Valuation of Businesses in Colorado Divorces

by Robert W. Levis

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Valuation of business interests for Colorado divorce purposes must use the "standard" of value established by Colorado case law precedent: value to the marital estate or owner/spouse. This value may not necessarily reflect market value or value to those other than the existing business owner.

Appraising business interests is a complex matter that requires expertise, experience, and a comprehensive understanding of the facts and circumstances surrounding the business interest subject to appraisal. Business valuations inherently involve a certain amount of subjectivity under any circumstances or for any purpose. Business valuation is sometimes referred to as an "art" or an "inexact science."

In the context of a Colorado divorce, the valuation of business interests often is more complex than a valuation performed for other purposes. In acquisition transactions, the buyer and seller negotiate a purchase and sale contract that allows tremendous flexibility in dealing with the inherent uncertainties and risks involved in transferring business interests. The terms of the transactions are structured to deal with the perceived risks. They include indemnification for breach of representations and warranties, hold-backs of a portion of the purchase price, non-compete agreements, earn-outs, and many other provisions. In business valuations for tax purposes, value is based on a fair market value standard,[1] which has been clearly established by the U.S. Tax Court and is based on a hypothetical sale between a hypothetical buyer and seller.

In addressing the valuation of businesses in marital dissolutions, Colorado appellate courts have approved rulings by various trial courts that followed the valuation approaches and methodologies of testifying experts. The courts do not appear to have established any judicially preferred valuation approach or methodology. In marital dissolutions, significant latitude is afforded trial courts in adopting an expert's opinion where he or she has applied generally accepted business valuation theories and methodologies. Nonetheless, the expert is expected to appropriately take into account the specific facts and circumstances relevant to the business interest being valued and apply the appropriate standard of value.[2]

This article provides a basic overview of business appraisal theory and applications. The article also addresses many of the unique aspects of appraising business interests that may arise under Colorado marital dissolution law.

Business Valuation Approaches and Methods

There are three generally accepted business valuation approaches that may be used when valuing a business. Each of the three approaches has several methods that may be applied in any valuation engagement. The quantity and quality of information available to the business valuation analyst, the facts and circumstances of the business interest being valued, and the appraiser's judgment are factors in selecting which methods should be applied in any given circumstance.

The three generally accepted approaches to valuing a business are as follows: (1) Asset-Based Approach; (2) Income Approach (including the Capitalization of Earnings Method); and (3) Market Approach. The popular Excess Earnings Method is a hybrid of the Asset-Based and Income Approaches, as discussed below. Some attorneys, CPAs, and business valuation professionals believe Colorado case law establishes preferences for certain methodologies, such as the Excess Earnings Method, and prohibits discounts for minority interests or marketability in marital dissolutions. However, such a belief is not conclusive.[3]

A properly performed appraisal will consider at least one method under each of the generally accepted appraisal approaches and "reconcile" the value indications of each business valuation method with a final opinion of value. This reconciliation analysis is a critical cross-checking process for the business valuation analyst. Significantly disparate value indications under various methods require the appraiser to revisit assumptions and calculations and to ensure that the reasons for such differences can be reasonably explained. Below is a brief discussion of each of the approaches used to appraise a business.

Asset-Based Approach

Under the Asset-Based Approach, the value of the business is reflected in the value of its individual assets less its liabilities. Note that "value" typically does not infer "book value" or the value of assets and liabilities on the business's financial statements or tax returns. Instead, the assets and liabilities of the business are individually appraised, usually with a Market Approach method (*see below*). The Asset-Based Approach generally is appropriate for a business where there is not a significant amount of income relative to the net assets of the company. This method is most relevant when there is little or no goodwill.

Income Approach and Capitalization of Earnings Method

Under the Income Approach, value is the present value of future benefit expectations —namely, income. It is the most theoretically sound of the valuation approaches where future "normalized" income expectations are converted to value using an "investor" required rate of return. The investor rate of return reflects the risks associated with the income stream subject to capitalization.

