Value: More Than a Superficial Understanding Is Required[1]

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A clear understanding of the assumptions in the standard of value used in estimating the value of a closely held business in connection with a marital dissolution matter is critical to the appraisal process. Courts use various standards of value, principally "fair market value" but also intrinsic or investment value. Each standard of value contains many assumptions and these assumptions can vary as the standard of value changes. It has been our experience that often the standard of value is not clearly delineated and this can result in substantial differences in the values developed by experts. Often courts refer to one standard of value and ascribe to it the characteristics of another standard of value.

This article will begin with a definition of "fair market value", including some of the critical assumptions underlying this definition of value. We then will compare the definition of this most frequently discussed standard of value with other standards used to evaluate closely held businesses, and clarify the distinctions between them. Further, we will discuss the application of these standards in the context of business and professional practice valuations in marital dissolution matters. We will review cases from several states which address the issue of standard of value, and will compare and contrast the positions developed in the different states.

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I. Standards of Value

Confusion often arises in discussing the "value" of an asset such as a business or a professional practice simply because the generic term "value" is not more specifically defined. In the context of the valuation of business and professional practice interests in marital dissolution matters, "fair market value" (FMV) is the most commonly cited standard of value.[2] Valuation professionals and valuation users should have more than a superficial understanding of the assumptions underlying this definition of value in order to apply and interpret it appropriately. As a means of further understanding the implications of the varying characteristics of standards of value, we will explore other definitions such as intrinsic or investment value and highlight the differences between the standards.

As a precursor to a discussion of how assets are valued and distributed in an equitable distribution setting, it is essential to understand the differing assumptions underlying the different standards of value. Only then can one compare how different states wrestle with these difficult issues and further understand the impact on the valuation process.

II. Definitions

A. *Fair Market Value*

This standard of value is well known to business valuators and is frequently used in income, gift, estate and other matters. It appears in Treasury Regulations dealing with taxes and in other contexts such as employee stock ownership plans.[3] The definition is as follows:

> Fair Market Value is defined as the 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. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as will-

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[2] Lavene v. Lavene, 392 A.2d 621, 162 N.J. Super. 187, 192, 193, 200 (N.J.Super.Ch., 1978); Thompson v. Thompson, 576 So.2d 267, 269 (Fla., 1991); Focke v. Focke, 83 Ohio App.3d 522, 615 N.E.2d 327 (Ohio App. 2 Dist., 1992).

[3] Treas. Reg. §25.2512-1(gift tax); Treas. Reg. §20.2031-1 (estate tax); Treas. Reg. §S1.170A-1 (c) (2) (charitable contributions).

> ing, to trade and to be well informed about the property and concerning the market for such property.[4]

Despite the brevity of the above definition, considerable content is contained in those few lines, and a specific examination of these underlying conditions and assumptions will allow us to isolate the factors which differentiate the standards of value.

1. *Price at which property would change hands*

Calculating the "price at which the property would change hands" requires the valuator to "make a reasonable estimate of the hypothetical sale price."[5] This assumes that the property is put up for sale in a hypothetical context. The hypothesized sale is an important part of the underlying assumptions of fair market value. Accordingly, there need not be an *actual* contemplated sale to determine fair market value. The definition requires consideration of what the property would bring in a hypothetical sale, whether or not the property is actually being sold.

In addition, as the Internal Revenue Service indicates, "the correct standard for valuation for our purposes is the amount that the property would bring in a *cash* sale."[6] In other words, fair market value assumes the seller will receive cash or cash equivalency at the valuation date. In the event the valuator uses comparable transactions as one of the methods of valuation, the consideration should be cash or cash equivalency. Therefore, if the comparable sale involved financing or Rule 144 stock, adjustments to the purchase price may be necessary to indicate the cash or cash equivalency of the consideration. This is particularly relevant in the valuation of smaller businesses because very often the buyer does not pay the full purchase price at closing, but rather there is a pay-out over time, and at times, this pay-out is without interest. In addition, the pay-out may be contingent upon future events, such as client retention.

The Tax Court case *Morris v. C.I.R.*[7] addressed the issue of financing arrangements, opining that the effect of favorable or

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4 Rev. Rul. 59-60, Sec 2, Sub .02, CB 237.

5 COMMERCE CLEARING HOUSE, INC., IRS VALUATION GUIDE FOR INCOME, ESTATE AND GIFT TAXES 1-5 (1994).

6 *Id.*

7 761 F.2d 1195, 56 A.F.T.R.2d 85-6485, 85-1 USTC P 13, 617 (6th Cir., 1985).

unfavorable financing should be considered in the estimation of fair market value. In this case the expert used comparable sales that were reflective of owner financing. Since owner financing was lower than third party financing the price reflected in the comparable sales was inflated. The court criticized the expert for not adjusting the multiples produced from the comparable sales downward to reflect their overstatement due to owner financing.

