, e.g.,* Terry and Proctor at B-25. For example, such evidence might include the value of being able, by virtue of ownership of stock in a closely held corporation:

- to earn a salary in excess of $100,000 per year;
- to drive a new automobile;
- to have health insurance paid for by the company;
- to have a company financed life insurance policy;
- to make trips at company expense;
- to have a company funded pension plan; and
- to belong to the country club at company expense, etc.

See, Id.

4. <u>Book Value</u>

There are two things that the Texas practitioner should know about book value. The first is the definition: book value means the sum of the asset accounts, net of depreciation and amortization, less the liability accounts, as shown on the entity's balance sheet. Pratt at 33. The second is that book value is entitled to little, if any, weight in determining the value of closely held corporate stock, or any other business. *See, e.g.,Bendalin v. Delgado*, 406 S.W.2d 897, 900-901 (Tex. 1966); *cf., Smallwood v. Singer*, 823 S.W.2d 319, 322, n. 2 (Tex.App.–Texarkana 1991, no writ) (in which the Texarkana Court of Appeals states that "[t]he only case that we have found in any jurisdiction to suggest that book value of stock in a closely-held corporation is prima facie evidence of value is *Percy v. Percy*, 115 Ariz. 230, 564 P.2d 919, 920 (Ct. App. 1977)").

D. Summary of Valuation Methods

1. <u>Adjusted Net Assets Method</u>

The Adjusted Net Assets Method sets a "floor value" for determining total entity value, *i.e.,* the fair market value (not book value) of existing assets less related debt. There is no reason that the owner of a closely held business or professional practice would be willing to accept less than the net asset value of a business or professional practice. This method is used when the business or professional practice earnings are not sufficient to give rise to an intangible value, for example, when it would be better to incur the cost of starting up a competing business or professional practice rather

than to purchase the existing business or professional practice. *See also* Terry and Proctor at B-16.

An asset based valuation approach, the Adjusted Net Assets Method therefore does not address the operating earnings of a business. However, the Adjusted Net Assets Method may include going concern value. Thus, when a professional practice has professional goodwill, but no commercial goodwill, the Adjusted Net Assets Method would be the preferred valuation method, since it would take into account the practice's going concern value.

2. Capitalization of Earnings Method

An income based approach, the Capitalization of Earnings Method is used to value a business based on future or normalized current earnings of the business. This method assumes that all of the assets, tangible or intangible, are an indistinguishable part of the business, and does not attempt to separate the values of the tangible or intangible earnings of the business. This method is most commonly used when the tangible assets of the business are not a material component of the business. However, it should be noted that the proper use of the Excess Earnings Method, as described below, should yield a value very close to the Capitalization of Earnings Method, since the rate of return on tangible assets of a business that has very few tangible assets will result in an insignificant increase in the total value of the business. *See, Id.*

3. Excess Earnings Method

The Excess Earnings method is an income and asset based method. The total value of a closely held business is the sum of the fair market values of net tangible and intangible assets. The value of intangible assets of a closely held business is determined by capitalizing earnings in excess of a reasonable return on the fair market value of the adjusted net assets of the business, after "reasonable owners compensation." As previously mentioned, in the case of a professional practice with very few tangible net assets, it should not be necessary to determine the rate of return on tangible assets since the calculated value would not differ materially from the Capitalization of Earnings Method.

Some business valuation experts discount the Excess Earnings Method in determining the value of a closely held business or professional practice, often citing Revenue Ruling 68-609 for the proposition that "[t]he 'formula' approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefor available." Realistically, a closely held business can be valued based upon asset based valuations, income based valuations, or a combination of income and asset based valuations, and sometimes based upon a comparable sales method. As discussed earlier, the current thought about "comparables" is that the guideline companies used in the valuation may be of much larger size than the subject company, provided both the subject company and the guideline company share the same or similar risk factors and revenue generators.

Morgan, 657 S.W.2d at 487, presents one example of the application of the Excess Earnings Method to a business valuation incident to divorce. The Excess Earnings Method has also been applied in at least one reported Texas partnership valuation case, *Taormina*, 355 S.W.2d 569.

Taormina involved a suit by a former partner to recover his proportionate share of the assets of a dissolved partnership. The former partner called an appraiser as an expert who testified that he had made an investigation of the partnership company, had observed its operations, and had examined its books. The expert testified that the partnership firm had goodwill, and fixed its value at the sum of $533,514.45. The expert testified that the method he used in determining the value of the partnership goodwill was based upon excess earnings (earnings in excess of eight percent to ten percent of the average tangible net assets or invested capital of the business), and when the net profits exceeded ten per cent of the tangible net assets or invested capital of a business, recognizable goodwill value existed. *Id.* at 574. The value of such goodwill, then, according to the expert, was computed on the basis of the amount by which the net earnings of the business exceed normal earnings in the same or similar business. *Id.* On appeal, the El Paso appellate court held that the trial court did not err in permitting the testimony of the expert witness to be considered by the jury. *Id.* at 575. *See Howell v. Howell*, 523 S.E.2d 514, 518-21 (Va. App. 1999) (the court accepted use of the excess earnings and discounted future earnings methods to

determine the value of husband's partnership interest in law firm). *See also* Fishman & Morrison, *Excess Earnings and Discounted Future Earnings to Value a Law Practice Interest,* 15 AM. J. FAM. LAW 314 (Winter 2001).

4. Discounted Earnings Method

Another income based approach, the Discounted Earnings Method is based on future earnings. The ultimate value of the business is determined from the present value of future earnings plus the present value of the terminal value of the business. The present value of the terminal value represents the capitalization of terminal year earnings. This method generally should not be used in a divorce case since future earnings, the separate property of the divorced professional or business owner, are not divisible in a dissolution of the marriage. *See, Berry*, 647 S.W.2d at 947. *See Howell v. Howell*, 523 S.E.2d 514, 518-21 (Va. App. 1999) (the court accepted use of the excess earnings and discounted future earnings methods to determine the value of husband's partnership interest in law firm). *See also* Fishman & Morrison, *Excess Earnings and Discounted Future Earnings to Value a Law Practice Interest,* 15 AM. J. FAM. LAW 314 (Winter 2001).

5. Rule of Thumb Methods

These are theoretical market derived comparisons and constitute a variation of the market comparison approach. These methods should be used only as a guidelines, or as "sanity checks," since there is usually limited knowledge about the actual transaction upon which the Rule of Thumb Method is based.

6. Market Based Methods

This method is based upon "comparable sales," or guideline companies, in a manner similar to real estate valuations. However, as already discussed, unlike real estate, there are very few, if any, "comparable sales" of closely held businesses or professional practices. Furthermore, it is very difficult to compare sales of publicly traded stock to the sale of the stock of closely held businesses or professional practices, unless there is sufficient information to correlate the subject company with the guideline companies based on similar risk and revenue factors.

Ultimately, utilization of market based methods to value a particular professional practice may well be similar to a real estate appraiser valuing Austin, Texas, property based upon the selling price of Newport Beach, California, property. The two are simply not comparable. If the sales compared are not "comparable," or the identified guideline companies not sufficiently comparable, then the conclusions drawn from the comparison will be utterly unreliable.

E. Valuation of Intangible Assets: Discreetly or Collectively?

When valuing a service business for purposes of divorce, in addition to the tangible assets of the business, such as the furniture, fixtures, equipment, accounts receivables, etc., there are also intangible assets to consider.

The intangible assets of a business can be categorized as follows:

- technology-related (engineering drawings, research and development information);
- customer-related (customer relationships, customer contracts, customer records);
- data processing-related (computer software, automated data bases);
- human capital-related (a trained and assembled workforce, executive employment agreements);
- marketing-related (trademarks, trade names, brand names);
- location-related (leasehold interests, easements);
- going concern value; and
- goodwill (personal and commercial).

Client files contain information and data useful in building a practice or business. Clients are more likely to return to where they have

previously received services and where their records are maintained.

Keeping the office space leased is critical since clients tend to identify with the business' location. Additionally, if the business has a favorable lease with the landlord, there is additional value in maintaining lower overall costs than other competing businesses, especially if there are a number of years remaining on the lease.

A trained and assembled work force in place, especially if the business is somewhat technical in nature. Other intangibles that create value can be a trade name, contracts in place, the name of the businesses, telephone number, etc.

Going concern value and goodwill are sometimes confused. The two are often, however, separate and distinct. As already discussed, going concern value deals with the operating value of the business or professional practice, *i.e.*, the value of having a work force in place, equipment set up and running, and inventory already stocked. Goodwill, on the other hand, does not deal with the actual physical assets of the business, but with the excess profits that are created from the tangible assets by the going concern. In contrast to going concern value, goodwill is keyed to reputation.

Intangible assets are a part of all businesses, as demonstrated by the following formula for computing the value of a business:

BEV = WC + FA + IA

Where:

BEV = Business Enterprise Value
WC = Value of Working Capital
FA = Value of Fixed Assets
IA = Value of Intangible Assets

In valuing the intangible assets of a business, two methods commonly used are (1) the discrete (or individual) method; or (2) the collective method.

In the discrete method, each individual intangible asset of the business or professional practice is identified and separately valued. Each "individual intangible asset" can also mean each individual category of intangible assets as enumerated above. The estimated value of each of the intangible assets, or of the category of intangible assets, is added to the value of the business' tangible assets and its net working capital to arrive at an estimated value of the entire business enterprise or professional practice.

In the collective method, all of the intangible value of the business or professional practice, from whatever source, is analyzed and quantified in the aggregate. It is not uncommon to refer to such collective intangible value as unidentified goodwill, or just unidentified intangible value. The label utilized is not important; rather, what is significant is the identification of the amount of the intangible value.

Thus, in the discrete method, *intangible assets* are identified and appraised; in the collective method, *intangible value* is identified and appraised. In the discrete method, it is necessary to identify which individual intangible assets create what amount of intangible value. In the collective method, it is sufficient to identify that intangible value exists and to quantify the total amount of such value. The source, or cause, of such intangible value is not especially relevant in the collective method.

There are benefits to both methods, and careful consideration should be given in selecting an approach. Considerably much more time and effort must be expended by the valuation expert in the discrete method, which results in much higher expert fees.

There is no right way, no single pattern or formula for determining the intangible value of a personal service business. As stated in Revenue Ruling 59-60:

> ...[a] sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment, and reasonableness must enter into he process of weighing those facts and determine their aggregate significance.

F. GAAP

"GAAP" stands for "generally accepted accounting principals." "Generally accepted accounting principles" establish guidelines relating to the process by which the transactions and events of a business entity are measured, recorded, and classified in accordance with a conventional format. *Hendricks v. Thornton*, 973 S.W.2d 348, 374 (Tex.App.–Beaumont 1998, pet. denied). As just one example, under generally accepted accounting principals, there must be numbers (data) to support whatever is reported as income on federal income tax returns. *Rivas v. Cantu*, 37 S.W.3d 101, 112 (Tex.App.-Corpus Christi 2000, pet. denied).

Accordingly, GAAP standards or adjustments provide the valuator with a starting point for financial statement analysis. However, the analysis should not end with such adjustments, as many valuators believe, or attempt persuade the finder of fact.

Rather, the financial statements of a professional practice should also be adjusted to normalize cash flow or earnings, as will be discussed in more detail below. A strong argument can be made that a valuation of a professional practice will be more influenced by normalization adjustments than by GAAP adjustments. Ultimately, to properly place an accurate value on any business, a willing purchaser must understand the business' normal cash flow and earnings.

Whether or not a valuation methodology complies with GAAP can be an issue in a valuation case. *See, e.g., Id*. at 124 (Seerden, C.J., dissenting) (the expert's methodology was unreliable, when, among other things, it did not comport with GAAP, and thus the expert's testimony should not have been considered evidence).

G. Capitalization Rates

The single most important factor in determining the ultimate value of a business is often the "capitalization rate." A "capitalization rate" has been defined as "any divisor (usually expressed as a percentage) that is used to convert a stream of income into value." INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (January 2000). "Capitalizing" is a mathematical procedure that converts a single flow of returns (income) into an indication of value. *See, e.g.,* Pratt at 164.

Theoretically, the capitalization rate represents the "risk" factor in the mathematical calculation that produces an estimate of a business' value. In other words, the capitalization rate is an estimate of risk, utilized when comparing a proposed investment in relatively risk free investments, such as stocks, municipal bonds, CD's, etc. to a proposed investment in a closely held business or professional practice. *Cf., Morgan*, 657 S.W.2d at 489 (capitalization rate of 15% represented the yield an investor in the current market would expect from his investment). The capitalization rate is an important factor in evaluating the risk involved in a proposed investment in a closely held business because an investor could always put his or her money into a "safe" investment, for a "safe" return. Given the risk involved in small businesses, some factor must be included that addresses the issue of risk, and that factor is the capitalization rate.

The mathematics of capitalization is simple: the return flow to be capitalized is divided by the capitalization rate. In other words,

$$PV = A/C$$

where:

PV = present value;

A = amount of return to be capitalized (usually dollars per year); and

C = capitalization rate.

Id. Thus, the higher the capitalization rate, the lower the value, and vice versa.

To illustrate the significance of the capitalization rate in the valuation of a business, assume that a business generates $100,000 in income per year. If one party to a valuation believes that the business represents a serious "risk," that party might decide to use a capitalization rate of 25%, in consideration of the perceived high risk. Using a capitalization rate of 25%, the business would be worth $400,000.

On the other hand, if the other party to the valuation believes that the business is relatively risk free, then that party might decide to use a capitalization rate of 10%. Accordingly, with the

10% capitalization rate, the business would be worth $1,000,000. Hence, the contest between capitalization rates becomes the contest over the "actual" value of the business.

The difference between a "capitalization" rate and a "discount" rate is growth: subtracting growth from a discount rate equals a capitalization rate.

H. Revenue Ruling 59-60

Revenue Ruling 59-60 is probably the determinative authority for the valuation of a closely held business corporation. For instance, the Texarkana Court of Appeals noted, in *InterFirst Bank Dallas, N.A.*, 739 S.W.2d at 891-892, that all of the expert valuation witnesses who testified–except one (who was not familiar with it)–recognized Revenue Ruling 59-60 as authoritative in evaluating closely held corporations; the Texarkana appellate court also noted, dryly, that the expert witnesses did not agree, of course, as to how Revenue Ruling 59-60 would apply to the evaluation of the shares of the corporation at issue in the case.

Revenue Ruling 59-60 was originally issued to provide guidance in the valuation of businesses (including professional practices) for which there had been no actual sale and therefore the valuation had to be based on a "hypothetical" buyer. Consequently, every valuator–as well as every Texas practitioner involved in a valuation case, should be intimately familiar with Revenue Ruling 59-60.

