

# **HOT TOPICS IN VALUATION\***

**Unfair Fair Market Value**

**Valuing Goodwill**

**Reasonable Compensation**

**Cross Examination**

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**Unfair Fair Market Value\***  
**(All things being equal the value of a business  
should not depend upon the state where the owner resides)**

**By**

**Donald C. Schiller  
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**Fair Market Value:**

In Revenue Ruling 59-60, the Internal Revenue Service defines fair market value as “. . . the price at which (business interests or) 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 having reasonable knowledge of relevant facts.” The International Glossary of Business Terms defines fair market value consistent with Revenue Ruling 59-60. Fair market value for tax purposes also assumes a hypothetical buyer and seller.

**Valuing a Business in Dissolution of Marriage Proceedings:**

Laws regarding the distribution of assets upon a dissolution of marriage vary from state to state. Most states direct their courts to “equitably distribute” property of the marriage to the divorcing parties. Some states known as community property states consider anything acquired by either party during the marriage as co-owned and, upon dissolution of marriage, either divide the co-owned property equally or in some fashion the court determines to be equitable. In carrying out this mandate, courts will distribute the property of the marriage in an equal or equitable manner. Where a privately-held business is involved, the court must deal with the value of the business. Typically courts will not leave people that are divorcing as business partners, so divisions in kind of ownership interests in a business are rare. Therefore, determining the value of the business is vital in order to accomplish the so-called “equal” or “equitable” division.

**Standards of Valuation:**

The law regarding standards for valuing a business upon a dissolution of marriage is not ordinarily statutory but evolves from case law. Predictably, different states go in different directions and even courts within the same state may go in separate directions. Nevertheless, for the most part, decisional case law refers to “fair market value” as a standard for valuing a business for dissolution of marriage purposes. Notwithstanding giving this lip service, courts in various states do not strictly adhere to the art and science of business valuers who come to fair market value conclusions using strict adherence to the fair market value definition.

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## **Is there an unfairness with fair market value in dissolution of marriage cases?**

The following are issues that must be dealt with in valuing a business or an ownership interest in a business and impact value for fair market value purposes. They are considered by some to be unfair considerations in valuations for dissolution of marriage purposes:

Personal goodwill being separated from enterprise goodwill;

Potential lack of a covenant not to compete by the entrepreneur owner;

Discounts for lack of marketability;

Discounts for minority interests;

Discounts for costs of a hypothetical sale i.e, broker's commissions, legal and accounting fees.

In various forms, the arguments that emerge focus on there being no real sale and, therefore, the spouse owner will be retain the full value of the entire interest while buying the other spouse out on dissolution of marriage using hypothetical discounts.

### **Fair Value:**

Fair value is generally discussed and used by courts in the context of shareholder disputes where an oppressed or a dissenting shareholder is entitled to payment for their shares. It is sometimes used by real estate developers when doing financial statements to banks for financing purposes. Although the literature tells us that "fair value" is different than "fair market value," it is hard to find any universal definition for "fair value". The Revised Model Business Corporation Act finds it as

"the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."

This definition appears to look at value from the oppressed or dissenting shareholders position and that party may not truly be a willing seller. The concept seeks to assure the seller fair consideration because he is unable to keep the stock. Domestic relations courts, when varying from the fair market value standards sometimes drift into fair value although that may not be expressly stated. After all, the spouse who is leaving the marriage without the business interest is generally not a willing seller either.

### **Intrinsic Value:**

Intrinsic value is also contrasted to fair market value. Its thesis is the true worth of asset based on its own particular circumstances. One looks to the characteristics inherent in the investment or business interest. Intrinsic value analysis may disclose that a dividend paying security discounted to present value may be worth more than its currently publicly-traded market value. So might a husband's business interest be of a greater value than what a fair market value would determine.

### **Investment Value:**

This value is also in contrast to fair market value. Here, one looks to a particular investor and what it would mean to that investor to acquire the spouse's interest being valued. It considers synergies that might occur to a particular buyer by obtaining the asset (or business) that may be of greater value to him than others who might be interested in purchasing the asset. This too is a cousin of fair value. In marital dissolution cases, some courts expressly or implicitly adopt this value when straying from fair market value. .

### **Although Fair Market Value Requires Consideration Of A Hypothetical Sale In A Divorce Case, Why Isn't It A Fair Standard Considering:**

- The value of an asset in dollars is measured by what someone would pay for that asset. The non-owning spouse effectively receives a cash buy-out while the owning spouse receives a closely-held business where the spouse must continue working and shouldering responsibility to protect the value of the asset.
- In professional practices, the owner spouse would otherwise pay a personal goodwill value to the non-owning spouse who may in turn invest her share in a passive investment generating income while the owning spouse must continue to work to generate the income that was the measure of value for the professional practice.
- Isn't paying the non-owning spouse for personal goodwill paying an ex-spouse for the owning spouse's post-dissolution efforts.
- Where there is no covenant not to compete, one should not be assumed in determining value, since the owning spouse's execution of a covenant not to compete prohibits him from earning a livelihood in what may be the only field where he is able to earn a reasonable livelihood. The issue is the value of the business at the time of the divorce without consideration for the owner's continued employment nor any prohibition of him working in a similar business after sale. Any value for that would compensate the spouse for the owning spouse's post-divorce conduct.