2. *Between a willing buyer and a willing seller*

The IRS further maintains that it is "irrelevant who are the real sellers or buyers."[8] Neither the buyer nor the seller is an actual person, but they are proxies for the participants in this hypothetical market, in a state of equilibrium. Obviously, both must be willing and able. The market, in this context, is the universe of all potential buyers and sellers of the same or similar businesses. In equilibrium, the market created by the willing and able buyer and willing and able seller is *not* influenced by special motivations exhibited by typical buyers and sellers. For example, strategic acquisitions in which the buyer hopes to realize benefits because of certain synergies are motivated by special circumstances and may not represent the amount paid by a typical buyer. Again, when searching for and relying upon comparable transactions, great care must be exercised by the valuator in ascertaining whether these transactions are usable in a fair market value context.

This concept has been addressed in several United States Tax Court cases, including *U.S. v. Simmons*[9] and *Estate of Bright v. United States*,[10] reinforcing the hypothetical market and the fact that motivations peculiar to specific buyers or sellers should not be considered in the estimation of fair market value.

3. *Not under compulsion to buy or sell*

Under the fair market value standard it is assumed that neither the buyer nor seller is compelled to be a party to the transaction, so that each has equal negotiating power. It is as-

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8 *Supra* note 3, at 1-6.

9 346 F.2d 213, 15 A.F.T.R.2d 1430, 65-2 USTC P 12,321 (5th Cir.(Ga.), 1965).

10 658 F.2d 999, 48 A.F.T.R.2d 81-629, 281-2 USTC P 13,436 (5th Cir. (Tex.), 1981).

sumed that the transaction price reflects that level of negotiation and that the price is not the result of a specific impetus of one of the parties. The fair market value concept also assumes, given the absence of compulsion, that the practice or business is valued as a going concern, not in a liquidation scenario. The liquidation value methodology is usually applicable to controlling interests when liquidation is a reality.

4. *Both having reasonable knowledge of all relevant facts as of the applicable valuation date*

The concept that "both parties have reasonable knowledge of all relevant facts" assumes both parties are operating from the same basic level of information, including an understanding of prevalent economic, industry and market conditions at the date of valuation. Identifying the circumstances that were reasonably foreseeable at the valuation date can sometimes be extremely difficult. Generally this means "not what is actually known as of the valuation date, but facts that are discoverable through reasonable investigation as long as the facts existed as of the valuation date even though they were not known."[11] In one instance, the Tax Court ruled that it was discernible and predictable that a construction company engaged in price fixing because of its higher than normal profit margins even though this fact became apparent many years after the death of a major shareholder.[12] The Tax Court has routinely rejected the use of hindsight in the fair market value analysis.[13] Therefore, the standard seems to be "discernible and predictable at the valuation date."

Recently, a number of federal Tax Court cases have dealt with the use of information, specifically transactions, which occur subsequent to the valuation date. In each of these cases the company was sold somewhere between sixteen months to four years subsequent to the valuation date. While the court in each instance reiterated the position that events not reasonably foreseen

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11 *Supra* note 3, at 1-7.

12 Tully's Estate v. U.S., 78-1 USTC (Ct. Cl. 1978).

13 *See e.g.*, Foltz v. U.S. News and World Report, 760 F.2d 1300, 245 U.S.App.D.C. 276, 6 Employee Benefits Cas. 1534 (D.C.Cir., 1985); Central Trust Co. v.U.S., 158 Ct.Cl. 504; 305 F.2d 393, 403; 10 A.F.T.R.2d 6203; 62-2 USTC P 12,092 (Ct.Cl., 1962); Ridgely's Estate v.U.S., 180 Ct. Cl. 1220, 1237-39, 20 A.F.T.R.2d 5946, 67-2 USTC P 12,481 (Ct.Cl., 1967).

at the valuation date that *affect* value are not permissible, these courts did comment on the principle that later occurring events may be taken into account as *evidence* of value.[14]

B. *Investment and Intrinsic Value*

Other commonly misunderstood standards of value are "investment value" and "intrinsic value." These terms are often used interchangeably, and are often confused with "fair market value." "Investment value" typically refers to the value perceived by a specific buyer based on a specific set of circumstances.[15] For example, one potential buyer may perceive a high investment value, anticipating synergies between the Target Company and his or her current operation. Another buyer, anticipating additional overhead expenses, fixed asset purchases, or a new location may perceive a lower investment value.

