

Firm Values

A Business Valuation Publication

Presented By:



BUSINESS APPRAISAL AND LITIGATION SUPPORT SERVICES

I provide this **Firm Values** newsletter to offer insight into current information on trends in business and the appraisal industry. I hope you find it useful and welcome any of your questions or comments. If there is a topic you'd like me to discuss or report upon, please let me know. If this is your first time reading this newsletter, welcome aboard and thanks for your interest.



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Principal

This edition of **Firm Values** examines technical valuation methodologies and legal standards governing business equity determinations. Click any topic below to jump directly to the complete analysis:

- [Buy-Sell Agreements](#): Valuation Formula Pitfalls and Standard of Value Definitions
 - [Goodwill Allocation](#): Personal vs. Enterprise Goodwill in M&A Transactions and Tax Structuring
 - [Divorce Litigation Support](#): Financial Normalization and Asset Characterization in Marital Dissolution
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Buy-Sell Agreements: Avoiding Critical Valuation Pitfalls in Shareholder Agreements

Buy-sell agreements serve as the primary mechanism for managing equity transfers during trigger events such as owner death, disability, retirement, or shareholder disputes. However, many closely held businesses rely on buy-sell provisions drafted with ambiguous or rigid valuation formulas that lead to contentious litigation when triggered.

Common Valuation Pitfalls in Drafted Agreements

1. Reliance on Fixed Book Value or Arbitrary Multiples:

Formulas specifying "book value" or a fixed earnings multiple (e.g., 4x EBITDA) fail to account for changes in working capital requirements, asset appreciation, or industry consolidation. Book value reflects historical accounting costs rather than economic earning power, frequently resulting in payouts significantly above or below true Fair Market Value.

2. Ambiguity Regarding Discounts (DLOC and DLOM):

Agreements frequently stipulate "Fair Market Value" without specifying whether a **Discount for Lack of Control (DLOC)** or **Discount for Lack of Marketability (DLOM)** should apply. Courts interpret silent agreements differently depending on jurisdiction and statutory precedents, creating substantial litigation risk between exiting and remaining shareholders.

3. Stale Stated Values:

Agreements requiring shareholders to update a "Certificate of Stated Value" annually rarely maintain compliance over time. When a trigger event occurs five to ten years after the last signed certificate, parties face dispute over whether the outdated figure holds or requires judicial intervention.

Best Practices for Corporate Counsel

- **Mandate Independent Appraisal:** Specify that value will be determined by a qualified, independent business appraiser adhering to USPAP (Uniform Standards of Professional Appraisal Practice) and ASA standards upon the occurrence of a trigger event.
- **Define the Standard and Level of Value:** Explicitly define whether the standard is Fair Market Value, Fair Value, or a non-discounted pro-rata share of total enterprise value.

- **Include Detailed Normalization Guidelines:** Instruct the appraiser on how to handle discretionary expenses, non-operating assets, and owner compensation adjustments.
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Personal vs. Enterprise Goodwill: M&A Structuring & Tax Allocation Analysis

In M&A transactions involving closely held corporations, separating **personal goodwill** from **enterprise goodwill** is a central consideration for tax planning and risk mitigation.

Economic Differences Between Goodwill Types

- **Enterprise Goodwill:** Represents the intangible value inherent to the business entity itself—such as brand recognition, proprietary software, standard operating procedures, trained workforce, and location. Enterprise goodwill transfers seamlessly to a buyer regardless of key individual departures.
- **Personal Goodwill:** Represents the intangible value directly attached to an individual owner's personal reputation, technical skill set, personal client relationships, or specialized licensing. Personal goodwill belongs to the individual rather than the business entity.

Tax Implications in C-Corporation Asset Sales

When a C-corporation sells its assets, corporate-level tax applies to gains before distributions are taxed at the shareholder level (double taxation). However, if personal goodwill is owned directly by the shareholder and sold independently to the buyer:

1. The proceeds from the personal goodwill portion are taxed once at individual long-term capital gains rates.
2. The asset allocation must be supported by an independent economic appraisal and backed by evidence that the owner was not bound by a pre-existing covenant not to compete with their own company.

Quantification Methodologies

To substantiate personal vs. enterprise goodwill under IRS scrutiny (*Martin v. Commissioner* and *Norwalk v. Commissioner* precedents), appraisers apply quantitative models:

- **Multi-Attribute Utility Analysis (MAUA):** Evaluates specific key-person factors (revenue contribution, unique technical skill, direct client contact) against institutional operational factors.
 - **With-and-Without Method:** Calculates the present value of projected discounted cash flows (DCF) assuming the key individual remains versus assuming their immediate departure.
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Business Valuation in Marital Dissolution: Normalization & Asset Characterization

In family law proceedings, closely held business interests frequently represent the largest and most complex asset in the marital estate. Appraising a business for divorce requires specialized forensic accounting, normalization of income, and compliance with state-specific legal standards.

Normalization of Income & Officer Compensation

Because business owners possess operational control over financial reporting, historical financial statements must be adjusted to reflect true economic earning power:

- **Reasonable Compensation Adjustments:** Owners may take below-market salaries to reinvest in growth, or above-market compensation and discretionary perks for tax management. Appraisers replace actual historical compensation with benchmark officer salary data (filtered by NAICS code, revenue size, and geographic market) to establish normalized operating income.
- **Discretionary and Non-Operating Items:** Discretionary family expenses, non-business real estate holdings, and personal travel/entertainment are eliminated from normalized EBITDA.
- **Non-Recurring Events:** One-time legal settlements, extraordinary litigation fees, or temporary pandemic disruptions are removed to establish representative ongoing cash flow.

Active vs. Passive Appreciation Analysis

In jurisdictions where separate property claims are raised, courts must distinguish between:

- **Passive Appreciation:** Increase in business value driven by market inflation, macroeconomic growth, or industry-wide multiples expansion.
- **Active Appreciation:** Increase in business value resulting from personal effort, capital investment, or operational contributions made during the marriage.

Appraisers build multi-period historical models isolates these economic forces to establish defensible separate vs. community property allocations.

Capitalization & Discount Rates: Cost of Capital Adjustments

Determining appropriate discount and capitalization rates within Income Approach models (such as the Discounted Cash Flow method) requires rigorous market analysis. Small adjustments to discount rates may exert a significant impact on final equity determinations.

Key Components of Capitalization Rate Derivation

1. Cost of Equity via Build-Up Method:

$$\text{Cost of Equity} = R_f + ERP + SSRP + CSRP$$

- **Risk-Free Rate (R_f):** Yields on long-term U.S. Treasury bonds.
- **Equity Risk Premium (ERP):** Long-term market risk compensation above risk-free assets.
- **Size Risk Premium (SSRP):** Micro-cap equity adjustments reflecting lower market liquidity and scale.
- **Company-Specific Risk Premium (CSRP):** Subjective risk adjustments based on internal operational factors.

2. Evaluating Company-Specific Risk (CSRP):

Appraisers must quantify internal operational vulnerabilities, including:

- **Customer Concentration:** High dependence on a single customer or top-tier client group.
- **Key-Person Dependency:** Operational reliance on a founder without depth in second-tier management.
- **Financial Leverage & Working Capital Stability:** Liquidity constraints or debt service burdens relative to industry peers.

3. Weighted Average Cost of Capital (WACC):

For enterprise valuation, equity costs are blended with net after-tax borrowing costs based on an optimal target capital structure, ensuring that debt service and debt capacity are properly reflected in enterprise value estimates.

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