Section 4.01 of Revenue Ruling 59-60, sets forth eight relevant factors which should be considered as fundamental, but not all inclusive, for the evaluation of stock in closely held corporations, or for stock of corporations for which the market quotations are either lacking or too scarce to be recognized:

(a) the nature of the business and the history of the enterprise from its inception;

(b) the economic outlook in general and the condition and outlook of the specific industry in particular;

(c) the book value of the stock and the financial condition of the business;

(d) the earning capacity of the company;

(e) the dividend paying capacity;

(f) whether or not the enterprise has goodwill or other intangible values;

(g) sales of stock and the size of the block of the stock to be valued; and

(h) the market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

See, InterFirst Bank Dallas, N.A., 739 S.W.2d at 892.

I. Discounts and Premiums

There are two "discounts" commonly encountered in the valuation of a closely held business: (1) the lack of marketability discount, and (2) the minority interest discount.

1. Lack of Marketability Discount

The concept of marketability deals with the liquidity of an interest, *i.e.,* how quickly and how certainly the interest can be converted to cash at the owner's discretion. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, VALUING A SMALL BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, p. 528 (3rd Ed. Irwin 1996). The "lack of marketability" discount measures the diminution in

value attributable to the lack of a ready market for a particular interest in property. *See, e.g., Ward v. Commissioner,* 87 T.C. 78, 106-107 (1986). The rationale underlying the lack of marketability discount is simple: any interest in a closely held business, subject to infrequent trading and therefore a lack of marketability, is less attractive to the average investor than a similar interest which is traded publicly and to which the public has ready access. *See, Central Trust Co. v. United States,* 305 F.2d 292 (Ct. Cl. 1962). Essentially, the lack of marketability discount "equalizes" an interest in a closely held business with an interest in a publically traded business.

Despite the absence of a specific regulation or ruling, the Internal Revenue Service has conceded the propriety of the lack of marketability discount in many valuation cases. *See, e.g., Estate of O'Connell v. Commissioner*, 37 T.C.M. (CCH) 822 (1978). Consequently, the fair market value of a closely held business is calculated according to established valuation criteria, and then discounted for its lack of marketability.

The lack of marketability discount may be simply a flat percentage of fair market value. *See, Id.* Alternatively, the discount may represent how much it would cost to create the missing marketability for the closely held business being evaluated. *Wallace v. United States,* 556 F. Supp. 904 (D. Mass. 1981).

There is no general rule regarding the size of the discount for lack of marketability, but generally it has ranged from 20% to 35%. *See, e.g., Estate of O'Connell v. Commissioner* (30%); *Wallace v. United States* (35%).

The Authors have located no reported Texas appellate case that specifically addresses the lack of marketability discount. In *InterFirst Bank Dallas, N.A.*, 739 S.W.2d at 892, the Texarkana Court of Appeals mentioned the fact that one of the defendant's experts applied a 25% discount for lack of marketability in valuing the shares of a closely held corporation, but made no comment upon the propriety of such a discount. It should be noted that the expert valued the stock at between $500 and $600 per share, *Id.* at 892-893, while the jury ultimately valued the stock at $1,548.79 per share. *Id.* at 890. However, several other jurisdictions have addressed the lack of marketability discount. *See, e.g., Offenbecher v. Baron Services, Inc.*, ___ So.2d ____, 2001 WL 527522 (Ala. Civ. App. 2001); *Advanced Communication Design, Inc. v. Follett*, 615 N.W.2d 285 (Minn. 2000); *Balsamides v. Protameen Chemicals, Inc.*, 734 A.2d 721 (N.J. 1999); *Hall v. King*, 177 Misc.2d 126, 675 N.Y.S.2d 810 (N.Y. App. Div. 1998). *See also* James Edward Harris, *Valuation of Closely-Held Partnerships and Corporations: Recent Developments Concerning Minority Interest and Lack of Marketability Discounts*, 42 ARK. L. REV. 649 (1989).

2. Minority Discount

By definition, a minority interest represents control of less than 50% of the shares of a corporation; in a partnership, it means less than 50% of the partnership interest. Courts have long recognized that the shares of stock of a corporation that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation. *See, e.g., Estate of Newhouse v. Commissioner*, 94 T.C. 103, 249 (1990); *Ward,* 87 T.C. at 106. The minority discount reflects a minority interest's lack of control over corporate policy and inability to direct the payment of dividends or compel the liquidation of the corporate assets. *Harwood v. Commissioner,* 82 T.C. 239, 267 (1984), *aff'd without published opinion,* 786 F.2d 1174 (9th Cir. 1986). Because the critical factor is lack of control, and lack of control may equally exist for a minority partner as for a minority shareholder, the minority discount applies in the valuation of partnership interests as well as interests in closely held corporations. *See, Moore v. Commissioner,* T.C. Memo 1991-546, 1991 WL 220426 at p. 7 (U.S. Tax Court 1991).

There is no general rule concerning the size of the allowable minority discount. The courts have consistently allowed a 20% to 35% discount for minority ownership. *Ward*, 87 T.C. 78 (33 1/3%); *Northern Trust Co. v. Commissioner*, 87 T.C. 349 (1986) (25%); *Henry J. Knott v. Commissioner,* 55 T.C.M. 424 (CCH 1988) (30% discount appropriate to reflect the illiquidity and lack of control inherent in the 50% limited partnership interest); *Moore,* 62 T.C. M. 1128 (court allowed a 35% discount from the underlying net asset value for a minority general partnership interest with certain restrictions on selling, withdrawing or assigning the partnership interest).

Although there is some overlap between the discount for a minority interest and the discount for lack of marketability, the discounts are conceptually distinct. *Estate of Newhouse,* 94 T.C. at 249; *Harwood,* 82 T.C. at 267. Nonetheless, courts have varied in their actual applications of the discounts to particular fact situations. Some courts combine the two "conceptually distinct" discounts into a single discount. For example, in *Estate of Newhouse,* 94 T.C. at 252*,* the Tax Court held that an estate acted properly in discounting a 44% interest in a closely held corporation 35% to reflect both lack of marketability and minority ownership.

However, it has been argued that such discounts are usually taken *consecutively*. *See,* Shannon Pratt, *Shannon Pratt's Business Valuation Update,* Vol. 3, No. 1, p. 2 (January 1997) (interview with Stacy Eastland) [hereinafter referred to as "Pratt's Update"]. Consecutive application of the discounts occurs as follows:

Net Asset Value:	$100
Minority Interest Discount - 30%:	-30
Publically Tradable Minority Value:	70
Marketability Discount - 40%:	-28
Net Minority Nonmarketable Value:	$42

See, Id.

A third approach taken by the courts is to add the discounts together. In *Barudin v. Commissioner,* No. 7156-94 (U.S. Tax Ct., August 26, 1996), the court added a 19% minority discount and a 26% marketability discount for a total discount of 45%. *See, Pratt* at 2 (Eastland interview); *see also, Whittemore v. Fitzpatrick*, 127 F.Supp. 710, 721-722 (D.Conn 1954) (combined a 50% lack of marketability discount with a 32% minority discount); *Lefrak v. Commissioner,* 66 T.C.M. 1297 (CCH 1993) (20% minority discount added to 10% lack of marketability discount).

Texas courts have rarely addressed, at least in reported appellate decisions, the issue of the minority interest discount. In *Gannon v. Baker,* 830 S.W.2d 706, 708-709, (Tex.App.–Houston [1st Dist.] 1992, writ denied), the Houston First Court of Appeals recited that the value of a minority shareholder's stock had been discounted by 35%, due to the stock's minority position and lack of marketability, but did not otherwise comment or rule upon the propriety of the discount, either in theory or as applied. Similarly, in *InterFirst Bank Dallas, N.A.*, 739 S.W.2d at 894, the Texarkana Court of Appeals noted, without further explanation, that one of the plaintiffs' experts took the position that a minority interest should not be treated as a minority interest because it was the swing block, and without it no one would have a majority interest. and thus the experts did not discount the stock as a minority block.

As with the lack of marketability discount, the Authors have located no reported Texas case that specifically addresses the minority discount as a part of the valuation of a business.

3. Control Premiums

If the value of owning a minority interest must be discounted due to a lack of control, it makes sense that the value of owning a controlling interest also may cause an adjustment to overall value, due to the presence of control. In fact, ownership of a controlling interest, *i.e.*, more than 50 percent of the voting stock, may be worth a "premium." As stated in Rev.Rul. 59-60 §4.02(g), 1959-1 C.B. 237:

> [t]he size of the block of stock itself is a relevant factor to be considered....[a]lthough it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

In *Estate of Salsbury v. Commissioner*, 34, T.C.M. 1441, 1451 (1975), the Tax Court stated:

> [t]he payment of a premium for control is based on the principle that the per share value of a minority interest is less than the per share value of a controlling interest.....[a] premium for control is generally expressed as the

percentage by which the amount paid for a controlling block of stock exceeds the amount which would have otherwise been paid for the stock if sold as minority interests and is not based on a percentage of value of stock held by all or a particular class of minority stockholders.

The concept of the control premium was further clarified in *Estate of Chenoweth v. Commissioner,* 88 T.C. 1577, 1581 (1987), when the Tax Court stated:

> [w]e would tend to agree that the sum of the parts cannot equal more than the whole, that is, the majority block together with the control premium, when added to the minority block of the company's stock with an appropriate discount for minority interest, should not equal more than the total 100 percent interest....

The Texarkana Court of Appeals tangentially addressed the issue of "control" in *Beavers,* 675 S.W.2d at 299, when it stated that in assigning values of closely held corporations in contested divorce actions, considerations given by the trial judge to company assets and to the realities of corporate control, such as a stock transfer restriction (which rendered the stock valueless), are appropriate. *Beavers,* 675 S.W.2d at 299.

J. Transfer Restrictions

Generally, the transfer of securities may be restricted. *See,* TEX.BUS. & COM.CODE art. 2.22(B). In Texas, a restriction on the transfer or registration of securities of a corporation is valid if it reasonably:

> (1) obligates the holders of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities; or
>
> (2) obligates the corporation to the extent permitted by [the Business Corporation Act] or any holder of securities of the corporation or any other person, or any combination of the foregoing, to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities; or
>
> (3) requires the corporation or the holders of any class of securities of the corporation to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities for the purpose of preventing violations of federal or state laws; or
>
> (4) prohibits the transfer of the restricted securities to designated persons or classes of persons, and such designation is not manifestly unreasonable; or
>
> (5) maintains the status of the corporation as an electing small business corporation under Subchapter S of the United States Internal Revenue Code, maintains any other tax advantage to the corporation, or maintains the status of the corporation as a close corporation under Part Twelve of [the Business Corporation Act].

TEX. BUS. & COM. CODE art. 2.22(D) (footnote deleted).

According to the Internal Revenue Service, transfer restrictions may affect the value of a security:

> Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending on the circumstances of each case, fix the value for estate tax purposes. However such agreement is a factor

to be considered, with other relevant factors, in determining fair market value.

Rev.Rul. 59-60, §8, 1959-1 CB 237.

Since the effect of transfer restrictions on value is fact-dependent, the results of the tax cases vary rather dramatically. Some courts hold that a restriction fixes the value of a security at a discount; on the other hand, at least one has held that a restriction actually increased the value of corporate securities. *See, generally,* Schwartz at EE-6; *see also, Estate of Hall v. Commissioner,* 92 T.C. 312 (1989) (as long as restrictions had a valid business purpose, the restrictions controlled the value of the stock for estate tax purposes); *cf., Luce v. U.S.,* 4 Cl. Ct. 212 (1983) (when the majority family stockholder testified that he would have a paid a premium to keep ownership of the securities in the family, the court held that a viable market existed for the security, and the restrictions enhanced the value thereof).

V. VALUATION PRACTICE

A. Valuing a Professional Practice

The valuation of a professional practice differs from the valuation of an operating non-professional business in the following areas:

1. professional practices are primarily service businesses and generally do not offer or produce tangible products;

2. clients or patients generally rely upon the professional involved; thus, the distinction between personal and commercial goodwill is usually critical, and may have a substantial impact on the value of the entity;

3. professional practices offer a wide variety of services, such as different specialities in law or medicine;

4. the nature of the client or patient base is very important in determining the amount and kind of goodwill attributable to the practice and/or professional; and

5. the value of a professional practice is heavily dependent upon intangibles.

B. Normalizing Income

In valuing a closely held business or professional practice, issues arise due to the owner's control. "Normalizing" the business' earnings represents one such inevitable issue. Close scrutiny must be given to the company's expenses, in order to unravel the sometimes muddled distinction between corporate and personal spending, *i.e.,* the issue of "excessive compensation." *See,* Terry and Proctor at B-1.

Excessive compensation represents an owner's taking profits out of a closely held business or professional practice. Such compensation is the amount of compensation above that which would be ordinarily paid to a manager of the business or an associate in the professional practice. Excessive compensation often includes various perks that the company may be paying on the owner's behalf, such as auto expenses, club dues, personal use of corporate credit cards, telephone service, maid service (or other expenses related to the owner's residence), non-working employees (family members and significant others), bartered (noncash) items, etc. Some companies even have direct payment accounts with liquor stores, grocery stores, florists, and other merchants that may have been used for "personal" expenditures.

In the case of a business that is not closely held, the excess profits paid out as "excessive compensation" normally would be paid to outside shareholders as dividends. Thus, such excess profits, or "excessive compensation," is an element of the business or professional practice that results in the business having a greater value than otherwise

would be produced by simply deducting business debt from the value of its tangible assets.

Through interviews with key people, review of financial documents and tax returns, and other forensic techniques, the expert can piece together a more realistic picture of the business' true income.

There are some valuation "experts" who believe that normalizing income is simply a matter of adjusting a company's financial statements to GAAP standards. Strictly speaking, such a view is not accurate. Normalizing income also has to do with adjustments relating to a potential purchaser, although such adjustments, under GAAP standards, may not necessarily be required. For example, a company's treatment of country club expenses may be done according to GAAP standards, yet, for the purposes of a potential sale, such treatment may need to be normalized, since the payment of country club expenses may well represent "excessive compensation," and thereby affect the value of the business.

C. Discovery and Valuation Experts

A trial to establish the value of a professional practice is likely to be a trial by expert. Since "creative" accounting and appraisal techniques appear to be the accepted professional norm, it is not uncommon to see expert appraisals differ by millions of dollars over the less liquid property interests, such as closely held businesses and professional practices. The growing tendency to produce "hired guns" in family law litigation has created an industry of valuation experts whose quality and integrity is frighteningly uneven.

On this point, it would be profitable to recall the testimony of the plaintiff's expert in *Salinas*. Although he "purported" to remove any personal goodwill from his valuation of the partnership, his valuation was nonetheless based on the future earnings potential of the defendants, *i.e.,* their personal goodwill. *Salinas*, 948 S.W.2d at 290. In other words, the valuation expert said one thing, but did another. Thus, it becomes obvious that family law attorneys must have a system for discovering the raw data needed for business valuations, and be able to discuss that data intelligently once it surfaces in the valuator's written report or testimony.