"Intrinsic value" is often used interchangeably with investment value and is often thought of as the value as a going concern, to a particular owner, without taking into consideration the marketability of the business or practice.[16] For example, executive stock options cannot be transferred, and thus have no fair market value, but they may have a substantial intrinsic value to the current owner. Another example is a license to practice law or medicine. Again, these are not transferable, a violation of one of the fundamental assumptions of the definition, so they have no fair market value. However, this asset may have substantial intrinsic value to its holder, since it may enable the professional to generate a benefit stream in excess of normal compensation. As discussed below, in some situations, for example in New York, licenses are treated as marital assets subject to equitable distribution.[17]

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[14] Estate of Jung v. C.I.R., 101 T.C. No. 28, 101 T.C. 412, Tax Ct. Rep. (CCH) 49,387, Tax Ct. Rep. Dec. (RIA) 101.28 (U.S. Tax Ct., 1993); Cidulka's Estate v. C.I.R., T.C.M. 1996 - 149, Scanlan's Estate v. C.I.R., T.C.M. 1996 - 331; Trompeter's Estate v. C.I.R., T.C.M. 1998 - 35.

[15] Pratt, Shannon P.; Reilly, Robert F.; Schweihs, Robert P.; Valuing a Business: The Analysis and Appraisal of Closely Held Companies, pp. 25-26 (1996).

[16] *Id.* at p.26. When not used interchangeably with investment value, it represents the appropriate price for a stock according to a security analyst.

[17] O'Brien v. O'Brien, 66 N.Y.2d 576, 498 N.Y.S.2d 743, 54 USLW 2348 (N.Y., 1985).

Much of the confusion in valuation of professional practices and businesses in the context of equitable distribution arises from confusion concerning the definition of value. Value in exchange or fair market value presupposes that all the underlying assumptions built into the definition of fair market value are upheld. When one begins to discuss specific circumstances of specific buyers or sellers, or when one values an asset that is clearly not transferable, one ventures outside the confines of the fair market value assumptions, and the resulting analysis must be classified as investment or intrinsic value.

C. *The Concept of the Notional Market*

To illustrate some of the differences between fair market value and investment value, we will introduce a concept used in certain jurisdictions and for income tax valuation purposes in Canada and the United Kingdom. The "notional" market is a hypothetical or imaginary market, which is deemed to have existed at the valuation date.[18] The notional market is differentiated from the actual or open market and has many of the same market conditions contemplated in the traditional interpretation of fair market value in the United States. The following is a chart that illustrates the perceived differences between the notional market and the open market.

NOTIONAL V. OPEN MARKET TRANSACTIONS

Notional Market	***Open Market***
Arm's length	Some transactions include non-arm's length parties
Economic value	May include sentimental value
Equally informed	One party may not be as informed as the other
Equally uncompelled	One party may be more "compelled" to transact than the other
Consistent market	Marketplace could include booms and panics

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18 Richard Wise, Financial Litigation and Business Securities Valuation, pp. 1-27 - 1-28 (1992). *See also*, Z. Christopher Mercer and Terry S. Brown, *Fair Market Value vs. The Real World*, Valuation Strategies, pp. 6-15 (Apr. 1999).

Free, open, unrestricted	Restrictions a possibility
Equal financial strength	One party may be financially stronger
Equal bargaining ability	One party may be in a better bargaining position

As illustrated above, the open market or real world of actual transactions often has situations in which particular circumstances violate the underlying tenets of the fair market value definition. For example, we often see transactions in which one can only assume that sentimental value played a major role for either the buyer or seller. In many other cases, a rational observer must conclude that one party was not as fully informed or as free of compulsion to transact as contemplated in the fair market value definition. In any valuation, it is important to attempt to understand the qualitative aspects of any transaction in order to evaluate the relevance of the quantitative aspects.

The violations of the fair market value assumptions are what make the market an interesting place and what make a wide variety of deals possible. The fact that one investor perceives something completely differently from another and over (under) pays for the dog (gem) and looks like a dunce (hero) in retrospect, is what keeps the marketplace so unpredictable.

III. The Standard of Value in Marital Dissolution Matters

In valuing a business or professional practice in a marital dissolution matter, the valuation expert and the attorney look to statutes and case law for guidance. Unfortunately, or in some cases, fortunately, the standard of value discussed in the statutes and the standard(s) emerging from the case law vary widely from state to state, and sometimes even vary within a state according to the type of asset being valued.

Many of the state statutes in marital dissolution matters use the term "value" without any description of the characteristics that underlie this crucial standard, and with very little guidance provided to the valuation expert. For example, the Divorce Code in Pennsylvania states, "'marital property' means all property acquired by either party during the marriage, including the *increase in value* prior to the date of final separation of any nonmarital property."[19] The section entitled "Equitable Division of Marital Property" provides that "the court shall, upon request of either party, equitably divide, distribute or assign, in kind or otherwise, the marital property between the parties" and later states that a relevant factor that should be considered by the court is "the *value* of the property set apart to each party."[20] These two references to value give no indication as to the standard of value to be employed.