For marital dissolution purposes, the most commonly applied form of Income Approach is the Capitalization of Earnings Method. Under this method, "expected" earnings (usually some average of historical earnings) are "capitalized" (divided by a capitalization rate),[4] using a risk-adjusted "investor" required rate of return.

Market Approach

With the Market Approach, value is based on the "theory of substitution," which holds that no one will pay more for something than an equally desirable substitute. When appraising a business, this substitute would be a "similar" business. To the extent that similar businesses have been bought and sold, they may provide meaningful indications of value for the subject business, usually based on factors such as price/revenue and price/earnings ratios.

For many types of businesses, there is significant information available regarding actual business sale transactions that may provide good indications of market value. For common or homogenous businesses such as accounting practices, there may be general valuation guidelines, typically referred to as "rules of thumb." These are commonly used for transaction purposes in the industry and can provide a range of value for the subject business.

Excess Earnings Method

The Excess Earnings Method, also known as the "formula method,"[5] is the most commonly applied method in valuing business interests in Colorado divorce cases. The Excess Earnings Method is a hybrid of the Asset-Based and Income Approaches to valuation. It separately determines the "value" of tangible assets and deducts a "reasonable" rate of return on the tangible assets from the earnings of the business to arrive at earnings attributable to goodwill (intangible assets). That figure is "capitalized" at an appropriate rate to calculate goodwill value, which is then added to the tangible assets to arrive at the value of the total business.

The Excess Earnings Method is popular because of its perceived ease of use and the clear distinction between specifically identifiable assets and the more subjective intangible (goodwill) assets. However, this method has been widely criticized in the business valuation community as outdated and theoretically unsound.[6] Nonetheless, if appropriately applied, the Excess Earnings Method is a suitable appraisal method in many situations, particularly when a business has a material investment in tangible assets. By contrast, if a business has only a minor tangible investment, an overwhelming portion of the total earnings becomes excess earnings, with the result that the Excess Earnings Method becomes similar to the Capitalization of Earnings Method.[7]

The concept of "excess earnings" is attributable to earnings of the business in excess of a market rate of return on the tangible assets. It does not, as is often assumed by divorce practitioners, refer to the "excess" earnings of a business or professional practice over a "reasonable, fair market compensation" for services performed by the owner/operator of the business. The latter is part of the "income normalization" process that is an essential step in the business valuation process, regardless of the valuation methodologies actually employed by the business appraiser.

Standards of Value: "Fair Market Value" and "Investment Value"

The "real" value of a business is what a willing buyer and seller will pay and take for the business, respectively. An appraisal or business valuation is merely an opinion of value for a specific purpose by a professional who is appropriately experienced and credentialed. The purpose of the appraisal will dictate a standard of value. The standard of value answers the basic question: "What is the value to whom?" In other words, beauty (or value) is in the eye of the beholder. Any asset or business has a different value for different people or entities, depending on their perceptions.

The standard of value provides a perspective of value that will be used by the business valuation analyst. It is the most important determination affecting factors that will be considered to influence an opinion of value. Typically, the standard of value used for divorce purposes is one of the following:

- *Fair Market Value*, which is based on the value in a hypothetical purchase or sale transaction
- *Investment Value*, which determines the value of the business based on its worth to the owner.

In a dissolution of marriage, the term "value" can range from a strict interpretation of fair market value to a broadly based view of investment value.[8] Some business valuation professionals have pushed for consistency among jurisdictions to adopt

a "divorce value" standard that is clearly defined. Generally, those practitioners espouse the investment value standard, and argue that the marital property should be "current value to the marital community in the hands of the present owner."[9] The primary concept behind this definition of a "divorce value" standard is to be "equitable" to the spouse who will not be allocated an interest in the business owned by the marital estate.