For example, it is essential to understand the valuation techniques being used in the case. There are more than 25 commonly accepted valuation techniques *and they should not be mixed*. It is proper to apply two or more valuation techniques in the valuation of a single enterprise and then to compare or weigh the results. But the techniques themselves should not be mixed. The price earnings ratio technique should not be combined with a goodwill capitalization technique. The results will be grossly inaccurate. *It is therefore not surprising that many valuation experts combine techniques* in order to weigh the result in favor of their client. The impenetrable veneer of accounting and valuation jargon enables them to attempt to camouflage distorted result. *See,* Terry and Proctor at B-35.

1. <u>Valuation Credentials</u>

The following is a summary of the common and important valuation credentials or designations.

a. ABV: Accredited In Business Valuation

Issued by the American Institute of Certified Public Accountants. In order to qualify for the exam, the applicant must demonstrate knowledge in the area of business valuations. To receive the credential, the candidate must pass an eight hour written exam. The credential requires 60 hours of business valuation continuing education every three years. The holder must be recertified every three years and must be a member of the AICPA in good standing.

b. CVA: Certified Valuation Analyst

Issued by the National Association of Certified Valuation Analysts. The candidate must be a CPA and a member of the AICPA in good standing. The requirements for

certification are forty hours of training in business valuation. a four hour proctored exam. and submission of a complete written business valuation report. A CVA must have thirty-six hours of continuing education every three years.

c. ASA: Accredited Senior Appraiser

Issued by the American Society of Appraisers. Requirements for certification include passing an eight hour exam and submitting two complete written business valuation reports. An ASA must have forty hours of continuing education every five years.

d. CBA: Certified Business Appraiser

Issued by the Institute of Business Appraisers. Requirements for certification include passing an four hour exam and submitting two complete written business valuation reports. A CBA does not have any minimum continuing education requirements.

2. Written Report

Pursuant to TEX.R.CIV.P. 195.5, an opposing expert may be required to produce a timely written report. At the very least, then, the attorney will have something to attempt to understand, to discuss, and to attack.

3. Depose the Expert

The expert should be deposed concerning (at the minimum) the following topics:

1. College degrees, post graduate degrees, actual fields of study, history of seminars, attending or post college training programs.

2. Textbooks read or other industry literature which has created this witness's expertise assisted the witness in this particular area. Get the titles, authors, dates published and dates read. Find out the "who" and "what" they recognize as authoritative. It makes impeaching possible.

3. (a) The nature of any preliminary study in connection with this particular valuation; and (b) each person the expert has interviewed (obtain and review the expert's notes from each interview).

4. Every assumption the witness has utilized or relied upon. Test each assumption to determine if the assumption is reasonable or speculative.

5. The history and details of the witness' publishings, teachings, or lecturing in the area of expertise and review them. If the attorney cannot personally review them, then they should have his or her own expert do it.

6. How long the expert has made appraisals, what kinds of appraisals he or she has made, how many and when, and the employment history (all

jobs including professional engagements) of the expert.

7. Memberships and affiliations with professional associations and the requirements for membership or affiliation.

8. (a) The relationship of the expert with opposing counsel or with the opposing party; and (b) when the expert was initially engaged and by whom; (3) the expert's fee arrangement.

9. The expert's history of testimony in other divorce cases, the names of the cases, the names of the judges in the court, the dates of testimony, the names of opposing experts and the amount and nature of differing appraisals, the final results, how much was the fee, and how was it determined.

10. What the expert knows about the particular industry or type of case involved.

11. If the expert has determined that commercial goodwill exists, have the expert explain in detail exactly how reasonable compensation was calculated, *i.e.,* how were the excess earnings separate and distinct from the earnings generated by the physician or principal determined.

12. The reasonableness of the ascertained value.

D. Documentary Evidence at Trial

The specific use to be made of a document will depend upon the attorney's overall trial strategy. Irrespective of valuation strategy, one should be most cautious in the utilization of documentary evidence and should always consider whether or not the other side can turn such evidence to their own advantage. A classic example of this might be the a keyman life insurance policy, the proceeds of which are intended to be used for redemption of the stock of a deceased key man. The attorney representing the keyman in a divorce case might utilize the face amount of the policy to prove that the corporation would be worth a great deal less without the services of the employee. However, the other spouse's attorney, for example, could argue that the value of the stock has been set by the amount of insurance provided for the redemption of the stock and such value could conceivably be considerably in excess of what the keyman spouse's attorney is contending. This is a particularly dangerous area for the keyman spouse's attorney since the value of the stock contemplates that the owner would no longer be a participant in the corporation. This falls foursquare within the methodology to be utilized in this particular type litigation in arriving at the present value of a business. *Cf., Rathmell,* 732 S.W.2d at 18.

The use of the documents, to a great extent, will be dictated by whether or not the litigator is representing the business owner spouse, whose business is being valued–in which case a lower valuation is more favorable–or the other spouse who would prefer that the business be valued at a higher amount. Equally important to the litigator's decision to use documentary evidence is whether or not such documents are being utilized in the case in chief, *i.e.*, as evidence of value, or if they are being utilized as a source of cross-examination in an attempt to discredit the valuation evidence of the opposing party. Thus, the following comments should be considered as applicable to the appropriate context, *i.e.*, case in chief or cross-examination.

1. Original Purchase Documents

If there was a recent purchase of the business (or an asset of the business), the purchase documents would be of considerable benefit.

On cross-examination, question whether or not the values set forth in the original purchase documents include anything other than actual purchase price. Examples of this could be such things as broker's commissions, or the satisfaction of other obligations between the buyer and the seller such as pre-existing debt that was not actually related to this particular transaction. A portion of the sales price may have been allocated specifically to goodwill or to a covenant not to compete. A full understanding of the relationship between the parties could possibly lead to additional matters to be covered on cross.

2. Corporate Minutes

Details such as stock purchases or exchanges of property for stock may be found in the minutes. It is self evident that any written record dealing with value could be evidence to be considered relative to value.

For purposes of cross-examination, it should be noted that there can be diverse reasons for assigning values to stock in corporate minutes, most of which have to do with tax planning. For instance, an attempt to make transactions totally tax free, or to provide an opportunity for a stepped up basis, both of which affect the tax consequences at the time of the transfer, can greatly influence values assigned to stock or assets exchanged for stock as reflected in the corporate records. The comments made here would be equally true for records of shareholders meetings and organizational meetings.

3. Corporate Balance Sheets, Profit and Loss Statements and Sales Forecasts

These records can likewise be beneficial as proof of value. Balance sheets, for instance, show such matters as long and short term debt, and quite often, will be part of an annual or periodic how-goes-it type approach to a business often accompanied by notes to the balance sheet reflecting either positive or negative comments which can be cross referenced with subsequent profit and loss statements as well as sales forecasts. Depending on valuation strategy, the argument can be made that the forecasts are either reliable or unreliable, depending upon how they match.

On cross-examination, inquires should be made as to the purpose for creation of the balance sheet. Likewise, inquiry should be made into any adjustments, etc., which should be reflected in notes to the balance sheet. As to profit and loss statements, one should inquire into compensation to owners or upper level management personnel. These can drastically affect the profit picture. Likewise, hidden expenses for travel and entertainment, and other executive perks, will affect profits. This may also be a good place to look, whether on cross or direct, for items that can be utilized for proof of value of the stock to the individual owning it, should the attorney be taking the "no market value" approach.

4. Representation of Values to Third Parties

This is a particularly valuable asset to both sides in proving value. Into this category would fall loan documents, financing statements, probate records, (such as inventory and appraisements), gift and estate tax returns, and inventories filed in divorce cases or other third party litigation. Such documents are particularly helpful if they are chronologically sequential, showing a consistent representation over a period of time in varying circumstances, which would show consistency of value or methodology for arriving at value.

On cross-examination, determination of the circumstances surrounding, and the purpose for, such representation of values to third parties is of paramount importance. The relationship of the third parties to the person making the representation is equally important. Such evidence can be attacked from the standpoint of the length of time since the representation, *i.e.*, that it is stale information. Attempts should likewise be made to determine if, since the representations were made to third parties, there have been occasions when inquiry was made into the value and there was a failure to respond to the inquiry with a statement of value.

5. Tax Returns, Buy-Sell Agreements, Partnership Agreements, and Stock Transfer Ledgers

Such documents might reveal payments made for items such as non-compete agreements, which would show up on amortization schedules of corporations, previous sales of stock, or explanations of purported tax free exchanges on an individual return, which might involve the stock in question or the tax treatment of various licenses, etc., on corporate or partnership tax returns. Buy-Sell Agreements have been addressed previously, but, again, they could be utilized as a starting point for proof of value, or as proof of an impediment to value since stock value could be reduced by restrictions placed upon it due to the buy-sell agreement or a right of first refusal. Stock transfer ledgers often will show, and should show, the consideration given for the transfer of shares of stock. Partnership agreements likewise will often set forth formulas for the purchase of a partner's interest in the event of a partner leaving the partnership under various circumstances such as death, buy-out, divorce, leaving without an intent to compete, etc.

On cross-examination, corporate tax returns are particularly valuable if an income approach to valuation is being utilized. Ordinarily, some multiple of earnings will be utilized by the valuator in order to compute present value. Corporate tax returns will show such things as compensation of owners, travel and entertainment expenses, large expenditures that might be a one time expense item, sale of assets, insurance, etc. All of these are merely leads to follow in the cross-examination depending upon whether the return supports or is adverse to the attorney's trial strategy. Typically, valuators will use a multiple of EBIT, (earnings before interest and taxes). Therefore, if executive compensation is excessive, or large write offs have occurred that are not of a recurring nature, or travel and/or entertainment expenses are excessive, these are items that should be added back to the EBIT prior to applying the multiple.

Some of these items may seem minimal. However, if a multiple of four or five is being utilized, even small add backs tend to become significant. As to partnership tax returns, the same reasoning would hold. Bear in mind that partnership returns are merely information returns and that any undistributed income passes through and is picked up on the individual return of the parties. Again, unusual expense items that can be added back to increase the profit picture, or further expenses that could be deducted to decrease the profit picture, can have substantial impact when utilizing a multiple of earnings approach.

Buy-sell agreements are automatically suspect and should be subject to extensive inquiry on cross examination since they are usually negotiated with one eye on the tax collector and the other on out-of-pocket expenditures, particularly as to pay out provisions. Customarily, there are extended periods of payout which substantially reduce the value of the consideration paid. The matter of a buy-sell agreement in a partnership can be of critical importance, and, prior to conducting cross-examination on such matters, the cross-examiner should be intimately familiar with *Nail*, *Rathmell*, *Finn*, and *Geesbreght*.

Stock transfer ledgers customarily reflect how the managers of the corporation want transactions to appear, rather than of what they actually were. The cross-examiner should be particular interested in canceled stock certificates that have been re-issued. What often happens is that the stock certificates are initially issued in one form or the other in certain denominations and later the principals decide there was a more advantageous way to have done the transaction. The stock certificate are often canceled and re-issued in different forms and denominations. This can be of particular importance if the distribution of stock is critical to the value in cases in which a discount factor is being applied for a minority interest.

6. <u>Prior Litigation</u>

These records can be a very good source of proof of value. For instance, if there has been prior litigation between partners or other third parties involving the value of particular assets such as accounts receivable, contracts, licenses, etc., these could all have direct bearing on the value of the asset involved in the current litigation.

On cross-examination, a complete understanding of the underlying facts of the previous litigation is absolutely essential to an effective examination of a witness utilizing prior litigation documents as proof of value. This is essential to understanding the motivation for the representations involved, and to determine if the present position being taken concerning value is consistent with that taken in the prior litigation. It

is particularly important to remember to get ***all*** the exhibits from the prior litigation introduced. Even though the prior exhibits may not have worked in that litigation, they could prove of substantial benefit in the present litigation with different players and different circumstances.

7. Loan Applications and Financial Statements

These records will invariably reflect a very high or inflated value. Seldom does one preparing a financial statements or loan applications try to make the value of assets listed appear less than what they actually are. One possible exception to this, however, might be a financial statement prepared for the Internal Revenue Service in an attempt to work a payout for delinquent taxes. It is reasonable to assume that one would not desire to appear overly wealthy, while attempting to get a long term payout.

Cross-examination regarding these documents can consist of matters such as the reason for filing the financial statement, who prepared it, what was the basis for the values assigned, the date of the application or financial statement, and the general business conditions and outlook for the business at the time the financial statements were prepared.

8. Personal Property Tax Rendition Records

These records are often overlooked and are not available in all instances. Usually their availability is restricted to the larger metropolitan areas.

On cross-examination, the cross-examiner will generally attempt to impeach these records since most likely they will have been utilized by the low-side litigator in the case in chief. They are subject to the usual cross-examination strategy that persons rendering property for tax purposes are ordinarily going to attempt to minimize the tax bite by making a low rendition.

9. Business Interruption Insurance Policies and Underwriters' Reports

These records can provide invaluable information to the litigator operating on a limited budget. This is particularly true for the litigator whose client has an interest in receiving a higher valuation. Invariably, underwriters and others selling this type of insurance will show tremendous income losses should the entity's business be interrupted. Otherwise, there would be no need to buy their insurance.

On cross-examination, point out that insurance salesmen typically sell more insurance that is actually needed, that insureds are urged to buy too much rather than too little insurance–particularly in light of the fact that the premiums are fairly low since they ordinarily have a kick-out period of 15, 20, 30 or 60 days before payments commence–that the premiums are deductible, and that the insurance is designed to protect against catastrophe, *i.e.*, some highly unlikely event, rather than day-to-day occurrences. Insurance of this type is typically sold based on gross income, rather than profit, since it is typically designed to cover fixed and ongoing expenses, rather than net profits.

10. Market Studies

These records can be of particular value to the litigator depending upon whether or not the outlook is overall good or bad. The content of the report itself would indicate its usefulness in a particular situation.

On cross-examination, the first thing to establish is the reason for the study, *i.e.*, is it to attract business, sell some service to the industry, etc. It should be established that many market studies conducted by trade associations or individuals can be designed and are often carried out for the sole purpose of helping to obtain financing or for promotional purposes. One final point to be considered on cross-examination is to make sure the study is applicable to the enterprise in question, *i.e.*, whether it is regional or national, short term or long term, etc. Coupled with the reasons for the study, the character of the study should enable an astute litigator to design an effective cross-examination.

11. Real Estate or Equipment Leases

These records can be of use to the litigator when and if they are keyed to revenues of the enterprise utilizing the real estate or equipment.

Additionally, if there is a long term lease accompanied by a right of renewal or extension it will probably be at a higher rate. The argument can therefore be made that the unexpired term of the lease has value since it is below what the market is expected to be at the time of its expiration, if, in fact, there is a substantial period of time remaining the on term.