The New York Domestic Relations Law states "as soon as practicable after a marital action has been commenced, the court shall set the date or dates the parties shall use for the valuation of each asset."[21] The statute carefully defines marital property, separate property and distributive award, but it never defines value. In Florida, fair market value is not referred to as a standard of value, but as one of numerous approaches for valuing the goodwill of a professional.[22] Unfortunately, for the beleaguered valuation expert, these states are not exceptional situations. When the standard of value is not clearly delineated in the law, one must look to the cases decided in each state for further guidance. The following sections illustrate some examples of the various standards of value applied in divorce cases.

A. *Pennsylvania Cases*

A review of some of the Pennsylvania cases relating to business and professional practice valuations reveals that the key words in Pennsylvania appear to be "net realizable value." However, a great deal of confusion surrounds Pennsylvania's position concerning the definition of value.

DeMasi v. DeMasi[23] illustrates one train of thought regarding fair market value compared to intrinsic value. Dr. DeMasi, a York County physician, owned a fifty percent interest in Associated Internists, Inc. The other fifty percent shareholder was Dr. Lampe. Dr. DeMasi developed a specialty in rheumatology, which Dr. Lampe did not share, and had very little if any compe-

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19 23 Pa. Const. Stat. Ann. § 3501(a) 1980 (emphasis added).

20 *Id*. at § 3502(a)(8) (emphasis added).

21 New York Dom. Rel. Law, § 236:B (McKinney 1993).

22 Thompson v. Thompson, 576 So.2d (Fla., 1991); Young v. Young, 600 So.2d 1140, Fla. L. Weekly D1165 (Fla.App. 5 Dist., 1992).

23 530 A.2d 871 (Pa. Super. Ct., 1987).

tition from other rheumatologists in the county. The trial court and Superior Court attributed no goodwill to the husband's practice, drawing an analogy to *Beasley v. Beasley*[24] and comparing DeMasi's position to Beasley's sole proprietor status. In reality, there is no reason to suspect that Dr. DeMasi's practice would be unmarketable. In fact, given his monopoly, one would suspect it may have been attractive to a potential buyer and that Dr. DeMasi could transfer his practice to another purchasing physician. The case indicates no impediment to Dr. DeMasi being able to "realize" the fair market value for his practice. However, that was not the opinion of the court.

A very different position was taken by the same court in *Buckl v. Buckl.*[25] Mr. Buckl and his partner, Mr. Jankowski, each owned fifty percent of an architectural firm. After differing rulings by the master and trial court, the Pennsylvania Superior Court stated the partnership agreement should be a factor, but noted it was unlikely that the agreement would contain specific valuation criteria for use in equitable distribution. The court went on to state the realities of the situation should be considered, and articulated the partnership interest's monetary worth, i.e., the capital account, accounts receivable, work in process, tangible assets' appreciation over book value, unbooked liabilities, and goodwill. Thus, the court deemed going concern value realizable and therefore relevant for purposes of equitable distribution.

In *Fexa v. Fexa*,[26] another professional practice case, Dr. Fexa, a dentist, had been in a partnership for twenty years. The Pennsylvania Superior Court viewed the fact that, despite personnel changes, the dental partnership had continued its work throughout the years evidence of the fact that the goodwill of the practice was attached to the practice rather than only to the individual dentists. The judges did not achieve unanimity, however, with the two judges in the majority opining that if the goodwill could be realized through a sale, then it must be factored into the valuation, and the form of the entity was immaterial. If, however, the goodwill was not realizable, then it should not be distributed. The dissenting judge found the facts in *Fexa* to be in

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24 518 A.2d 545 (Pa. Super. Ct., 1986).

25 373 Pa.Super. 521, 542 A.2d 65, 70 (Pa.Super., 1988).

26 578 A.2d 1314 (Pa. Super. Ct., 1990).

accord with those in *DeMasi* and *Beasley* and would have found no goodwill.

McCabe v. McCabe,[27] decided by the Pennsylvania Supreme Court in 1990, concerned the valuation of a partnership interest in a law firm, and again discussed the net realizable value. Mr. McCabe was party to an agreement which involved many other attorneys. The provisions of the agreement were clear and precise, had not significantly changed since 1963, and were used as the basis for partners joining and leaving the practice. The withdrawing partner was entitled to his/her capital account, less debt to the firm, plus the share of profits through the date of withdrawal. At death, an additional $20,000 was added to this amount. The agreement specified that no partner could remove accounts receivable, liquidate or sell a share, or retire and continue receiving profits. Because of the specific nature of the rights and terms in the agreement, because it had been in place for almost thirty years, and because it had been the basis of transactions, the court decided that the rights of the partner were limited to those specified in the agreement. The method set forth in the agreement for determining realizable value for a partner's share was determined to be the controlling valuation factor. The court pointed out that, due to the restrictions in the agreement, no market existed for the interest and the going concern value could not be realized in any manner.