- Regarding the lack of marketability or liquidity discount, the reality is that the non-owning spouse should have her interests purchased considering the lack of marketability or liquidity. When the owner ultimately sells to enjoy the cash value of the asset, the consideration he receives will be affected by the business's lack of marketability or liquidity by the next purchaser.
- Regarding a minority discount, there is no guarantee to the owning spouse that he will indefinitely be in business with the owners comprising the majority. He alone should not bear the risk. Prudence or necessity may require the sale of his minority interest and thereby he would suffer reduced consideration in selling his minority interest.
- Costs of sale, like brokerage, attorney's fees and accounting fees, should be subtracted from value since, when the owning spouse sells his interests post-divorce, he will suffer these costs to realize cash – therefore, why shouldn't the non-owning spouse on divorce have her consideration affected by these same customary costs?

## **Valuing Goodwill\* (What a Quagmire)**

**By**

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### **Goodwill:**

In the financial reporting/accounting world, goodwill is what is left after all intangible and identifiable intangible assets have been valued. In divorce valuations, goodwill is generally defined as the value received with the sale of a business that exceeds the value of the company's tangible assets. Factors like possessing brand names; reputation for quality; good values; reliability; and the expectation of continued patronage are all elements of goodwill. When one buys a going concern, paying a price higher than tangible asset value is mostly due to goodwill, notwithstanding that there may be other intangible assets affecting value as well.

### **Valuing Goodwill:**

There is no overall consensus on how goodwill should be valued. Obviously, it is an intangible asset and a first step might be to separate it from other intangible assets defined under Internal Revenue Code Section 197 as including workforce in place, books and records, operating systems, customer lists, patents, copyrights, licenses, permits, franchises, trademark or trade name, to include a few. Nevertheless, because of the peculiarities of individual state laws, it often requires a segregated value as well as a segregated subvalue.

### **The Premise for Segregated Value for Goodwill:**

In dissolution of marriage cases, courts seek to make equal or equitable distributions of property and consider the value of all marital or community assets and liabilities. A spouse's business may be a marital or community asset. If the business is a closely-held and there is no readily obtainable value for the owner's interests, it is necessary to value the business or, in a case where the spouse is a fractional owner, the fractional interest in the business. As discussed before, the general standard of value employed by most states in valuing a business is "fair market value." Fair market value of a business ordinarily includes all aspects of value including goodwill. Nevertheless, in dissolution of marriage matters, there is a tension between making an equitable distribution of assets as they exist at the time of the dissolution and not allowing a spouse's future efforts and earnings and post-divorce activities be considered in the property aspects of the

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division. The fundamental basis for this concern is that the business-owning spouse's future income will also be considered in arriving at support obligations, and may be a factor in determining the percentages of an equitable distribution and, therefore, should not be counted twice. Therefore, to the extent it is possible, in a number of states personal goodwill must be segregated from enterprise goodwill and only the latter is permitted to be included in the business valuation.

### **State's Prohibiting the Inclusion of Personal Goodwill as Part of Fair Market Value:**

The following states are a sampling of those that do not permit inclusion of personal goodwill in a fair market value business valuation:

Illinois (*In Re the Marriage of Schneider*, 214 Ill.2d 152, 824 N.E.2d 177, 291 Ill.Dec. 601)

Maryland (*Prahinski v. Prahinski*, 321 Md. 227, 582, A.2d 784)

Pennsylvania (*Beasley v. Beasley*, 359, Pa. Super.20, 518 A.2d 545)

Texas (*Geesbreght v. Geesbreght*, 570 S.W. 2d 427)

Wisconsin (*Holbrook v. Holbrook*, 103 Wis.2d 327, 309 N.W.2d 343)

The Illinois Supreme Court in *Schneider* stated:

“. . . goodwill represents merely the ability to acquire future income. Consideration of goodwill as a divisible marital asset results in gross inequity.”

“Notably, in *Talty*, although no award of maintenance or child support was made, this court nonetheless held that personal goodwill should not be considered an asset of the business [car dealership] because the elements that constitute personal goodwill are considered under section 503(d) of the Dissolution Act in dividing marital property.”

Also, the Wisconsin Supreme Court in *Holbrook* stated:

“. . . The goodwill or reputation of [the law firm] is reflected in [Holbrook's] substantial salary. The salary was considered in setting the family support award. To also treat the goodwill of the law firm as a separate divisible asset would constitute double-counting. . . . The California approach has been deservedly criticized as a 'confusion of rules and methods of valuation, compounded by inconsistencies in logic and application and conceptual problems over possible duplication of spousal support and denial of equal protection.'”

## **States That Allow the Inclusion of All Goodwill in Business Valuations Include:**

The following states are a sampling of those allowing consideration of all goodwill.