On cross-examination, one should bear in mind that, if the lease is keyed to revenues, particular attention should be given to whether or not it is net or gross revenues and to the definitions or methodology to be utilized in determining the net or gross. One can cast great doubt on lease documents if the applicable definitions are not very specific and tight in determining the lease payments.

12. Real Estate Tax Records

Historically, real estate renditions have been considerably below present market value. However, much more emphasis is now being given to tax roll renditions since state law now requires that all real estate be rendered at 100% of market.

On cross-examination, one must be aware that when real estate values are in a decreasing phase, it is more likely that the tax rolls will have the real estate in question over valued. The cross-examiner should establish this, or in the alternative, if he is on the opposite side, establish that, if it is over-valued, that the owner has known about the over-valuation for some time, and if he truly believed that it was over-valued, he would have taken steps to correct it. As a precautionary note, there are only certain times after a tax roll rendition during which an appeal of the rendition may be taken. It would be well for the cross-examiner to know these appeal windows prior to undertaking cross-examination.

13. Trade Association Brochures and Literature

These records are of particular benefit to the litigator on a short budget. If such literature supports the client's position, the argument is that people knowledgeable in the business, who are independent of the client, authored the records.

On cross-examination, the cross-examiner should establish that business associations are self serving, that for the greater part they only report things that will be favorable to their point of view, and that they will attempt to minimize any adverse information regarding the industry. Cross-examination should be made of the witness of any as to prognostications of future prospects, and particularly, concerning any long term projections. Detailed cross examination should be conducted as to the source and reliability of the date upon which such forecast is based.

14. Offers to Buy/Sell

Unaccepted offers to buy or sell are inadmissable. *Hanks v. Gulf, Colorado & Santa Fe Railway Co*., 320 S.W.2d 333, 336 (Tex. 1959); *Southwestern Bell Telephone v. Wilson* 768 S.W.2d 755, 762 (Corpus Christi 1988, writ denied). However, it does not hurt to try to get such evidence before the trier of fact, and if the other side is not on their toes with a proper objection, such evidence can be admitted.

On cross-examination, offers are meaningless since they did not result in an ultimate sale. Therefore, they are not evidence of value. The circumstances regarding the offer to buy or sell may not have been at arms' length, or possibly they were an attempt by one owner to get out of an unpleasant business situation. This hardly qualifies as a willing buyer and a willing seller under no compulsion to buy or sell. Lastly, question whether the circumstances are now different than they were at the time the offer to buy or sell was made.

15. Record Replacement Insurance

This is an often overlooked valuation tool. As is often the case, in a corporate valuation situation, the largest value is going to be intangible value, whether it is called goodwill, on going business, blue sky, or something else. The value of the records replacement insurance is to prove either a high or low value for the records themselves, which are a tangible asset. This may either help or hurt the valuation situation depending on the client's position. Sorting out the hard assets and identifying the blue sky portion of the valuation is one of the favorite techniques of most valuation litigators. Thus, the litigator should be aware of these insurance policies and be prepared to utilize them either as a sword or as a shield as the facts may dictate in the particular case. The same could hold

true for casualty insurance policies on such things as equipment or improvements to real estate.

On cross-examination, establish that insurance is customarily for replacement value and is therefore different than a willing buyer and a willing seller situation. If it is being used against the client to prove a high value, then the litigator should bring out the fact that, just because it is insured for the amount in question, it does not necessarily mean that such amount is the market value. It also could be argued that the very reason for the insurance is that such records are not for sale on the open market and therefore are irreplaceable.

E. You Don't Always Need A Hired Gun

In *Laprade v. Laprade*, 784 S.W.2d 490, 492 (Tex.App.–Fort Worth 1990, writ denied), the wife testified that, in her opinion, the current value of the community business was "in excess of $200,000." *Id*. On appeal, the husband argued that the trial court erred in permitting the wife, as part owner, to give her lay opinion concerning the value of the business. *Id*.

The Fort Worth Court of Appeals, however, held that the admission of the wife's testimony concerning the market value of the company was not an abuse of discretion by the trial court, since the evidence showed there was a basis for the wife's knowledge of the value of the property. *Id*. Specifically, the evidence showed that the wife had knowledge of the business accounts receivable, ran the business for five years, and knew what was paid for each of the business' trucks, as well as the value of other smaller, similar businesses for sale. *Id*. Thus, under TEX.R.EVID 701, the wife's testimony, an opinion derived rationally from established facts, as well as helpful to the court, was admissible to establish the value of the business. *Id*.

Laprade remains the law in Texas on the admissibility of lay opinion testimony from an owner concerning the value of a business or other asset. *See also, e.g., Ramex Const. Co. v. Tamcon Services Inc*., 29 S.W.3d 135, 138 (Tex.App.–Houston [14th Dist.] 2000, no pet.) (it was error to exclude the testimony of the principal shareholder of a closely held corporation concerning the value of the corporation; the shareholder held an accounting degree, had worked for the company for many years, was familiar with the accounts receivable and the company's books, and was the person who oversaw liquidation of the company's assets when it shut down); *Hochheim Prairie Farm Mut. Ins. v. Burnett*, 698 S.W.2d 271, 276 (Tex.App.–Fort Worth 1985, no writ) (homeowner was allowed to testify concerning the value of his house damaged by fire; the owner had owned rent houses before, knew the market value of the house, had listed it for sale before the fire, had knowledge of the construction and decor of the house, and had personally inspected the house after the fire).

F. Specific Contract Provisions

Occasionally, a contract for the sale of a professional practice will specifically allocate a portion of the sales proceeds to "goodwill." An interesting issue is raised thereby.

Conceptually, the allocated goodwill, if determined by the excess earnings generated by the professional, would indeed be personal goodwill, particularly if the excess earnings were generated entirely by the personal efforts of the physician. Assume that a sale is completed, and the owner gets his money. Thereafter, though, he files for divorce. The wife argues that the sales proceeds are all community property.

An argument can be made that the portion of the sales proceeds separately allocated for any existing covenant not to compete represents compensation for the owner's personal goodwill and willingness not to expend post-sale efforts competing with the buyer. Under *Rathmell,* the sales proceeds therefore would represent non-divisible, separate personal goodwill.

Thus, a prudent professional or key-man owner, who desires to protect his or her separate property, should be very careful to draft the sales contract to allocate portions of the total sales price not only to specific tangible assets, but to intangible assets as well, such as the covenant not to compete, personal goodwill, and commercial goodwill. Upon receipt of the sales proceeds, the prudent professional would then deposit the community portion into community accounts, and the portions attributable to personal goodwill and the covenant not to compete into separate property accounts.

VI. COMMON PROBLEMS IN VALUING A PROFESSIONAL PRACTICE

A. Transfer Restrictions: Binding on Spouse?

Closely held corporations or partnerships will typically have bylaws or partnership agreements restricting transferability of shares or interests. In the context of a divorce, an issue of immediate significance is whether such provisions will be applicable to the non-employee spouse. Interestingly, there is a paucity of case law in Texas on the issue, particularly with respect to effect of transfer restrictions on the non-employee spouse.

1. Family Law Context

In *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192, 196 (Tex.Civ.App.–Houston [1st Dist.] 1975, no writ), the wife was awarded a 21% ownership of the closely held corporation owned and controlled by the husband and his sons. When she sought to have the shares transferred into her name, the corporation took the position that share transfer restrictions, which gave the corporation or other shareholders a first right to purchase the shares, became effective upon the transfer incident to the divorce. *Id*. at 198. Not surprisingly, the wife sued. *Id*.

On appeal, the Houston First Court of Appeals noted that a provision which restricts a stockholder's right to sell or transfer his or her stock, particularly one which affords a prior right of purchase to the corporation or to another stockholder, is not looked upon with favor in the law and is strictly construed. *Id*. at 202; *see also, Docudata Records Management Servs., Inc. v. Wieser*, 966 S.W.2d 192, 198 (Tex.App.–Houston [1st Dist.] 1998, pet. denied) (sound corporate jurisprudence requires courts to narrowly construe rights of first refusal and other provisions that effectively restrict the free transfer of stock). The Houston appellate court further noted that a transfer restriction like the one in *Earthman's* generally was not applicable to a "transfer" occurring as a result of an involuntary sale, or by operation of law, unless, by some specific provision in the restriction itself, the restriction was made applicable to such transfer. *Id.*

The First Court of Appeals next cited the Louisiana case of *Messersmith v. Messersmith*, 86 So.2d 169 (La. 1956), in which it was contended that certain community owned stock should not be divided in kind, as decreed by the divorce court, and that the husband should be permitted to retain the stock and to pay his wife one-half its book value in accordance with a restrictive clause in the corporate charter requiring a stockholder, who wished to sell his stock, to first offer it to the other stockholders or officers of the corporation. *See,* 526 S.W.2d at 202. In *Messersmith*, the Louisiana Supreme Court determined that the restrictive provision of the charter could not prevent the recognition of the wife's share of ownership in the corporation, held that she was entitled to have delivered to her in kind the interest awarded to her under the divorce decree, and stated:

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

526 S.W.2d at 202, *quoting,* 86 So.2d at 173.

Accordingly, the Houston First Court of Appeals in *Earthman's Inc*. held that the restrictive provision should not be construed so as to preclude the wife's right to have her shares of ownership reflected on the books of the corporation and to have the stock certificates evidencing her ownership issued to her. 526 S.W.2d at 202; *see also, Consolidated Bearing and Supply Co., Inc. v. First Nat. Bank at Lubbock*, 720 S.W.2d 647, 650-651 (Tex.App.–Amarillo 1986, no writ) (*citing Earthman's* with approval).

2. Commercial Context

Article 2.22 of the Texas Business Corporation Act generally provides that stock transfer restrictions are enforceable against the holder of the restricted security or any successor or transferee of the holder, if such restrictions are

reasonable and are conspicuously noted on the stock certificate.

In *Dixie Pipe Sales, Inc*, 834 S.W.2d at 492, upon the death of a shareholder, the corporation refused to transfer the shareholder's stock to the beneficiaries under the shareholder's will, and opted instead to pay the beneficiaries the book value of the stock pursuant to a right of first refusal contained in the corporation's bylaws. The parties agreed that, under article 2.22 of the Texas Business Corporation Act, the restriction was valid, and thus the question was whether the corporation was entitled to the right of first refusal when the transfer was made by the will. *Id*. at 493.

On appeal, he Houston appellate court stated that restrictions on the power of a corporate shareholder to transfer his or her shares of stock may validly be imposed in the charter or the bylaws of a corporation, provided such restraints are reasonable and not contrary to public policy. *Id*. According to the Fourteenth Court of Appeals, the reasonableness of such a restriction is ordinarily to be determined by applying the test of whether the provision is sufficiently necessary to the particular corporate enterprise to justify overruling the usual policy of the law in opposition to restraints on the alienability of personal property. *Id*.

The Houston appellate court also noted that article 2.22 specifically provided that a transfer restriction could be enforced against any successor or transferee of the holder. *Id*. Thus, the transfer restriction applied to a beneficiary under the will. *Id*. at 494.

In discussing whether the restriction was reasonable, the Houston Fourteenth Court of Appeals stated:

> The provision in [the corporation's] bylaws is not unreasonable, but is calculated instead to advance legitimate objectives of both the corporation and its individual stockholders, that is, to keep the stock in the family. Such a restriction is inherently more "reasonable" when applied to the stock of a corporation having only a few shareholders who are active in the business and members of the same family, than when imposed on the stock of a corporation that has many shareholders who are not only unrelated to one another, but who, ordinarily, do not participate actively in the day-to-day management of the corporation.

Id.

Certainly, under *Dixie Pipe Sales, Inc.,* it could be argued that a spouse, who is to receive stock of a closely held corporation or professional practice pursuant to divorce, is a "successor" or "transferee" of the employee spouse. Even if the transfer restriction does not contain a provision explicitly addressing divorce, then, *Earthman's Inc.* notwithstanding, the restriction may well apply to the non-employee spouse under *Dixie Pipe Sales, Inc*.

Other Texas cases in the area of commercial law generally support the enforceability of transfer restrictions. *See, e.g., Ling and Company v. Trinity Savings and Loan Ass'n,* 482 S.W.2d 841, 844 (Tex. 1972) (there was nothing "unusual or oppressive" in requiring a selling shareholder to notify and give an option to buy to more than twenty other shareholders); *Shindler v. Harris,* 673 S.W.2d 600, 609 (Tex.App.–Houston [1st Dist.] 1984, writ ref.'d n.r.e.) ("clear and unequivocal" forfeiture provision appearing in a written joint venture agreement upheld); *RGS, Cardox Recovery v. Dorchester Enhanced Recovery,* 700 S.W.2d 635, 639 (Tex.App.–Corpus Christi 1985, writ ref.'d n.r.e.) (requirement that no partnership action could be taken at a meeting unless 75% of voting members present and voting was upheld since the parties had a right to agree and contract to "whatever limitations upon themselves" they desired, however, "burdensome or awkward").

3. <u>Enforceability Against Non-Employee Spouse</u>

Several issues pertain to the enforceability, against a non-employee spouse, of transfer restrictions in corporate bylaws, stock purchase agreements, or partnership agreements.

a. Signature

First, it must be determined whether the non-employee spouse signed any document evidencing the restrictions. *See and cf., Southwest Texas Pathology Associates, L.L.P.*, 27 S.W.3d at 208 (the nonsignatory wife was not bound by the terms of an arbitration provision in the agreement of a professional medical partnership of which the physician husband was a partner, because the wife was not asserting claims against the husband or the partnership that required reliance on the terms of the written agreement containing the arbitration provision).

Further, the precise nature of the document signed must be ascertained. A simple signature at the end of the document containing the restrictions–as well as many other unrelated provisions–will probably not be as persuasive in supporting enforceability as will a more explicit, precise acknowledgment and waiver, such as, for example, the following provision:

> The undersigned spouse of the Purchaser [the employee spouse] has read and hereby approves the foregoing Stock Purchase Agreement. In consideration of the Company's granting the Purchaser the right to acquire the Purchased Shares in accordance with the terms of such Agreement, the undersigned spouse hereby agrees to be irrevocably bound by all the terms of the such Agreement, including (without limitation) the right of the Company (or its assignee) to purchase any Purchased Shares in which the Purchaser is not vested.

b. Legal Representation

As is the case with premarital or postmarital agreements, whether the non-employee spouse obtained, or was encouraged to obtain, legal representation regarding the effect of any agreements containing transfer restrictions or buy-out provisions may be an important issue. *See and cf., e.g., Marsh v. Marsh,* 949 S.W.2d 734, 740-741 (Tex.App.–Houston [14th Dist.] 1997, no pet.) (the husband acknowledged that he was free to consult an attorney and accountant before the execution of the agreement; the lawyer who drafted the agreement testified that he met with both parties over several hours in discussing the proposed agreement, including three visits with the husband alone, at which time he "strongly" recommended that the husband obtain independent counsel); *Chiles v. Chiles,* 779 S.W.2d 127, 129 (Tex.App.–Houston [14th Dist.] 1989, writ denied) (the wife was represented by counsel at all times during extensive negotiations and drafts of the agreement); *Sadler v. Sadler*, 765 S.W.2d 806, 808 (Tex.App.–Houston [14th Dist.] 1989), *rev'd on other grounds*, 769 S.W.2d 886 (1989) (the attorney who drafted the agreement testified at length to the circumstances of execution, stating that the parties freely entered into the agreement, that the attorney had dismissed the husband from the room and repeatedly counseled the wife to engage her own attorney; nonetheless, the wife declined the invitation and duly signed the contract, refusing to take it home and think about it).

c. Fairness of Agreement

Dixie Pipe Sales, Inc., 848 S.W.2d at 494, addresses the issue of "reasonableness," as discussed above. The reasonableness of an agreement may turn on whether it is fair, and several factors are implicated in such a determination. Perhaps the most important is how the stock is to be valued: fair market value will necessarily be more reasonable than other indicia of value, such as book value. Further, the process whereby the value of the stock is to be determined is also important.