Another case which falls in the *Fexa/Buckl* camp is *Butler v. Butler*.[28] Mr. Butler owned a fifty percent partnership interest in an accounting practice as of the date of separation. Citing *McCabe*, he asserted that the value of his interest should have been governed by the partnership agreement, which stated that the value of his interest at termination or disability was $2,450. The trial court and the Superior Court disagreed, stating that the partnership agreement did not provide a clear valuation of his interest, pointing out that the amount realizable by a partner at the time of death was a much larger $100,000. The trial court also noted that the husband's father started the firm and that, as in *Fexa*, practitioners had joined or left the practice. Clients were successfully transferred at these times, with the practice retaining

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27 575 A.2d 87 (Pa., 1990).

28 621 A.2d 659 (Pa. Super. Ct., 1993).

the clients when individual accountants left. Both courts considered the goodwill of the practice as attached to the practice, not only to the individual, and indicated that since going concern value could presumably be realized by a partner, that value, and not the value prescribed in the partnership agreement, should be the governing one.

In 1995, the Pennsylvania Supreme Court rendered an opinion that addressed, among other issues, the relevance of shareholders' agreements in determining value in an equitable distribution matter.[29] The court stated:

> We agree that under the terms of the shareholder agreement in force here, Husband would be unable to ever realize a value based on the going concern. However, it does not necessarily follow therefrom, that the value as set forth in the shareholder agreement should here control as it did in *McCabe.*

The court explained that the terms of the agreement in this case can be distinguished from those in *McCabe*, and this agreement did not provide an appropriate value for Mr. Butler's current interest in the firm.

The Pennsylvania Supreme Court disagreed with the lower courts, and concluded that the trial court erred in including goodwill in its valuation of Mr. Butler's interest. The court opined that Mr. Butler's clients were personal to him and would follow him if he left the firm. The *Butler* court quoted from *Fexa:*

> If the nature of the economic good will is purely personal to the professional spouse, it is not alienable; hence, it cannot actually be realized and may not be included in the equitable distribution. If, however, a portion of the economic good will is attributable separately to the corporation or business and can be realized by sale to another (by selling the enterprise in whole or in part, buy-ins and buy-outs included), then to that extent, there is good will value subject to equitable distribution.[30]

The Supreme Court's disagreement with the trial court's decision was grounded on the theory that the goodwill of the practice was personal to Mr. Butler and therefore not transferable.

The most recent Pennsylvania case to address the distinction between personal or professional goodwill and practice or enter-

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29 Butler v. Butler, 541 Pa. 364, 663 A.2d 148 (Pa., 1995).

30 578 A.2d at 1317.

prise goodwill is *Gaydos v. Gaydos*.[31] Dr. Gaydos was a 67 year old dentist whose practice was structured as a sole proprietorship. He had a loyal but aging and dwindling patient base, and no partners or employees. His equipment was usable, but obsolete and the practice was not located in a prosperous area.

The *Gaydos* trial court drew the distinction between goodwill and going concern value, saying that goodwill and going concern are two separate methods of valuation. The Superior Court disagreed, referring to the Butler definition of going concern value as the "ability of a business to generate income without interruption even after a change in ownership" and goodwill as the "pre-existing relationship arising from a continuous course of business which is expected to continue indefinitely."[32] The *Gaydos* court also pointed out that goodwill is one of the many benefits of owning a functional business rather than an assemblage of assets and was therefore a component of going concern value.

The *Gaydos* court reiterated that goodwill, which is intrinsically tied to the individual, is not subject to equitable distribution because it is inalienable and is the exclusive property of the professional and is therefore not transferable. This is referred to as "personal" or "professional" goodwill. Goodwill, which is wholly attributable to the business or practice itself, is presumably transferable to the potential buyer of the practice and subject to equitable distribution. This goodwill is referred to as "practice" or "enterprise" goodwill. Therefore, while the court does not distinguish between goodwill and other intangible assets, *Gaydos* illustrates the continued focus of Pennsylvania courts on the transferability of the assets in question.

Although controversy continues to exist in Pennsylvania, the governing principle of valuation appears to be the realizable value. The valuation task in Pennsylvania is to analyze the factors specific to the subject business or practice interest, including any ownership agreements, and determine what value would be realizable in a transaction of the subject interest. In addition, valuations should explore the issue of personal as opposed to practice/business goodwill and issues surrounding the transfera-

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31 693 A.2d 1368 (Pa. Super. Ct., 1997).

32 *Butler*, 663 A.2d at 152 n.9.

bility of the goodwill. Valuation difficulties arise in Pennsylvania situations where an asset exists with significant intrinsic value, but no market or realizable value. Approaches taken by other states to address these difficult areas are explored below.