No standard of value is defined in Colorado's version of the Uniform Dissolution of Marriage Act ("UDMA").[10] Moreover, there is little Colorado case law precedent to serve as a guide for business valuation analysts on how the rather vague standard of value that has evolved over time should be applied in various circumstances.[11]

In Colorado divorces, case law appears to dictate an investment value standard for business valuations equaling the value of the business interest to the owner/operator spouse who will continue to own the business after the date of decree.[12] Investment value is defined as

> the specific value of an investment to a particular investor or class of investors based on individual investment requirements; distinguished from market value, which is impersonal and detached."[13]

It also is commonly referred to as "fair value," a legally created standard of value,[14] or "intrinsic value."

The most basic and important difference between the applicable standard of value in a Colorado divorce and those applicable for other purposes is that business interests that may not have much value to a "hypothetical buyer" under the fair market value standard may have significant value to the owner/operator spouse due to the unique facts and circumstances of that particular individual. Thus, the value of the business sometimes may be significantly higher to that individual than to most other individuals.

Value of Goodwill (Intangible Assets)

The differences in assigning value using the investment value standard in a Colorado divorce context and a fair market value context usually relate primarily or exclusively to goodwill value. The *International Glossary of Business Valuation Terms* defines "goodwill" as

> that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.[15]

Goodwill consists of "enterprise goodwill" and/or "professional goodwill," which often is referred to as "personal goodwill." In Colorado, both forms of goodwill are to be included in the valuation opinion to be consistent with the investment value standard.[16] The primary issue facing the business appraiser is how to quantify the value of goodwill.

Enterprise Goodwill

Enterprise goodwill is the intangible value in the nature of goodwill that is associated primarily with the business as an institutional entity.[17] Brand name recognition, location, products, assembled workforce, computer systems, and customer loyalty to the business because of its reputation are components of enterprise goodwill. For example, customers may buy coffee from Starbuck's because they heard the

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company has a consistent high quality of coffee drinks, clean conditions, and service.

Personal (Professional) Goodwill

Personal (professional) goodwill is the intangible value in the nature of goodwill that is associated primarily with the individual practitioner or owner/operator of the business. A certain portion of the business's customers, clients, or patients may come to that individual because of his or her personal reputation. Presumably, this refers to the individual's skills or experiences that, in turn, generate earnings for the business. In theory, if the owner/operator suddenly left the business, a large majority of the income generated from these personal customers, clients, or patients likely would leave as well.[18]

How to Value Personal Goodwill

A 1974 California case, *In re Marriage of Lopez*,[19] is one of the best known and often cited cases where personal goodwill is an issue in marital dissolutions. In this case, the husband owned a 50 percent interest in a law firm partnership. The California Court of Appeals held that the value of an interest in a law firm is the spouse's proportionate share of the partnership's assets, adding that "the economic value of any asset is based upon the future receipts which the assets will produce."[20]

Five factors were considered appropriate in determining personal goodwill, according to the *Lopez* court: (1) the age and health of the professional; (2) the professional's demonstrated past earning power; (3) the professional's reputation in the community for judgment, skill, and knowledge; (4) the professional's comparative professional success; and (5) the nature and duration of the professional's practice, either as a sole proprietor or as a contributing member of a partnership or professional corporation. Although these five factors are important in determining the existence of personal goodwill, they do not provide sufficient guidance to a business valuation analyst on how to quantify or measure the personal goodwill.

Distinguishing Between Enterprise and Personal Goodwill

The distinction between enterprise goodwill and personal goodwill is not always clear. Nonetheless, this distinction is important for a well-performed valuation analysis, even though both enterprise and personal goodwill are considered property in Colorado.[21] Enterprise goodwill transcends the individual owner or practitioner. It typically has a different risk profile, and therefore different value given the same level of expected income, than personal goodwill associated exclusively with the individual owner of the business interest.[22]

The business valuator must carefully analyze the facts and circumstances associated with the business interest being valued. He or she should attempt to identify whether income is being generated by the entity or by the individual. Such an analysis is one of the most challenging tasks associated with appraising business interests. Separating the value of enterprise and personal goodwill is not unique to marital dissolution proceedings. However, it is more difficult in the sense that a cash equivalent value opinion must be the end result. Unlike an acquisition transaction, the business's value cannot be conveyed via structure and contracts.