For instance, a buy-out agreement that provides that the remaining shareholders may buy out the selling shareholder at a predetermined price, for example, $1 per share, may be enforceable as between the shareholders. It may not be enforceable, however, against a spouse, particularly if the shares are worth far in excess of $1 per share.

A reasonable valuation method often used is to provide that, in the absence of agreement as to the value of the stock or interest in question, the parties will select an appraiser to determine the value; if the parties cannot agree on the selection of an appraiser, each selects his or her own, and the two appraisers then select a third who is charged with the determination. The allocation of the costs of the appraisal is significant as well.

d. Sophistication of Non-Employee Spouse

Analogously, marital agreement cases concerning enforcement often allude to, and sometimes turn on, the relative levels of the parties' sophistication. *See and cf., e.g., Marsh,* 949 S.W.2d at 743 (the husband was active in trading stocks, and both parties had business experience and were educated); *Fanning v. Fanning,* 828 S.W.2d 135, 139 (Tex.App.–Waco 1992), *rev'd in part on other grounds,*847 S.W.2d 225 (Tex. 1993) (both parties were practicing attorneys when the premarital agreement was executed); *Williams v. Williams,* 720 S.W.2d 246, 248-249 (Tex.App.–Houston [14th Dist.] 1986, no writ) (the wife's job exposed her to contracts which dealt with banking financial records, and both parties had experiences with the sale of properties); *Daniel v. Daniel,* 779 S.W.2d 110, 115 (Tex.App.–Houston [1st Dist.] 1989, no writ) (the husband was a licensed attorney and a certified public accountant, and once was employed as vice-president and assistant to the president of an engineering firm before he started his own venture capital firm).

B. The Effect of Buy-Sell Agreements

In today's increasingly complex economic climate, partnerships and closely held corporations frequently have buy-sell agreements in place between partners and shareholders. Normally intended for the mutual protection of the partners or shareholders, and to promote the continuous, harmonious and successful management of the business (by allowing the surviving or remaining parties to maintain ownership and control of the business), a buy-sell agreement typically contains mutual covenants to buy and sell a shareholder's or partner's interest at death or if a shareholder wished to make an inter vivos sale of his or her interest in the business. *See, e.g., Little v. X-Pert Corp.*, 867 S.W.2d 15, 16 (Tex. 1993). Buy-sell agreements also typically require the interest or stock to be purchased at a particular price, often "fair market value," and provide a mechanism for determining such value.

In the context family law, there are two current developments of significance. First, buy-sell agreements increasingly trigger upon the divorce of a partner or shareholder. Second, non-involved spouses are signing such agreements with increasing regularity. *See, e.g., Donahue v. Bowles, Troy, Donahue, Johnson, Inc.*, 949 S.W.2d 746, 748 (Tex.App.–Dallas 1997, writ denied) (all company shareholders and their wives executed a buy-sell agreement, which required that, within ninety days of the termination of a shareholder's employment, such shareholder must sell his stock and the company must buy it).

If, for example, a buy-sell agreement provides that, upon the involved spouse's divorce, the business has a right to buy back, at a specified price, that spouse's interest in the business, and if the buy-sell agreement is enforceable against the non-involved spouse, then certainly the issues concerning the valuation of the interest (for purposes of divorce) have become decidedly simplified. Thus, the binding effect of buy-sell agreements is becoming more and more a concern for both parties and their lawyers in Texas.

There appear to be only two reported cases in Texas that, in the context a of divorce, specifically address the issue of the effect of a partnership agreement on the valuation of a partner's interest, *Finn*, 658 S.W.2d 735, and *Keith*, 763 S.W.2d 950, both of which have been discussed at some length previously in this paper. Naturally, the two cases are at odds with each other.

In *Finn*, under the terms of the law firm's partnership agreement, if the husband died or withdrew, he was entitled only to (1) the amount contained in his capital account, (2) any earned income which had not been distributed, and (3) his interest in the firm's reserve account, less ten percent of his proportionate share in the accounts receivable for clients' disbursement. By a vote of three fourths of the senior partners, the husband could have been required to withdraw, and in that event he was entitled to the same compensation for his interest as provided for under the voluntary withdrawal provisions. The partnership agreement did not provide any compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill. 658 S.W.2d at 741-742. It is interesting to note that the opinion of the Dallas Court of Appeals in *Finn* does not mention that the partnership agreement contained buy-out provisions upon divorce, or that the wife signed the agreement. It is probably safe to assume–but this is just an assumption–that the

partnership agreement contained no such provisions and that the wife did not sign it.

The Dallas appellate court majority held that the community estate was not entitled to a greater interest than that to which the husband was entitled in the firm's goodwill, and that the extent of the husband's interest was governed by the partnership agreement. *Id*. at 741. Justice Stewart, it will be recalled, specifically disagreed that the partnership agreement controlled the value of the individual partnership interests, arguing that the asset being divided was the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. *Id*. at 749.

In *Keith,* 763 S.W.2d 950, the (non-professional) husband asserted on appeal that trial court erred by failing to find the market value of a partnership, of which he was a partner, by applying the formula set forth in the partnership agreement, since his wife had signed the agreement, stating her approval of the agreement and her acceptance of its provisions, and agreeing to be bound by it. *Id*. at 953. The partnership agreement provided a method for determining the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners. *Id*. The Fort Worth appellate court stated that it agreed with the concurring opinion of Justice Stewart in *Finn* to the effect that the formula set forth in the partnership agreement with respect to death or withdrawal of the partner was not necessarily determinative of the value of a spouse's interest in the ongoing partnership as of the time of divorce. *Id*.

It can be argued that the trend in Texas has been to acknowledge that Justice Stewart's dissent in *Finn* is the better position, as evidenced by *Keith*. That so few reported cases exist on this point–even though the issue arises more frequently these days–seems revealing. Underlying Justice Stewart's argument is the hard question posed by the extreme case: what do you do when the buy-out agreement establishes a value demonstrably, and egregiously, below a fair and reasonable estimate of value?

Conceptually, one problem with the majority position in *Finn* is that it seems to ignore what could be considered the two different purposes of the typical buy-out agreement: (1) to define the rights and duties of parties in times of turbulence and change; and (2) to provide incentive for loyalty (or put another way, to provide disincentive for disloyalty). The incentive/disincentive aspect of buy-out agreements necessarily undervalues the interest at issue. Thus, an issue of fairness may well exist in using the buy-out mechanism as the determinative indicator of value.

Moreover, in *Beavers*, 675 S.W.2d at 299, the Dallas Court of Appeals did not hold that the wife was bound by the corporate buy-out provisions, but rather used an "actual" or "intrinsic" value roughly based on the corporation's underlying assets (as opposed to "book value," the value established in the corporate buy-out provisions), since the buy-out agreement rendered the shares in question valueless. The Dallas appellate court did not explain its rationale for avoiding the effect of the buy-out agreement, stating only that "...[i]n assigning values to closely held corporations in contested divorce actions, those considerations given here by the trial judge to company assets and to the realities of corporate control are appropriate." *Id.*

Additionally, in *Beavers*, 675 S.W.2d at 299, the Dallas Court of Appeals referred to the concept of "value to the owner," a notion which potentially opens the door to all sorts of proof regarding factors that may inflate the "value" of a business to an owner. In turn, this leads to Justice Stewart's conclusion in *Finn*, 658 S.W.2d at 749, that the husband's partnership agreement should not have precluded consideration of other "facts" in valuing the husband's interest in the law firm, a conclusion echoed by *Keith*. Thus, under appropriate circumstances, *Beavers* might well be used to undermine *Finn*.

In the end, *Finn* survives. If the Dallas appellate court was correct in *Finn* when it stated that the community estate was not entitled to a greater interest than that to which the husband was entitled in the firm's goodwill, and that the extent of the husband's interest was governed by the partnership agreement, then a enforceable buy-sell agreement that defines the value of a business interest will limit the value of that interest that can be awarded pursuant to a divorce.

Accordingly, the prudent Texas practitioner confronted with a draconian buy-sell agreement would do well to think hard about the considerations involved concerning the binding effect of transfer

restrictions. Given the state of the existing case law, it is an area ripe for creative lawyering.

C. Dirty Tricks

1. Hiding income

Believe it or not, people do attempt to hide money, and not just from the IRS. *See, e.g.*, *Underwood v. Underwood*, 902 S.W.2d 152, 154 (Tex.App.–Houston [1st Dist.] 1995, no writ) (in a SAPCR action, the former husband purposely hid his ownership interest and income from two business entities). More typically, however, income will be "lost" in a business in the form of perks paid to owners, or expenses paid by the business (perhaps to fake vendors). Income can also be hidden by failing to convert work-in-progress to accounts receivable, and then not billing for such work. Sometimes, income is simply stolen.

It must always be remembered that, in divorce cases, parties often subscribe to the firm conviction that "what's mine is mine, and what's yours is mine." Such an approach often allows–even justifies–the most peculiar ethical positions. Consequently, the prudent practitioner, and his or her valuation experts, will always investigate the income issue carefully, and always "normalize" a business' or practice's income.

2. Improper Valuation Methods

Not surprisingly, lawyers and their accountants often present estimates of value based upon questionable, if not utterly preposterous, valuation methodologies, or based upon legitimate methodologies corrupted with subtle, but insupportable assumptions or assertions of fact. The Authors are aware of at least two such valuation "strategies" that have come across their desks in the past few years. Many others occur. The Authors are further aware that Texas trial judges sometimes "bite" on such offerings. The Texas practitioner must be constantly diligent to expose and extirpate impermissible valuations methodologies. *Cf.*, *City of Harlingen v. Estate of Sharboneau*, 48 S.W.3d 177 (the expert's subdivision development appraisal took more than a dozen analytical steps, most involving assumptions and estimates, any one of which could have seriously affected the appraisal's accuracy; thus, according to the Texas Supreme Court, the resulting wide margin for error counseled against using the expert's appraisal in ordinary circumstances).

a. Harnessing Future Earnings

In many divorces, what exists in the way of divisible assets may not be nearly as attractive as what might exist in the future. As already discussed, a spouse's future earnings may represent an irresistible morsel in many cases.

The Texas Supreme Court's opinion in *Salinas*, as discussed above, has cautioned against any attempt to harness future earnings under the guise of goodwill. Texas law simply does not permit a spouse to share, post-divorce, in the future earnings of the other spouse. Many Texas cases to that effect exist, and the Texas family law practitioner needs to know them. Among the more significant are: *Berry*, 647 S.W.2d at 947; *Licata v. Licata*, 11 S.W.3d 269, 278 (Tex.App–Houston [14th Dist.] 1999, pet. denied) ('[w]e recognize a spouse is not entitled to a percentage of his or her spouse's future income"); *Butler*, 975 S.W.2d at 768 (wife has no interest in the husband's post-divorce earnings); *Smith*, 836 S.W.2d at 692 (valuation erroneously based on post-divorce earnings); *Rathmell*, 732 S.W.2d at 18 (post-divorce time, toil and talent of a business owner must be excluded by the trial court when determining the value placed on a business).

b. "Gross Receipts" v. "Profits"

Although perhaps it seems elementary to most people that income based valuations must be based upon earnings, and not gross receipts or revenue, since profits represent gross income less expenses and other associated costs. As stated by one respected commentator:

> To a large extent, the profitability of a business is viewed as an indicator of value of an interest therein. Before a profit figure can be reached, all items of income and all expenses must be identified and analysed [sic].

Arnold J. Rutkin, *Valuation of a Closely Held Corporation, Small Business or Professional Practice*, VALUATION AND DISTRIBUTION OF

MARITAL PROPERTY, Vol. 2, pp. 22-23 (Matthew Bender 1998).

The Austin Court of Appeals has specifically recognized the impropriety of a valuation methodology based upon "gross receipts." In *Travis Cent. Appraisal Dist.*, 947 S.W.2d 724, one of the major issues was the proper valuation of multiple unimproved lots in a subdivision. The Austin appellate court stated that professional appraisers acknowledged that, although the "retail price" of individual lots should be considered in their valuation, direct and indirect development and marketing costs must also be considered in order to find true market value. *Id.* at 729.

Further, according to the Third Court of Appeal, labeling "expected gross receipts as any kind of value estimate is highly misleading and should be avoided." *Id.* To illustrate the fundamental error of using gross receipts as an indicator of value, the Austin Court of Appeals also posed the following hypothetical:

> For example, imagine a company that is in the business of selling widgets. The company has on hand a stock of 100,000 widgets, which retail for $2 each. Thus, the company hopes to receive $200,000 in gross receipts from the sale of its widgets. Assume the evidence shows, however, that in all likelihood it will take one year to sell off this entire stock of widgets; during that year, the company will likely spend $25,000 to lease a widget store, $25,000 to staff the store with salespersons, $25,000 to advertise the widgets, and $25,000 to maintain the widgets in good condition while they are waiting to be sold. Thus, the company hopes, by the end of the year, to net $100,000 profit from its widget sales (less the original cost to buy the stock of widgets). What would a reasonable, willing buyer with full information pay for the entire inventory of widgets at the beginning of the year? No more than $100,000, possibly less. Yet the simplistic method of multiplying the number of widgets on hand (100,000) by the retail sales price of each ($2) would produce a "fair market value" of $200,000, even though no "willing buyer" would pay that much for the company's inventory as a unit.

Id. at 731-732.

Recently, the impropriety of "gross receipts" as a factor or basis in determining value has struck home, and, in many areas of country, central Texas included, has struck home hard. Over the past several years, it became rather the standard to value the new internet companies on the basis of anticipated gross revenues, since the companies had neither current nor historical earnings. As has been heavily reported in the media, such companies were given grossly inflated values. Of course, for many of such companies, the expected revenues never materialized, and the result has been a glut of bankruptcies and lawsuits.