B. *New Jersey Cases*

In New Jersey, cases create the interesting dichotomy of holding business valuations to the fair market value standard, while, in other instances, quantifying professional goodwill and even celebrity goodwill, which have no value in exchange. *Lavene v. Lavene*[33] states clearly "the valuation of the stock of a closely held corporation calls for an attempt to fix a fair market value for the stock — that is, the 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 the relevant facts." A discussion of fair market value could not be more explicit; however, New Jersey is also home to the *Dugan v. Dugan*[34] case involving an interest in a New Jersey law firm. Mr. Dugan argued that since the Canons of Ethics at that time did not allow the sale of a law practice, the practice could have no fair market value, and there could be no goodwill. The Supreme Court of New Jersey found that the intrinsic value, the value to Mr. Dugan, was the relevant value for purposes of equitable distribution. To make things even more interesting, New Jersey also has the concept of celebrity goodwill. In the famous case, *Piscopo v. Piscopo*,[35] involving comedian Joe Piscopo, the New Jersey Court discusses the value of such items as the celebrity's name and likeness, clearly non-marketable "assets", and another clear indication of intrinsic value.

The thread that joins *Lavene, Dugan* and *Piscopo* is the fact that each litigant had an interest in a commercial entity. In *Lavene* at issue was the value of an interest in a corporation while *Dugan* and *Piscopo* did business as sole proprietors. Each of the litigants functioned as an entrepreneur rather than an em-

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33 392 A.2d 621, 623 (N.J. Super. Ch. Div., 1978). See also Bowen v. Bowen, 96 N.J. 36, 473 A.2d 73, 56 A.L.R.4th 847 (N.J., 1984).

34 92 N.J. 423, 457 A.2d 1 (N.J., 1983).

35 231 N.J.Super. 576, 555 A.2d 1190 (N.J.Super.Ch., 1988), *cert. denied*, 555 A.2d 1040 (N.J., 1989).

ployee. This was not the case in *Seiler v. Seiler*[36] where the issue was the goodwill of an Allstate agency.

C. *New York Cases*

New York also provides us with an example of the use of intrinsic value as the standard of value, most notably in the valuation of professional degrees and licenses. In *O'Brien v. O'Brien*,[37] Mrs. O'Brien worked while Dr. O'Brien attended medical school. Two months after he obtained his license to practice medicine, during his general surgery residency, he filed for divorce. Since Dr. O'Brien had no practice, there was none to value, but the wife's expert valued the doctor's medical license using the enhanced earnings capacity it afforded Dr. O'Brien. The expert compared the average income of a general surgeon to the average income of a college graduate, and after adjusting for mortality, time value of money and other factors, calculated the difference, and called that calculation the value of the license. Clearly the license was not transferable, or even separable from Dr. O'Brien, and therefore had no value in exchange. However, this case set the standard in New York, where the intrinsic value of both professional degrees and licenses are calculated and subject to equitable distribution.

Recently, the O'Brien standard was discussed in *McSparron v. McSparron*[38] where the New York Court of Appeals held that a license and a practice can be valued. Previously, licenses in many instances were deemed to have merged with a practice when the licensee had maintained a professional practice for a substantial period of time.[39] Opting for what it called a common sense approach, the court of appeals stated that the merger concept should be eliminated.

Another example of intrinsic value evidenced in New York is the valuation of celebrity goodwill. In *Golub v. Golub,*[40] the court held that the acting and modeling career of wife, Marisa

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36 706 A.2d (N.J.Super., 1998).

37 120 A.D.2d 656, 502 N.Y.S.2d 250 (1986).

38 87 N.Y.2d 275, 662 N.E.2d 745, 639 N.Y.S.2d 265, 64 USLW 2389 (N.Y., 1995).

39 Marcus v. Marcus, 135 A.D.2d 216, 525 N.Y.S.2d 238 (N.Y.Sup. 2 Dept., 1988).

40 139 Misc.2d 440, 527 N.Y.S.2d 946, 56 USLW 2602 (N.Y.Sup., 1988).

Berenson, constituted marital property; however, there was no evidence at trial on the value or quantum of her career. Accordingly, while Golub raised the issue of the investment value of a celebrity's goodwill, it provided no insight into its quantification. *Elkus v. Elkus*,[41] involved the opera career of Frederica Von Stade. The court held that her career as a performing artist and its accompanying celebrity status constituted marital property, stating that "[t]hings of value acquired during the marriage are marital property even though they may fall outside the scope of traditional property concepts."[42] However, neither the trial court nor the appellate decision provided any insight into how celebrity goodwill is valued.

Recently, a New York appeals court held that an investment banker's career was divisible marital property. The asset was created because of the increased or enhanced earnings capacity of the investment banker as compared to some similarly situated individual. The court indicated that "defendant's enhanced earning capacity as an investment banker is subject to equitable distribution regardless of whether or not such a career requires a license."[43] New York is the only state that considers licenses or enhanced earnings as distributable marital property. Identifying, valuing and distributing licenses, degrees, enhanced earnings or celebrity goodwill is the clearest example of the crossover from a value in exchange concept inherent in fair market value to a value to the holder concept inherent in intrinsic value.