The risk factors associated with the components of the business generating income, and therefore goodwill, will be used to: (1) develop an appropriate capitalization rate under the Capitalization of Earnings Method or Excess Earnings Method; or (2) adjust value parameters, such as the price/earnings ratio, as indicated, based on similar business sales. In some situations, the business interest is marketable or has similar characteristics to businesses or professional practices that are marketable. If there is credible market information regarding sales of similar businesses, the Income Approach or Excess Earnings Method can be reconciled with such information to assist in arriving at a reasonable opinion of value.

Marketability of Personal Goodwill

A common misconception is that personal goodwill is not marketable because it cannot be transferred. Although the transfer of personal goodwill is more difficult than the transfer of enterprise goodwill, there are procedures by which an individual can facilitate the transfer to another well-qualified individual of all or a portion of his or her personal goodwill.

Personal goodwill is rarely so exclusively tied to an individual that none of it can be transferred.[23] For example, an owner/operator often can engage an associate to whom the personal goodwill is transferred over time, with the profits from the business transferred shared during the transition. In an acquisition context, personal goodwill is usually paid in the form of compensation for a period of time necessary to effectively transfer the business to the new owner; a non-compete agreement is incorporated into the arrangement.

In situations where the individual is an equity holder in a larger entity subject to a buy-sell agreement, such as a regional law firm that provides no goodwill to that individual on severance, there is no opportunity actually to sell goodwill associated with that equity interest. Even so, the individual may have the ability to "sell" his or her personal goodwill by transferring to another firm, for example. Presumably, such a transfer would be made so that the individual is better off than if he or she had stayed with the former firm.

For purposes of valuing a business, it sometimes is appropriate to assume that the business is nothing more than the alter ego of the professional spouse. A consulting business based on the unique talents, experience, reputation, and contacts of an individual is an example of such a business. The income benefits of the business

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are not transferable to anyone else. However, the owner/operator spouse may be able to sell and transfer his or her business from one entity to another. For example, a manufacturer's representative selling a particular line of products for one company may be able to "sell" his or her book of business to another manufacturer. Similarly, a stockbroker may be paid a premium in salary or bonuses for bringing his or her customers to a new brokerage.

The ability and relative ease with which personal goodwill can be transferred will depend on the facts and circumstances of each case. In situations where the transfer of personal goodwill income is relatively difficult (or impossible), the risks associated with receiving this income in the future generally will be relatively higher and, correspondingly, the value relatively lower, all other things being equal.

In summary, many personal services businesses would have little goodwill value using a hypothetical buyer perspective under a fair market value standard. However, in a dissolution of marriage, there may be considerable goodwill value to the owner/operator using an investment value standard.

Conclusion

The most important determination in any business appraisal is the "standard of value." Because value is a subjective concept, and different people value assets differently, the perspective of value dictated by the standard of value will have a significant impact on the factors considered in the appraisal opinion.

In Colorado divorce cases, an investment value standard, using a "value to the marital estate in the hands of the current owner," seems to have been adopted by the Colorado courts through precedent established by earlier cases. Accordingly, goodwill is considered marital property whether it is associated with the entity or the owner/operator of the business. The former is referred to as "enterprise goodwill" and the latter, "personal" or "professional goodwill."

A properly performed appraisal analysis will consider the extent to which the income expected to be generated by the business in the future (typically the source from which a value opinion is derived) is associated with enterprise or personal goodwill. The appraisal analysis should carefully assess the risk factors associated with the different components of income, and therefore goodwill. The appraiser then should adjust the capitalization rate used to convert such income into value to properly account for the perceived risks.