3. Intentional Devaluation

In *In re Marriage of Parker*, 997 S.W.2d 833, 838 (Tex.App.–Texarkana 1999, pet. denied), the wife contended at trial that the husband had devalued his business assets through questionable business dealings with a long-time business associate. The trial court believed the wife, and awarded her $50,000 as a part of the just and right division of property. *Id.*

On appeal, the Texarkana Court of Appeals noted that the husband had started the business, of which he was the incorporator, sole investor, and sole shareholder, after the marriage with $139,000 in community assets. *Id.* at 838-839. Further, during the parties' pending divorce, on the same date the trial court conducted a hearing on a motion for temporary orders restraining the parties from disposing or encumbering any property, the husband signed a note and security agreement to his business associate for $1.2 million, for alleged cash advances over a period of time. *Id.* at 838. Of course, the husband testified that there were no contemporaneous writings to support the debt owed to the associate because the money had been loaned in a series of "handshake deals." *Id.* at 838-839.

Later, in a voluntary foreclosure resulting from the husband's default on the note (and conducted in the office of the husband's divorce attorney), the husband transferred the business to his associate. *Id.* at 839. A new company, of which the husband was just an employee, then took over the husband's business at the same location and showed over $2 million in sales in the first fifteen months. *Id.*

At trial, the wife argued that the husband could have made the payments on the outstanding note, and thereby avoided the foreclosure, but did nothing. *Id.* The husband denied that his transactions with his associate were an attempt to defeat any claim the wife may have had to any of the property. *Id.* Not unexpectedly, the Texarkana Court of Appeals found sufficient evidence to support the trial court's award of $50,000 to the wife. *Id.*

4. Partnership Conspiracy to Defraud

In *Southwest Texas Pathology Associates, L.L.P.*, 27 S.W.3d at 205, after the physician husband filed for divorce, the partnership of which he was a partner amended its partnership agreement to permit, for the first time, a partner to be expelled without cause by a unanimous vote of the partners, and to require arbitration of disputes arising out of the partnership agreement. After the wife obtained an order for $10,000 per month in temporary support, the partnership abruptly voted to expel the husband. *Id.* at 206. Although the husband sought and obtained a temporary restraining order to prevent his expulsion, the TRO was soon dissolved on the basis that the husband had an adequate remedy at law for damages. *Id.* He also filed a motion seeking a modification of the temporary support orders based on his unemployment. *Id.*

Unimpressed, the wife immediately joined the partnership as a defendant in the divorce action, alleging, among other things, that the husband and the partnership engaged in a conspiracy to terminate the husband for the purpose of defrauding the wife of her community property rights and interest in the husband's medical practice. *Id.*

The partnership filed a motion to compel arbitration, alleging that the wife was bound by the arbitration provision because all of her claims were derived from the husband's former status as a partner, *i.e.*, her claims could not stand independent of the partnership agreements since, in the absence of the partnership agreements, she had no economic interest in the assets of the partnership entities. *Id.* at 206-207.

The trial court found that the husband had violated the temporary orders in signing the amendment to the partnership, that the wife was not a party to the partnership agreements and that she was not bound to arbitrate with the partnership. *Id.* at 207. On appeal, the San Antonio Court of Appeals affirmed the trial court. *Id.* at 205.

VII. COMMON PROBLEMS IN VALUING A PROFESSIONAL LAW PRACTICE

A. Problems with the Professional Corporation

For purposes of divorce, the problem with a professional legal corporation is that the shares representing ownership are transferable only to persons duly licensed or authorized to perform the same type of professional service as that for which the corporation was organized. TEX.REV.CIV.STAT. art. 1528e, §12. In other words, a trial court may not divide the shares of a professional legal corporation in kind between an attorney-spouse and a non-attorney spouse.

The Authors have located no reported Texas that addresses such difficulties in the specific context of a professional corporation.

B. Problems with Personal Injury Practices

Personal injury law practices are, perhaps, the hardest type of law practice to value. The primary problem with these practices surrounds the client files and the nature of the contingency fee contract. Because personal injury cases are handled on contingency fees, there are no readily ascertainable "accounts receivable." In some instances, there will be no recovery for the client, and therefore no fee to be received by the firm. Certain cases may realize a much better return by settlement or judgment than expected, while other cases may realize less. Frequently, even the attorneys involved are not able to accurately assess the likelihood of recovery, or the eventual amount.

There is a whole host of problems with the valuation of personal injury cases. The final determination in these valuations will often come down to the role of the personal injury trial expert. Such expert, based upon his or her own experience in handling cases of the sort being valued, must determine from the available information the actual value of the case. Such value can vary widely, depending upon a number of factors, including the identity of the law firm that is handling the case and the manner in which the client's case is being prepared. Thus, a case may ultimately be worth more than $100,000.00 in the hands of one firm, but less than $100,000.00 in the hands of another.

Further, the personal trial expert, in valuing the individual files, must project the amount of additional work necessary to complete the case–and the manner in which individual attorneys manage their cases varies widely. The number of depositions, the amount and form of investigation performed, and typical pre-trial preparation, are idiosyncratic to particular firms, and to particular lawyers within each firm. For example, on complex cases, some firms will conduct "mini trials," or other studies, to determine the type jury most favorable to the case. Substantial work by expert witnesses may be required, or models may need to be built. A case once estimated to be 50% complete at the time of valuation may well later turn out to have been only 20% complete.

Obviously, when valuing a personal injury practice's "client files" to determine the value of the practice, a number of practical and ethical issues develop.

1. Percentage of Completion

Because in a personal injury practice there are no "accounts receivable" at any given time, there is no means to obtain a current "snapshot" of the value of client files. Additional work by the firm will usually be necessary to finalize most cases and to achieve therein a quantifiable recovery.

When a case first comes into the office, before any work is done on it, there is some chance that the case is worth little to nothing. By the time a demand letter is sent, and work has been underway, however, the case has some value, but not as much as a case that is already in trial or settlement talks, or subsequent to trial on appeal. Any estimate of value for any case will be affected by the amount of work yet to be done. It is therefore necessary to determine the "stage" of each client file at the time of the valuation.

Generally, a percentage of completion formula is applied that takes into account the estimated final value of the case and multiplies that number by the estimated stage of completion. For example, if the case is valued at $100,000.00, and is 60% complete, then the value assigned to that case will be $60,000.00.

2. Inception of Title

Questions regarding the "inception of title" of individual cases being valued may (or should) often arise. In Texas, property is characterized as "separate" or "community" at the time of the inception of title to the property. *See, Parnell v. Parnell*, 811 S.W.2d 267, 269 (Tex.App.–Houston [14th Dist.] 1991, no writ). Inception of title occurs when a party first has right of claim to the property by virtue of which title is finally vested. *See* , *Strong v. Garrett*, 148 Tex. 265, 271, 224 S.W.2d 471, 474 (1949).

In a personal injury case, does title arise when the case is "signed up," and the injured person becomes a client of the firm? Or does the attorney have "title" when the funds in settlement funds are ascertained to be a sum certain, or when the judgment is actually collected? Arguably, until money is collected, the firm or attorney has no more than an expectancy interest. The question, however, is really unsettled as a matter of Texas law.

3. Referral Fees

a. Fees Paid Out

Each case valuation must also take into account whether there is an agreement to pay a referral fee to another attorney or firm. In such cases, the value of the case will be reduced by the amount of the fee to be paid.

For example, in the case discussed above and valued, because of the "stage" at which it stood, at $60,000.00, if a referral agreement exists, calling for a 33 1/3% fee, then the real value to the firm will be about $40,000.00.

b. Fees Paid In

The valuation of the entire firm must include the amount of fees that may be recovered from other law firms on cases that were referred "out" from the firm being valued (which may generate later referral fees for the firm). There are quite a few obstacles in placing values on such fees, however, particularly since the pertinent files are generally outside the firm, held by another firm or by lawyers who are not members of the firm being valued. When a case has been referred out, and there are no written referral fee agreements, placing a value on the eventual fees to be recovered by the firm may encounter, among other things, "inception of title" problems.

4. Structured Settlements

Structured settlements also involve potential problems with the inception of title doctrine, as well as with terms of the applicable contingency fee agreements. Often, when a personal injury case is resolved by means of a structured settlement, the attorney's fees percentage will be paid up front in a lump sum. In such cases, it is easy to determine the value of that particular client file. In other instances, however, there may be valuation problems if the contingency fees are also structured.

One commentator has suggested that a Texas court will most likely date the inception of the title to the fee back to the contract with the client, comparing the case to a winning lotto ticket. *See*, Larry H. Schwartz, *Handling the Divorce Involving a Law Practice*, p. A-6, MARRIAGE DISSOLUTION INSTITUTE (1998). If the lotto ticket is purchased during the marriage, it is presumptively community property. Schwartz, at A-6. If the parties later divorce, and the lotto ticket wins, then "inception of title" arose at the time the ticket was purchased. *Id*. Mr. Schwartz also observes that most lotto winnings are paid out over time, but the entitlement still dates back to the purchase of the ticket. *Id*.

These authors agree, in general terms, with the lotto ticket analogy on contingency fee cases. However, it should also be noted that structured settlements are somewhat distinguishable from other contingency fee cases. If a case with a structured settlement has already settled, the amount of the settlement, and consequently the associated attorneys' fees, are readily ascertainable. Title should vest once the structured settlement is signed since the right to receive the funds is contractual, and not merely an expectancy.

5. Advanced Expenses and Costs

In most personal injury cases, the law firm will advance the client expenses and associated costs, *i.e.*, "fund" the lawsuit. The contract with the client frequently provides for the payment of such expenses and costs out of the client's percentage of any future recovery. Clearly, some attorneys are better able to predict the likelihood of a successful recovery than others. In valuing the client files, the valuation expert will need to be cautious and mindful as to whether the firm has advanced more costs and expenses than they can expect to recover in any given matter, or as a whole. Additionally, the expert will need to predict whether, in any particular case, additional costs and expenses will need to be advanced for a successful recovery, and the approximate amount of those costs and expenses. Such a prediction is necessary to arrive at a "net value" of the individual client file.

6. Partners' or Shareholders' Percentage Interests

Once the individual cases are valued, the attorney spouse's percentage of ownership interest will also need to be determined. If the attorney spouse has the same percentage ownership interest in recoveries already received but not yet disbursed, or expected to be received in the future, then the percentage can be applied across the board. However, in many cases the interest will change from one point in time to another, or from one case to another. In such instances, the percentage interest must be applied on a case-by-case basis. Further, the percentage interest may be subject to change due to some future event (such as promotion within the partnership).

7. Shelf Life of Cases

The "shelf life," or amount of time a case has been pending, will also affect the value of the client file. Some attorneys are more aggressive than others, and actively work their cases on the assumption that they will receive a higher recovery if they "strike while the iron is hot." Others tend to allow their cases to languish and often become

dormant, which results in a lack of interest by the defendants, adjusters, and insurers. In order to determine the pattern of the firm being valued, the expert witness will need to look at the history of similar cases within the firm.

Equally, the "type" of personal injury cases within the firm will also be important. It is, for example, typical for a complex class action toxic tort case to take far longer to finalize than a rear end automobile collision with little damages.

C. Contingent Fees

1. States In Which Contingent Fee is Marital Property

The following states recognize contingent fee contracts as part of the marital estate subject to being divided upon divorce.

a. Arizona

A contingent fee contract has valid enforceable contract rights, therefore, it is a valuable property right that can be divided. The community estate is entitled to the percentage of the time expended as community labor in realizing the fee. Therefore, a contingent fee contract is not characterized as a community or separate asset because it is the community effort put forth enhancing the value of the asset that the court can divide. The contingency fee contract sets the value of the services. The services may be worth nothing, a reasonable hourly fee, or the full value of the contract. Therefore, it is proper for the trial court to have continuing jurisdiction over the matter to monitor the value of the services. Whether the attorney spouse was diligent in expending community labor to increase or realize the contingent fee contract is not an issue. *Garrett v. Garrett*, 683 P.2d 1166 (Ariz. Ct. App. 1984).

b. Arkansas

Any enforceable right to property that is acquired during marriage, by virtue of a contingency agreement, is marital property under Arkansas Code Annotated, §9-12-315. This is because there are enforceable contract rights in a contingency fee contract. The difficulty in valuing these rights should not preclude courts from finding that they are marital property. Any difficulty in valuation can be solved by reserving jurisdiction until the fee is determined. "The marital share in the ultimate recovery should be based on the portion of the time devoted to the case during the marriage as compared to the full amount of time devoted to earning the fee." *McDermott v. McDermott*, 986 S.W.2d 843, 848 (Ark. 1999).

c. California

In valuing a law practice that is based on contingent fee cases, a trial court may retain jurisdiction over the matter when the valuation at the time of divorce is too difficult to ascertain. The trial court's jurisdiction must have some foreseeable finite ending. The right to receive fees contingent on future events does not negate their status as divisible community assets. When a contingency fee is realized, it is community property, even though it is not yet received. *In re Marriage of Kilbourne*, 281 Cal. Rptr. 211 (Cal. Ct. App. 1991); *Waters v. Waters*, 170 P.2d 494 (Cal. Dist. Ct. App. 1946).

d. Colorado

Because other types of deferred compensation, earned during marriage but payable after dissolution, are marital property, contingency attorney fees are also marital property and are subject to division on divorce The method that should be used to value the contingency payments is the "reserved jurisdiction method." *In re Marriage of Vogt*, 773 P.2d 631 (Colo. Ct. App. 1989). The trial court should limit its order to the portion of the husband's interest in the fee attributable to work done during marriage. This overcomes any arguments that the amount received from a contingent fee contract is speculative.

e. Louisiana

The assets of the community include obligations based upon the right to receive money in the future, which includes contingent fee contracts. Contingent fee contracts create enforceable rights in the attorney. Even if the attorney is fired or passes away, he has some right to recover from his time and labor, therefore, a contingent fee contact forms part of the community property of the spouses insofar as its value is based on the attorney's services performed during marriage. *Due v. Due*, 342 So.2d 161 (La. 1977).

f. Massachusetts

The interest of an attorney in a contingent fee arrangement constitutes property that is subject to division upon divorce. The value of speculative claims for money damages can be divided on a "if and when" basis, meaning that the money, if and when received, can be divided according to a predetermined formula. *Hanify v. Hanify*, 526 N.E.2d 1056, 1059 (Mass. 1988). This is an equitable way to divide future income because it allows both spouses to equally share in the contingencies of the income, whether it is never realized, or whether it is more than anticipated. An "if and when" order, because it specifies a fixed formula for dividing the money, does not require the trial court to retain jurisdiction over the case. *Lyons v. Lyons*, 526 N.E.2d 1063 (Mass. 1988); *Hanify v. Hanify*, 526 N.E.2d 1056 (Mass. 1988) (*Lyons* relied on this case for the "if and when" valuation).