D. *The Wild West*

Part of the problem in attempting to compare cases, either within or between states, is that no two cases are ever exactly alike. Interestingly, two states, Washington and Colorado, have recently tackled the valuation of State Farm agencies, and arrived at two very different conclusions, again illustrating the diversity of possible results in marital dissolution valuations in the United States.

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41 169 A.D.2d 134, 572 N.Y.S.2d 901, 60 USLW 2139 (N.Y.A.D. 1 Dept., 1991), *appeal dismissed*, 588 N.E.2d 99 (N.Y. 1992).

42 *Id*. at 902.

43 Hougie v. Hougie, 1999 WL 278, 171 (N.Y.A.D. 1 Dept.).

1. *The case(s) of the State Farm agents*

In April 1993 the Washington Court of Appeals decided *In re Zeigler* case,[44] concerning the value of a State Farm insurance agency. The court found, after reviewing the State Farm Agency Agreement, which prohibits the transfer of the agency, that the goodwill was not divisible. Less than two years later, in December 1994, the Colorado Court of Appeals disregarded the State Farm Agency Agreement in *In re Graff*.[45] The *Graff* court found there was goodwill of $129,500 and awarded 50 percent of that goodwill to the wife. What's a valuation expert to do?

2. *Washington, Zeigler, 1993*

In 1981, Mr. Zeigler entered into an agreement with State Farm Insurance Company, Inc., with him as the agent. Later, the Zeigler Insurance Agency, Inc., a closely held corporation, was a "captive" agency, with Mr. Zeigler, the sole stockholder.

The agreement limited all sales to State Farm approved products, all policyholder names and information were trade secrets of State Farm, and the computer system, software, records and book of business all belonged to State Farm. The Agency could not sell or assign the book of business. Upon termination, the Agency could retain its name, staff, location, and internal procedures, but was prohibited from soliciting State Farm policyholders for one year. During that year, however, the Agency could solicit customers who were not active State Farm policyholders, or sell to State Farm policyholders who approached them for a different product. Assuming the agent complied with these termination restrictions, the Agency would be paid 20 percent of the prior year's commissions paid out monthly over five years.

The Zeigler Agency had been State Farm's most profitable one in Washington for the prior eight years, and Mr. Zeigler normally worked 10 to 11 hours per day. Even while recovering from major heart surgery, Zeilger continued to work 8-hour days, six or seven days per week.

Mr. Zeigler's expert testified that, because of the restrictive terms of the State Farm Agreement, the Agency had no goodwill.

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44 69 Wash.App. 602, 849 P.2d 695 (Wash.App.Div.3, 1993).
45 902 P.2d 402 (Colo.App., 1994).

The goodwill was owned by State Farm, and because Zeigler did not have an interest in State Farm, he did not own the goodwill, but was merely developing it for State Farm.

Mr. Zeigler's expert referred to prior Washington cases[46] and selected the capitalization of excess earnings as a valuation methodology. Based on his assumed fair rate of return of 15 percent, and the fact that he considered Mr. Zeigler's reported compensation fair, given how hard he worked, he calculated that the net income after deducting Mr. Zeigler's salary was less than his 15 percent fair rate of return. The expert thus determined that there were no excess earnings, and therefore, the value of any goodwill the Agency might have had was zero. Any success the Agency had was primarily due to the personal earning capacity and efforts of Mr. Zeigler.

Mr. Zeigler's wife, Ms. Summers, also hired an expert, who referred to the factors and methodologies in the same cases, and who also used the capitalization of excess earnings method. Summers's expert selected a 10 percent fair rate of return because it was a small closely held corporation, and adjusted Mr. Zeigler's salary to reflect industry averages. Summers's expert's calculations led to the conclusion that he had excess earnings, and goodwill valued at $231,000.

The trial court agreed with the husband's expert, deciding that because of its captive status the agency had no goodwill, and that any value the Agency may have had over and above its tangible net assets was attributable to the termination payments. The court found the "location, reputation, office organization and Zeigler Agency insurance name do not necessarily enhance the earning capacity of Mr. Zeigler."[47]

The Court of Appeals stated the major issue was whether goodwill exists in the Agency, and, if so, whether that goodwill has value. Interestingly, the court pointed out that although the prior cases dealt with professional practice goodwill, the existence of goodwill in this corporation was not dependent on any distinction between professional practices and commercial businesses.

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[46] In re Marriage of Hall, 103 Wash.2d 236, 692 P.2d 175 (Wash., 1984); In re Marriage of Fleege, 91 Wash.2d 324, 588 P.2d 1136 (Wash., 1979).