In analyzing the value of a closely held business or business interest, no single method is an absolute. To produce a sound conclusion, the professional valuator uses as many or as few of the different methods that are appropriate under the given circumstances of the situation and for which the necessary information is available. Because valuation is not an exact science, it is expected that estimates of value determined by various methods will not be in exact agreement. Fortunately, comprehensive and thorough analysis can generate ranges of value that are reasonable and relevant. Further, the valuator should use common sense, informed judgment, and reasonableness in determining the aggregate significance of the methodologies considered.

When business appraisals are appropriately and thoroughly conducted by experienced and objective business valuation experts, there should not be significant value differences. At the very least, the reasons for major differences should be apparent to and articulable by the two appraisers. Thus, if the finder of fact understands the differences of opinion and the impact such differences have on the valuation conclusions, he or she should be able to incorporate personal opinions regarding the facts and perceptions of expert opinions into a proper ruling regarding the value of the business.

NOTES

1. Federal tax law has an extensive business valuation case law history, which has clearly defined what constitutes a "hypothetical buyer and seller" of business interests. The general interpretation is that hypothetical buyers are the most probable buyers. The seller is a hypothetical seller that is well informed about the facts and value relevant to the business interest; he or she is not the actual existing owner of the interest. The hypothetical seller does not necessarily have all of the characteristics of the existing owner of the interest that is subject to valuation. *See, e.g., Pabst Brewing Company v. Comm'r*, T.C. Memo 1996-506.

2. *In re Marriage of Page*, 32 Colo.Law. 181 (April 2003) (App. No. 00CA1757, *annc'd* 2/27/03) ("The trial court also has discretion to choose the property valuation of one party over that of the other or to make its own reasonable determination of value, and such determination will be upheld unless clearly erroneous.").

3. *See Pueblo Bancorporation v. Lindoe, Inc.*, 32 Colo.Law. 224 (March 2003) (S.Ct. No. 01SC645, *annc'd* 1/21/03) (stockholder dispute case disapproving of marketability and minor-

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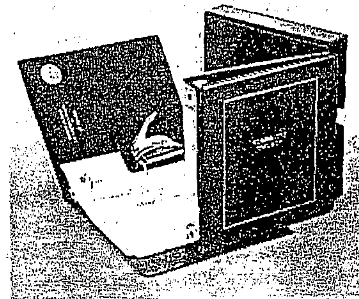

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ity discounts). This case is not to the contrary because it concerned the statutory definition of Fair Value. In contrast, *see Kalcevic v. Kalcevic*, 397 P.2d 483 (Colo. 1964) (minority discount might be appropriate in cases other than where a court is dividing family assets of closely held corporation that is alter ego of three brothers responsible for its operation).

4. The inverse of a capitalization rate is a "multiple."

5. Rev. Rul. 68-609, 1968-2 C.B. 327.

6. There is a lack of empirical data from which to derive a range of capitalization rates used to convert the excess earnings into a goodwill value. Even the IRS, which authored this "formula method" in 1920, considers it a method of last resort. The first sentence in Rev. Ruling 68-609, *supra*, note 5, is as follows: "The 'formula' approach may be used in determining the fair market value of intangible assets of a business *only if there is no better basis available* for making the determination. . . ." (*Emphasis added.*)

7. Pratt, Reilly, and Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (New York, NY: McGraw-Hill, 2000); Bishop, "Excess Earnings Cap Rate—Six Market Influences," *Business Appraisal Practice* 4 (Winter 1999).

8. Fishman *et al.*, *Guide to Business Valuations* (Fort Worth, TX: Practitioners Pub. Co., 2002).

9. *See, e.g.*, Zipp, "Business Valuation Standards for Divorce is Different from Fair Market Value," *American J. of Family Law* 167-72 (Fall 1997).