g. New York

Like any other asset of a partnership, the value of a contingency fee case can properly be considered in determining the value of a spouse's interest in a law practice upon divorce. Because "[t]he value of pending contingent fee case files likely not reflected in ledgers," the spouse of the lawyer "is entitled to have such files considered by the expert" for valuation purposes. *Litman v. Litman*, 123 A.D.2d 310, 347 (N.Y. App. Div. 1986). While disclosure of these files raises obvious concerns regarding the attorney-client privilege, the courts have concluded that "sufficient safeguards can be put in place to as to preserve the confidentiality of client-attorney communications and prevent any violation of Code of Professional Responsibility." *Fox v. Fox*, 2002 Slip Op. 00321 at 3 (N.Y. App. Div. 2002). *See Frink v. Frink*, 494 N.Y.S.2d 271 (N.Y. Sup. Ct. 1985).

h. Washington

A contingent future interest, including the right to receive contingent legal fees, that is earned during marriage is marital property to be divided by the court upon dissolution. Because of the inherent difficulty in valuing a contingent fee, any proceeds received on contingency fee agreements which originated during marriage should be awarded to both parties and divided between the spouses when received, based on the number of hours worked during the marriage versus the total number of hours worked on the case. *In re Marriage of Estes*, 929 P.2d 500 (Wash. Ct. App. 1997).

i. West Virginia

"In spite of their 'possibly contingent nature,'...when a contingent fee contract is acquired during marriage, it is 'marital property' within the meaning contemplated by West Virginia Code § 48-2-1(e)(1)." *Metzner v. Metzner*, 446 S.E.2d 165, 173 (W. Va. 1994). However, only the portion of the fee earned for work done during the marriage can be considered a community asset. Because of the uncertain value of an ongoing contingency fee case, the court should retain jurisdiction and determine the proper distribution if and when the fee is actually received. *See White v. Williamson*, 453 S.E.2d 666 (W. Va. 1994).

j. Wisconsin

"The fact that an asset is impossible to value on the day of divorce, however, is not sufficient reason to ignore the asset when dividing the marital estate. Rather, it is within the discretion of the trial court to determine the appropriate division." *Weiss v. Weiss*, 365 N.W.2d 608, 613 (Wis. Ct. App. 1985). The court decided that "divid[ing] the asset upon receipt of payment of the contingent fee receivables" appeared to be "the only practical approach."

2. States In Which Contingent Fee is Not Marital Property

The following states do not recognize contingent fee contracts as part of the marital estate subject to being divided upon divorce.

a. Florida

"The client owes the lawyer nothing until and unless the client recovers money. [A] lawyer and his firm may do everything they can reasonably and properly do, but the contingency may still never occur." *Roberts v. Roberts*, 689 So.2d 378, 381-82 (Fla. Dist. Ct. App. 1997). Because of the speculative nature of contingency fees, they cannot be considered marital property.

b. Georgia

"[I]t is impossible to know in advance whether any specific contingent fee case will ultimately yield a fee – or, if it does, how much the fee will be. It is also nearly impossible to gauge how much work and expense will be required after the date of the divorce to become entitled to collect a contingent fee. These qualities of contingent fee agreements make them too remote, speculative and uncertain to be considered marital assets in making an equitable division of property." *Goldstein v. Goldstein*, 414 S.E.2d 474, 476 (Ga. 1992).

c. Illinois

Contingent fees are not marital assets for three reasons: (1) an attorney has no right to receive the fee unless and until the case is disposed of; (2) the amount of the fee is highly speculative; and (3) the worth of the contingent fee to an attorney remains intangible until the firm actually receives payment in the form of cash or other consideration. Additionally, dividing a contingent fee would create an impermissible fee-sharing arrangement between an attorney and a non-attorney in violation of Rule 5.4 of the Illinois Rules of Professional Conduct. *See In re Marriage of Zells*, 572 N.E.2d 944, 945 (Ill. 1991). However, contingent fees can be considered in the determination of income for support and maintenance. Contingent fees earned by an attorney contribute to the annual income figures relied upon in awarding maintenance and support. *See Carlson v. Brandt*, 250 B.R. 366, 371 (N.D. Ill. 2000).

d. Missouri

The fees generated from a contingency case are future income and what will be received is "purely speculative." Therefore, they are not marital property subject to the division of the court. *See In re Marriage of Hershewe*, 931 S.W.2d 198, 204-205 (Mo. Ct. App. 1996).

e. Oklahoma

Because an attorney is not certain to receive anything under a contingent fee contract, a contingent fee should not be considered marital property. At most, an attorney has a potential for earning income in the future. "He is not assured of earning anything for his efforts nor does he acquire a vested interest in the income from those cases unless his client recovers, an event impossible to accurately predict." *Musser v. Musser*, 909 P.2d 37, 40 (Okla. 1995). As a result, pending contingency fee cases of a law firm are future income and not a part of the marital assets.

f. Pennsylvania

"It is tenuous and risky to attempt to evaluate the likely return on contingent fees and as such, no value can be placed on them for purposes of equitable distribution." *Beasley v. Beasley*, 518 A.2d 545, 554 (Pa. Super. Ct. 1986); *Perlberger v. Perlberger*, 626 A.2d 1186 (Pa. Super. Ct. 1993).

3. <u>When to Divide: Now or Later</u>

Even though the majority of states recognize contingent fee contracts to be part of the marital estate subject to being divided upon divorce, valuing the contingent fee can be problematic.

The most popular method employed in valuing these cases is for the court to retain jurisdiction until the fee is actually realized and divide the money at that time. *See Garrett v. Garrett*, 683 P.2d 1166, 1170 (Ariz. Ct. App. 1984); *see also McDermott v. McDermott*, 986 S.W.2d 843 (Ark. 1999); *see also In re Marriage of Kilbourne*, 281 Cal. Rptr. 211 (Cal. Ct. App. 1991); *see also In re Marriage of Vogt*, 773 P.2d 631 (Colo. Ct. App. 1989); *see also Lyons v. Lyons*, 526 N.E.2d 1063 (Mass. 1988). This appears to be the most fair way to divide such cases because both spouses then share in the risk that there may be no recovery, as well as the benefit if the recovery exceeds what was expected. *See Hanify v. Hanify*, 526 N.E.2d 1056, 1060 (Mass. 1988).

There are concerns that retaining jurisdiction keeps two individuals involved in litigation with each other until the contingent fee cases are decided, which may take years, which crowds the courts' dockets. An alternative plan was used in *Hanify v. Hanify*, in which the court actually divided the fee using a predetermined formula, and when the fee was realized the division was already decided. *Id.*

D. Problems with Discovery

1. <u>Texas</u>

A competent, thorough valuation of the community estate's interest in a law firm, particularly when the firm has contingent fee contracts with clients, requires analysis of the firm's records, both financial and regarding the contingent fee cases. If the law firm is a partnership, the contingent fee files are an asset of the partnership. *Bader v. Cox,* 701 S.W.2d 677, 682 (Tex.App.-Dallas 1985, writ ref'd n.r.e.). If, on the other hand, the firm is a corporation, the corporation owns the file. *See, Thomas*, 738 S.W.2d at 343. In such situations, of course, the community owns an interest in the partnership or in the corporation, and not the partnership or corporate assets, but an accurate valuation of the partnership or corporation still necessarily entails a valuation of the partnership or corporate assets, including contingency fee cases. Not surprisingly, efforts to discover a law firm's files, however, often encounter objections that such information is protected by the attorney-client privilege and work product exemption.

One reported Texas appellate court case, *Enos v. Baker* 751 S.W.2d 946, 949-950 (Tex.App.–Houston [14th Dist.] 1988, no writ) held that a trial judge's order for an attorney to produce "an inventory of any evaluation or demand that has been made on behalf of any client" and "all active client files" constituted an abuse of discretion because (1) the active client files of law firm were protected by the attorney-client privilege and (2) the law firm's evaluations and demands made on behalf of clients were protected as attorney work product. Even though the lawyer husband admitted that the true value of the law firm resided in the value in the firm's cases, the Houston appellate court believed that any evaluation, based on the probable outcome of personal injury and workers' compensation suits in various stages of the litigation process, would be little more than conjecture. *Id.* at 949. Further, the Houston Fourteenth Court of Appeals stated that the need of each client for privacy, guaranteed to them at the time the communication was made, is of greater importance than marital economics and convenience. *Id.*

In *Finn,* 658 S.W.2d 735, the Dallas Court of Appeals considered a similar issue, when the wife contended that the trial court improperly denied discovery of the balance sheets, profit and loss statements, and records reflecting salaries and disbursements to senior partners of her husband's law firm (the trial court granted discovery of the firm's partnership agreement and retirement plan and of the husband's K-1 schedules, which provided annual summaries of the husband's share of the firm's assets and earnings). *Id.* at 742.

The Dallas appellate court held that the denial of discovery deprived the wife of access to material information needed to effectively cross-examine the husband's experts as to valuation and to allow her experts all the information they required to accurately calculate the value of the husband's interest in the firm (the wife's experts were not required to rely on secondary data in determining and presenting to the court her estimate of the value of the community interest in the firm). *Id.* at 744. Further, the denial of discovery was material not only because it denied the wife information needed to adequately present her case to the court, but also because it deprived the trial court of sufficient evidence on which to base a valuation of the community interest in the law firm. *Id.*

The Dallas Court of Appeals recognized the need to protect the confidentiality of the records of the husband's law practice, but stated that such need did not constitute an absolute bar to discovery because the trial court may order an *in camera* inspection of the documents to protect confidential client records. *Id.* at 746. In conclusion, the court observed:

> We find that the denial of discovery was such a denial of the rights of the wife as was reasonably calculated to cause and probably did cause the rendition of an improper judgment. The husband's interest in the firm was a major asset of the community estate. Lack of this discovery left the trial court's valuation of this asset without proper support in the evidence. Since this interest is the largest item of the community estate, and its value was the principal contested issue at the trial with respect to the division of the property of the parties, we conclude that without a proper valuation the trial court could not properly exercise its discretion in making a "just and right" division within [former] section 3.63 of the

Texas Family Code. Under these circumstances we hold that the trial court's division of the community estate was an abuse of discretion.

Id.

Similarly, in *Fanning v. Fanning*, 841 S.W.2d 949, 951 (Tex.App.–Waco 1992, no writ), a child support action, the Waco appellate court held that the blanket denial of discovery of financial records of husband's law firm was an abuse of discretion. Although the Waco Court of Appeals acknowledged the need to protect the confidentiality of the records of the law practice, it found that such a need was not an absolute bar to discovery because the trial court could order an *in camera* inspection of the documents to protect confidential client records. *Id*.

In *Turner v. Montgomery*, 836 S.W.2d 848, 851 (Tex.App.–Houston [1st Dist.] 1992, no writ), the Houston First Court of Appeals observed that the following two discovery requests, with respect to the husband's law firm, did not seek "unquestionably" privileged communications between attorney and client:

> (32) [w]ith regard to the cases which the law firm of Barnes and Turner currently has pending, please produce the following: Barnes and Turner attorney fee contracts; all settlement records (letters, agreements, statements); all final orders, judgments, non-suits, or dismissals; any structured settlement letters, statements, or agreements, trust accounts, notes or promises to pay Sylvester Turner or any firms with which he is or was associated...;
>
> (39) [w]ith regard to the cases which the law firm of Barnes and Turner currently has pending, please produce copies of all documents relating to any funds, from any source, which may be received by you individually or by any other party.

The Houston appellate court then stated that the mere possibility that a document might be partly privileged will not justify its total exclusion. *Id.; cf., Methodist Home v. Marshall,* 830 S.W.2d 220, 231 (Tex.App.–Dallas 1992, no writ) (the attorney-client privilege protects confidential communications, not information). Thus, although the Houston First Court of Appeals ultimately ruled in favor of the wife on grounds that the husband waived his right to assert that the requested information was protected by the attorney-client privilege, the court's reasoning supports the positions of *Finn* and *Fanning, i.e.,* that privileged materials can be protected during a divorce while at the same the time the compelling need to properly value a law firm may be satisfied as well.

Discovery may take several forms. By way of example, it is time consuming, but not impossible, to obtain some information on a specific attorney's client files by reviewing discovery responses from the case that have been filed with the court. However, such information will be available only when a lawsuit has been actually filed, and many claims do not reach the point of suit being filed. The information would also be limited to those cases in which written discovery has been conducted and responses have been made part of the public record.

There are also some sources of information that may be less confidential than others, even though the information is in the attorney's client files. However, Texas courts have not been uniform in their decision as to which information will always be made available.

2. <u>Other Jurisdictions</u>

In *Frink v. Frink*, 494 N.Y.S.2d 271 (N.Y. Sup. Ct. 1985)(on motion to reargue), the court established the following guidelines for the discovery of confidential information for valuation purposes:

> The examination of plaintiff's case files shall be conducted by defendant's expert in plaintiff's office or such other place as mutually agreed upon between the parties. Defendant's expert shall be an attorney admitted to practice

> in the State of New York whose practice includes negligence law. No other individual shall accompany defendant's expert during his inspection of plaintiff's case files. Plaintiff or his representative may be present during the inspection.
>
> Defendant's expert shall be restrained and permanently enjoined from disclosing any information, not previously made public by plaintiff, contained in plaintiff's case files for any purpose beyond that necessary for the evaluation of plaintiff's law practice. In addition, defendant's expert shall be restrained and permanently enjoined from revealing the name of any party to any action in which a court index number has not been obtained and shall refer to these case files by a method of identification other than the names of the parties. Prior to the inspection by defendant's expert, plaintiff may, if so advised, redact the names of the parties from his case files in which a court index number has not been obtained.
>
> The official court files in any action in which a court index number has been obtained will contain the names of the parties as well as any motion papers in the action and may contain copies of the pleadings. Inasmuch as the official court files, other than matrimonial files, are open for public inspection, the disclosure of such public information need not be restricted.
>
> Plaintiff may remove from his outstanding negligence litigation files any correspondence, personal notes or other material which would be excludable from evidence pursuant to CPLR 4503.
>
> Plaintiff shall maintain a separate identifiable file until the conclusion of the trial of this action containing any material he has removed from his files.

Id., at 273. This methodology was approved in *Fox v. Fox*, 2002 Slip Op. 00321 (N.Y. App. Div. 2002), in which the court held that "the *Frink* guidelines strike a good balance between plaintiff's need for discovery and defendant's paramount interest in protecting the confidences of his client." *Id.* at 3. These guidelines are similar to those contained in the appendix to Tiso, *Are Contingency Fee Cases Part of the Marital or Communal Estate?*, 15 J. AM. ACAD. MATRIM. LAW. 391, 409-410. By employing such a mechanism, courts can preserve the right of the non-attorney-spouse to have an accurate valuation of all the community's interests while still protecting the confidentiality of the clients of the attorney-spouse.