[47] In re Marriage of Zeigler, 849 P.2d 695, 698 (Wash. App., 1993).

The court noted that because of the captive status of the Agency, any goodwill or as it is defined, the expectation of continued patronage, resides with the reputation of State Farm, not with Mr. Zeigler or his Agency. Because State Farm retained the rights to the policyholder information and book of business, including renewals, and because Mr. Zeigler, after terminating his relationship with State Farm, could not solicit the State Farm customers, the court determined that the "expectation of continued public patronage attaches primarily to State Farm, not its captive agency."[48]

The Court of Appeals observed that both experts used the same method of valuation, but disagreed on fair salary and fair rate of return. The court of appeals stated that the trial court, faced with these conflicting opinions, was entitled to rely on the husband's expert's opinion that the goodwill, if any existed, had zero value. Therefore, the court of appeals held, "if the court's determination that the Agency had no goodwill was error, it was harmless."

The lone dissenting opinion stated that the elements affecting the expectation of continued public patronage, including continuity of name, location, reputation for honest and fair dealing, and individual talent and ability, are factors present at the Zeigler Insurance Agency. The Agency could still maintain its name, staff, internal procedures and location, all of which, according to the dissenter, would assure public patronage of the agency. The dissenting judge would have reversed the court's conclusion that no goodwill existed and remanded to the trial court for reconsideration of the value of the goodwill.

3. *Colorado, Graff, 1994*

Eighteen months after the Washington decision, the Colorado Court of Appeals decided a case involving a State Farm agency, with the same contract. This time the husband's expert testified that no property interest could be identified in the Al Graff Insurance Agency because of the captive agent status described in the Agency Agreement. The expert also pointed out that the Agency could not sell, assign, exchange, divide or mort-

[48] *Id*. at 698.

gage the value represented by the Agency's ability to generate income.

The wife's expert testified that the Agency was a valuable property right because, "among other factors, husband set his own hours, decided the location of his office, hired and fired his own employees and set their salary, selected and purchased his own supplies, was characterized in his State Farm contract as an independent contractor and reported his income as that of a business on Schedule C of his tax return."[49] The wife's expert, utilizing a discounted income approach, concluded that the Agency's value was $131,500, of which goodwill comprised $129,500.

The trial court found that the same restrictions that precluded the existence of goodwill in Washington in 1993 did not do so in Colorado in 1994, especially since the record contained no evidence that a transfer or termination was contemplated. Therefore, it concluded that the husband's interest constituted a property interest and agreed with the wife's expert in terms of the value of the goodwill of the Agency.[50]

The court of appeals approved the reasoning of the trial court, stating that: "the value of goodwill is not necessarily dependent upon what a willing buyer would pay for such goodwill, rather the important consideration is whether the business has a value to the spouse over and above the tangible assets. . . Goodwill may be valued even though an agreement, as here, prevents the sale of an agency."[51]

The Colorado Court of Appeals agreed with the Washington court's statement that the trial court had discretion to rely on one expert's opinion, but disagreed with the *Zeigler* majority that, as a matter of law, any goodwill attached to a local State Farm insurance agency was indistinguishably intertwined with the reputation and goodwill of State Farm.

The Colorado courts determined that even though State Farm exercised constraints on the Agency, the Agency controlled its business expenses, reported the husband's interest as a business ownership by reporting it as a Schedule C on Graff's personal tax return, the net income of the Agency had increased

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49 In re Marriage of Graff, 902 P.2d 402 (Colo. App., 1994).

50 *Id*. at p. 404.

51 *Id*. at p. 405.

under Graff's ownership, and he had no plans to terminate the State Farm relationship.

4. *Washington v. Colorado: Fair Market Value v. Intrinsic Value*

In Washington the court examined and considered tenets of fair market value, and the decision was that the State Farm agency could not be freely transferred by a willing seller. Therefore one of the key assumptions of fair market value was violated, and the agency had no fair market value. In Colorado, however, the courts agreed the agency could not be transferred, but they asked a different question: What was the value of the Agency to the owner of that agency? They inquired whether the agency had any intrinsic value or investment value, that is value to a specific owner, in this case the husband in a divorce action. The fact that the agency was not marketable was irrelevant.

IV. Conclusions

This article began by reviewing two of the most common standards of value found in marital dissolution cases, fair market value and intrinsic value. The former looks to the marketability of the asset while the latter examines the asset's value to its owner. In the context of those definitions and the underlying assumptions they imply, we compared some of the conflicting decisions in various states.

A thorough understanding of the relevant economic considerations and different standards of value, and an exploration of the thinking and case decisions in many states will hopefully provide additional insight and promote meaningful dialogue. We continue to wrestle with valuation issues in complex situations, each with its own set of facts and circumstances, while attempting to fulfill the goal of creating a fair and equitable distribution of assets between divorcing parties.