Arizona (*Mitchell v. Mitchell*, 152 Ariz. 317, 732 P.2d 208)

California (*Golden v. Golden*, 270 Cal.App.2d 401, 75 Cal.Rptr. 735) and (*In Re The Marriage of Lopez*, 38 Cal.App.3d 93, 113 Cal.Rptr. 58)

Colorado (*In Re The Marriage of Graff*, 902 P.2d 402)

New Jersey (*Dugan v. Dugan*, 92 N.J. 423, 457 A.2d 1)

Washington (*In The Matter Of The Marriage of Fleege*, 91 Wash,2d 324, 588 P.2d 1136).

The California cases of *Golden* and *Lopez* tell us that, although goodwill may be difficult to value, it must be considered in the division of property and that personal goodwill is something that was earned through joint spousal efforts and labors. The non-owning spouse contributed to the acquisition of the goodwill in the same manner that the spouse contributed to any of the owner spouse earnings and assets acquired during the marriage and is therefore entitled to be compensated for that contribution which the owner spouse will continue to benefit from after divorce.

Arizona's *Mitchell* case put it this way . . . "The economic reality [is] that the goodwill of a professional practice has value and it should be treated as property upon dissolution of the community."

## **Are the Methods Used to Value Covenants Not to Compete Reasonable to Use in Valuing Personal Goodwill?**

Valuing a covenant not to compete seems to measure the same factors as valuing the personal goodwill of an owner. Also, like with personal goodwill, a number of courts have held that covenants not to compete are not part of the marital estate because to the extent that a covenant restricting an individual from competing after divorce is dependent on the reputation of the person who gives the covenant, it is not a marital asset. (*See Lowe v. Lowe*, 372 N.W.2d 65 (Minn. Ct. App. 1985) (supporting proposition that one spouse should not benefit from an agreement that restricts the other spouse's employment); *Johnson v. Johnston*, 778 S.W.2d 674 (Mo. Ct. App. 1989) (holding that value of covenant not to compete is not marital property); *Hoefl v. Hoefl*, 600 N.E. 2d 746 (Ohio Ct. App. 1991) (stating monies received from covenant not to compete in sale of dental practice were not marital property).

## **Methods Used to Value Covenant Not To Compete:**

Compensation Approach: The Seller's average compensation is calculated and projected over the life of the covenant and discounted to present value. This measures the loss to the seller by not being able to be employed where there might be competition. This

approach is not reasonable in determining the value of the business where there is no covenant not to compete.

Value Of What Buyer Acquired: – The value of the business and what it would be worth if the seller competed. (Anson Tool & Manufacturing v. Commissioner T.C. Memo 1992-121) First, determine the fair market value of the business with a covenant not to compete from Seller and then subtract the present value of the expected loss of future earnings during the forecast period.

This method is full of pitfalls in:

- (i) trying to forecast (speculate) earnings without the covenant;
- (ii) considering a risk analysis of the seller’s likelihood to compete and arriving at an Earnings Discount rate. The following is an example of a Risk Analysis:

**RISK ANALYSIS CHART\***  
**TYPE OF COVENANT – NON-PIRACY**

Risk Factors	Highly Like or Yes	Somewhat Likely	Somewhat Unlikely	Unlikely or No
Seller’s financial ability to compete	X			
Seller’s health condition		X		
Seller’s Age		X		
Seller’s stated intentions to compete	X			
Seller has ability to attract existing customers/clients				X
Seller ability to develop new business		X		
Seller’s ability to establish same or similar product lines		X		
Seller’s ability to hire existing employees or contractors				X
The length of the agreement is less than 5 years				X
The protected market area is reasonable				X
Other agreements which prevent Seller from competing				X
Discount to First Year Earnings (%)	31%+	21-30%	11-20%	0-10%
Selected Earnings Discount	15%			

\* *Divorce Interactive: Risk Criteria And Valuation Methods For Valuing Covenants Not To Compete*, by Jeff Jones.

Courts will want to know the reliability of the data used for the percentage ranges in the chart. Effectively this method is the same as doing a second business valuation assuming no covenant and adjusting percentages based on the likelihood that the seller would compete. The difference between the second adjusted value and the first value would be the value of the covenant not to compete

### **Courts As Gatekeepers:**

The United States Supreme Court's standards as expressed in *Daubert v. Merrell Dow, etc.*, (1993) 509 U.S. 579, 113 S.Ct. 2786, are used by most state courts in screening expert scientific testimony. In *Daubert*, the Supreme Court reminded us that scientific methodology is based on generating hypotheses and "testing" them. Publication of a theory and peer review does "not necessarily correlate with reliability".

### **Tensions Affecting Value Of Covenant Not To Compete:**

Even if there is an expressed value for the covenant not to compete, can it be relied upon as the statement of true value? Each party may have their own agenda:

- Buyer: Overvalue the covenant not to compete since it will be amortizing it for income tax purposes.
- Seller: Minimize the value so more of the proceeds of sale are treated as capital gains rather than ordinary income.
- Divorcing Spouse/Owner who may want to have more value assigned to the covenant in an attempt to keep those proceeds out of the marital estate.

In a small or medium sized business or profession with an owner employee having product acquisition contracts as well as customer contacts, can there be a going concern value for the business that would not include personal goodwill within a "reasonable degree of certainty?"