E. Ethical Considerations

1. Privileges

Clients have privileges which must be fully protected at all times. Rule 503 of the Texas Rules of Evidence sets forth the Lawyer-Client Privilege and provides, in pertinent part, as follows:

> (b)(1) A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client:
>
> (A) between the client or a representative of the client and the client's lawyer or a representative of the lawyers;
>
> (B) between the lawyer and the lawyer's representative;
>
> (C) by the client or a representative of the client, or the client's lawyer or a representative of the lawyer, to a lawyer or a representative of a lawyer representing another party in a pending action and concerning

> a matter of common interest therein;
>
> (D) between representatives of the client or between the client and a representative of the client; or
>
> (E) among lawyers and their representatives representing the same client.

TEX.R.EVID. 503(b). The exceptions to the Lawyer-Client Privilege are found in Rule 503(d). There is no privilege under Rule 503 for the following: (1) furtherance of crime or fraud; (2) claimants through same deceased client; (3) breach of duty by a lawyer or client; (4) document attested by a lawyer; and (5) joint clients. TEX.R.EVID. 503(d).

The Texas Rules of Civil Procedure further provide that certain matters are not discoverable. Rule 192.5, for example, entitled "Work Product," provides, in pertinent part:

> (1) core work product–the work product of an attorney or an attorney's representative that contains the attorney's or the attorney's representative's mental impressions, opinions, conclusions, or legal theories–is not discoverable; and
>
> (2) any other work product is discoverable only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the material by other means.

TEX.R.CIV.P. 192.5(1); TEX.R.CIV.P. 192.5(2).

It should also be noted that an attorney may employ an accountant for the client's benefit in order for communications from the client to qualify for the attorney-client privilege. *Parker v. Carnahan*, 772 S.W.2d 151, 157 (Tex.App.–Texarkana 1989, writ denied). However, mere employment of the accountant does not make the accountant an agent of the attorney; rather, basic principles of agency law would be applicable, and such agency would have to be determined on the basis of the attorney's control of the work done by the accountant. *Id.*; *see also*, *Lone Star Partners v. NationsBank Corp.*, 893 S.W.2d 593, 600 (Tex.App.–Texarkana 1994, writ denied) (merely engaging an accountant does not, absent evidence of control, make the accountant an agent of the employer).

2. Confidentiality

Paramount in all cases is the concept of confidentiality. An attorney's clients are entitled to the confidentiality privilege afforded by the attorney/client relationship. The privilege belongs to the client, rather than to the attorney, and cannot be disturbed because of disputes the attorney may have either in his or her personal life or in the life of another member of the law firm. A client should not have the additional burden, over and above the problems which led the client to seek legal counsel and representation in the first place, of worrying about whether the personal disputes of the attorney may result in the client's confidential information being disclosed to a third party.

However, diametrically opposed to the client's right of protection and confidentiality, is the non-attorney spouse's right of access to information necessary to value his or her interest in a community property asset in the context of a divorce.

Rule 1.05 of the Rules of Professional Conduct sets out the standards regarding confidential information. Comment 1 to Rule 1.05 expresses the theory and policy behind the client's right to an expectation of confidentiality:

> Both the fiduciary relationship existing between the lawyer and the client and the proper functioning of the legal system require the preservation by the lawyer of confidential information of one who has employed or sought to employ the lawyer. Free discussion should prevail between the lawyer and client in order for the lawyer to be fully informed and for the client to obtain the full benefit of the legal system. The ethical

obligation of the lawyer to protect the confidential information of the client not only facilitates the proper representation of the client, but also encourages potential clients to seek early legal assistance.

Rule 1.05(a) defines "confidential information" as both "privileged information" and "unprivileged client information." It further provides that "privileged information" is that information which is protected by Rule 503 of the Rules of Evidence. Although Rule 503 lists exceptions to the privilege, those exceptions are limited. The exceptions to Rule 1.05 of the Rules of Professional Conduct are also limited.

(c) A lawyer may reveal confidential information:

(1) When the lawyer has been expressly authorized to do so in order to carry out the representation.

(2) When the client consents after consultation.

(3) To the client, the client's representatives, or the members, associates, and employees of the lawyer's firm, except as otherwise instructed by the client.

(4) When the lawyer has reason to believe it is necessary to do so in order to comply with a court order, a Texas Disciplinary Rule of Professional Conduct or other law.

(5) To the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between the lawyer and the client.

(6) To establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or lawyer's associates based upon conduct involving the client or the representation of the client.

(7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.

(8) To the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.

Clearly, there is no exception provided for the disclosure of such information in the attorney's own divorce, or in the divorce litigation of an attorney's partner. One commentator has argued that Rule 1.05(c)(4) (disclosure permissible to comply with a court order) provides a means by which the disclosure of such information may be permitted to comply with discovery orders of the Court related to the attorney's divorce, provided additional precautions are taken. Schwartz, at A-11.

3. Precautions to Protect Confidentiality

Although burdensome to the office personnel of the personal injury attorney, substantial controls can be put into place in order to protect the confidential information in the attorney's client files. These precautions take several forms. Most precautions are directed at removing the client's identifying information, such as name, age, social security and driver's license numbers from documents. Other precautions may also be taken, such as removing facts that are unnecessary to the valuation of the client's claim. Clearly, a confidentiality agreement would also be required to protect any inadvertently disclosed information.

On the issue of confidentiality agreements, it cannot be overemphasized that, whenever proprietary information from a legal practice is disclosed to opposing parties–either voluntarily or through discovery–confidentiality agreements must be put into place. The bottom line is: court orders or carefully drafted agreements are required whenever sensitive proprietary information of a professional practice is disclosed to outside parties.

VIII. THE PROFESSIONAL LICENSE

A. Argument

The question of whether or not a professional license is "property" subject to valuation in a divorce appears to have first been addressed in Texas in *Frausto v. Frausto*, 611 S.W.2d 656 (Tex.Civ.App.–San Antonio, 1980, writ dism'd).

In *Frausto*, both the husband and wife were school teachers, but the husband wanted to be a doctor, so he quit work and the wife supported the family while he went back to school. At the time of the parties' divorce, the husband was a moderately successful doctor, but as yet no appreciable estate had been accumulated. In the divorce, the trial court awarded the wife $20,000 as a part of the division of the estate of the parties, and as a reimbursement for her share of the community contribution to the husband's medical education. *Id.* at 657.

On appeal, *Frausto* constituted a case of first impression in Texas. The San Antonio Court of Appeals accordingly looked to California and Colorado cases which stood for the proposition that an education or a professional license was not property subject to division. The San Antonio appellate court found *Nail*, although not involving a spouse's education, "comparable and persuasive," and therefore that the professional education acquired during the marriage was not property and thus not subject to division. *Id.* at 659.

It should be noted that Texas is in the majority of states which uphold the view that a professional license is not "property subject to division." The following states do not allow a student spouse's degree to be considered or treated upon divorce as marital property: Arizona, *Pyeatte v. Pyeatte*, 135 Ariz. 346, 661 P.2d 196 (Ariz.Ct.App. 1982); California, *In Re Graham*, 194 Colo. 429, 574 P.2d 75 (Colo. 1978); Connecticut, *Zahler v. Zahler*, 8 Fam. L. Rptr. 2694 (Conn.Super.Ct. 1982); Delaware, Wright v. Wright, 469 A.2d 903 (Del.Fam.Ct. 1983); Florida, *Hughes v. Hughes*, 438 So.2d 146 (Fla.Dist.Ct.App. 1983); Illinois, *In Re Weinstein*, 470 N.E.2d 551, 555 (Ill.Ct.App. 1984); Indiana, *McManama v. McManama*, 272 Ind. 483, 399 N.E.2d 371 (Ind. 1980); Iowa, *In Re Marriage of Horstmann*, 263 N.W. 2d 885 (Iowa 1978); Kentucky, *Inman v. Inman*, 648 S.W.2d 947 (Ky. 1982); New Jersey, *Mahoney v. Mahoney*, 91 N.J. 488, 453 A.2d 527 (N.J. 1982); New Hampshire, *Ruben v. Ruben*, 123 N.H. 358, 461 A.2d 733 (N.H. 1983); New Mexico, *Muckelroy v. Muckelroy*, 84 N.M. 14, 49 8 P.2d 1357 (N.M. 1972); Oklahoma, *Hubbard v. Hubbard*, 603 P.2d 747 (Okla 1979); Wisconsin, *In Re Marriage of Lundberg*, 107 Wis.2d 1, 318 N.W.2d 918 (Wis. 1982); Wyoming, *Grosskopf v. Grosskopf*, 677 P.2d 814 (Wyo. 1984).

B. Counter-Argument

Community property law in Texas is essentially based upon the principal that a marriage is an economic partnership to which both spouses contribute as a spouse, parent, wage earner, and/or homemaker. Thus, is the professional license really property *subject* to division, in spite of *Frausto*?

It should be noted that a minority of jurisdictions hold that professional licenses constitute marital property. In New York, for example, the following professional licenses are considered marital property : law degrees (*Cronin v. Cronin*, 502 N.Y.S.2d 368 (N.Y.App.Div. 1986)); accounting degrees (*Vanesco v. Vanesco*, 503 N.Y.S.2d 480 (N.Y. 1986)); a podiatry license (*Morton v. Morton*, 515 N.Y.S.2d 499 (N.Y. 1987)); a doctor's assistant certificate (*Morimando v. Morimando*, 536 N.Y.S.2d 701 (N.Y. 1988)); teaching certificates and academic degrees (*McGowan v. McGowan*, 535 N.Y.S.2d 990 (N.Y.App.Div. 2d 1988)); and even (although not a "professional license") the celebrity career of a model/actress (*Golub v. Golub*, 527 N.Y.S.2d 946 (N.Y. 1988)).

In *Cronin*, 502 N.Y.S.2d 368, the court specifically held that the applicable New York statute did not restrict valuing professional licenses only for ongoing businesses, but the valuation may also include those practices not yet established. The court held that despite the fact that the plaintiff's employment did not reflect the professional license acquired, the legal license may still have an enhanced earning capacity value.

In *Parlow v. Parlow*, 548 N.Y.S.2d 373 (N.Y.App.Div. 1989), the court held that the value of the husband's teaching license merged into the husband's practice; therefore, the license did not have a value for purposes of marital assets distribution. Although both parties agreed that the license was marital property subject to equitable distribution, the theory of merger was applied to avoid the "two bites of the same apple" issue, or

double recovery to the non-titled spouse. *Id.* at 374. The court held the husband's assets had produced assets capable of valuation and thus no unrealized "increased earnings capacity" existed to be reflected in the career valuation.

IX. CONCLUSION

A fair divorce involving a professional law practice will normally require an accurate valuation of the practice. This paper has attempted to present the principles and methodologies underlying responsible and accurate valuation technique, in an intelligible fashion, in the hopes that the practitioner–working together with opposing parties, opposing lawyers, experts, trial judges and juries–may better achieve fair results in divorce litigation involving professional law practices.

APPENDIX A

Are Contingency Fees a Part of the Marital Estate?

50 States and Washington D.C.

STATE	YES (Majority)	NO (Minority)	UNDECIDED OR UNKNOWN
Alabama			X
Alaska			X
Arizona	Garrett v. Garrett, 683 P.2d 1166 (Ariz. Ct. App. 1984).		
Arkansas	McDermott v. McDermott, 986 S.W.2d 843 (Ark. 1999).		
California	In re Marriage of Kilbourne, 281 Cal. Rptr. 211 (Cal. Ct. App. 1991); Waters v. Waters, 170 P.2d 494 (Cal. Dist. Ct. App. 1946).		
Colorado	In re Marriage of Vogt, 773 P.2d 631 (Colo. Ct. App. 1989).		
Connecticut			X
Delaware			X
District of Columbia			X
Florida		Roberts v. Roberts, 689 So.2d 378 (Fla. Dist. Ct. App. 1997).	
Georgia		Goldstein v. Goldstein, 414 S.E.2d 474 (Ga. 1992).	
Hawaii			X

Idaho			Smith v. Smith, 860 P.2d 634 (Idaho 1993) (Dicta indicates that court might consider contingent fee to be community property if representation occurred during marriage.)
Illinois		In re Marriage of Zells, 572 N.E.2d 944 (Ill. App. Ct. 1990); but see Carlson v. Brandt, 250 B.R. 366 (N.D. Ill. 2000) ("[S]uch fees are best treated as part of a divorcing attorney's income and considered in the context of support and maintenance determinations.").	
Indiana			X
Iowa			X
Kansas			X
Kentucky			X
Louisiana	Due v. Due, 342 So.2d 161 (La. 1977).		
Maine			X
Maryland			Quinn v. Quinn, 575 A.2d 764 (Md. Ct. Spec. App. 1990)(Court left open the possibility that in another case contingency fees could be divided upon divorce).

Massachusetts	Lyons v. Lyons, 526 N.E.2d 1063 (Mass. 1988); Hanify v. Hanify, 526 N.E.2d 1056 (Mass. 1988).		
Michigan			X
Minnesota			X
Mississippi			X
Missouri		In re Marriage of Hershewe, 931 S.W.2d 198 (Mo. Ct. App. 1996).	
Montana			X
Nebraska			X
Nevada			X
New Jersey			X
New Hampshire			X
New Mexico			X
New York	Fox v. Fox, 2002 Slip Op. 00321 (N.Y. App. Div. 2002); Litman v. Litman, 123 A.D.2d 310 (N.Y. App. Div. 1986); Frink v. Frink, 494 N.Y.S.2d 271 (N.Y. Sup. Ct. 1985).		
North Carolina			X
North Dakota			X
Ohio			X
Oklahoma		Musser v. Musser, 909 P.2d 37 (Okla. 1995).	
Oregon			X

Pennsylvania		Perlberger v. Perlberger, 626 A.2d 1186 (Pa. Super. Ct. 1993); Beasley v. Beasley, 518 A.2d 545 (Pa. Super. Ct. 1986).	
Rhoda Island			X
South Carolina			X
South Dakota			X
Tennessee			X
Texas			Enos v. Baker, 751 S.W.2d 946 (Tex.App. – Houston [14th Dist.] 1988, *n.w.h.*)(Opinion suggests that interest in contingency fee based firm can be valued but did not actually address issue of pending contingency fees.).
Utah			X
Vermont			X
Virginia			X
Washington	In re Marriage of Estes, 929 P.2d 500 (Wash. Ct. App. 1997).		
West Virginia	White v. Williamson, 453 S.E.2d 666 (W. Va. 1994). Metzner v. Metzner, 446 S.E.2d 165 (W. Va. 1994).		
Wisconsin	Weiss v. Weiss, 365 N.W.2d 608 (Wis. Ct. App. 1985).		
Wyoming			X