10. CRS § 14-10-113. *See In re Marriage of Lord*, 626 P.2d 698, 699, 699-700 (Colo.App. 1980) ("However valid the concept of 'real value' might be in other contexts, we conclude that . . . the market value of real property in dispute is the standard adopted by the General Assembly. . . ."), *cert. granted, then dismissed on stipulation, Lord v. Lord*, 653 P.2d 385 (Colo. 1982). Although the UDMA does not define the term "value," cases involving dissolution proceedings have recognized implicitly the propriety of using market value in establishing the value of real property; *see In Re Marriage of Weaver*, 571 P.2d 307 (Colo.App. 1977); *In Re Marriage of Wildin*, 563 P.2d 384 (Colo.App. 1977); *Rhoades v. Rhoades*, 535 P.2d 1122 (Colo. 1975).

11. Further, the laws of other jurisdictions that address the "market value" approach have not been cited in Colorado over the last twenty years. *See Lord v. Lord, supra*, note 10. In the context of business valuations, *Lord v. Lord* seems to have been tacitly abandoned by later decisions. *See, e.g., In re Marriage of Martin*, 707 P.2d 1035 (Colo.App. 1985).

12. *Martin, supra*, note 11 (value of goodwill not necessarily dependent on what a willing buyer would pay for it; important consideration is whether husband's business has *value to him* above and beyond the tangible assets). (*Emphasis added.*)

13. *The Dictionary of Real Estate Appraisal*, 3rd ed. (Chicago, IL: Appraisal Institute, 1993) at 190.

14. Pratt, Reilly, and Schweihs, *supra*, note 7 at 30.

15. The *International Glossary of Business Valuation Terms* was developed and adopted jointly by the American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and The Institute of Business Appraisers. *See, e.g.*, http://www.bvappraisers.org/glossary/glossary.pdf or http://www.cicbv.ca/client/cicbv/CICBV.nsf/web/Valuation+Terms!OpenDocument.

16. *See In re Marriage of Bookout*, 833 P.2d 800 (Colo.App. 1991) ("The few courts that consider personal goodwill as nothing more than probable future earning capacity have concluded that goodwill is not a divisible asset. . . . However, this minority view is contrary to the law which we have adopted in this jurisdiction. . . ."). *See also In re Marriage of Banning*, 971 P.2d 289, 292 (Colo.App. 1998) ("The mere fact that husband could leave the existing business, and start again with a different name, location, or even business structure without impact on his earnings does not mean that no goodwill exists of value to the spouse. Even in a new business, husband would retain his reputation, his customer base, and his customer relations, all of which were developed during the marriage. . . . These together constitute goodwill that supplements, and is distinct from, husband's earning capacity."). (*Citations omitted.*)

17. Pratt, Reilly, and Schweihs, *Valuing Small Businesses and Professional Practices* (New York, NY: McGraw-Hill, 1998) at 584.

18. *Id.*

19. *In re Marriage of Lopez*, 113 Cal.Rptr. 58 (Cal.App. 1974).

20. *Id.* at 67. (*Citations omitted.*)

21. *Bookout, supra*, note 16.

22. *Banning, supra*, note 16 at 294 (". . . overvaluation is a common problem when the excess earnings method is used to value goodwill for purposes of marriage dissolution. The problem arises when a critical point is overlooked: 'Goodwill for marital property purposes is substantively different from goodwill for business sale purposes.' . . . Among the differences is that the value of goodwill inherent in the spouse participating in the business depends completely on what happens to that spouse in the future. This presents a greater risk than is typically present for the purchaser of goodwill in an ongoing business. In addition, goodwill as an asset that is inherent in the participating spouse will immediately begin diminishing in value upon the marriage dissolution. All future income created by post-dissolution efforts must be eliminated from the valuation. . . ."). (*Citing* Zipp, *supra*, note 9; *other citations omitted.*)

23. Pratt, Reilly, and Schweihs, *supra*, note 17 at 585 and 586. ■

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