

The Impact of Rule 1.17: Valuing Law Practices in Divorce
and Other Contexts

by

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INTRODUCTION

The enactment of Supreme Court Rule 1.17 on the sale of a law practice removes an existing inequity in the treatment of lawyers based upon the legal nature of the entity within which they practice law. The valuation of a law practice has its own unique aspects which set these valuations apart from the valuation of other professional practices. The purpose of this article is to analyze the case law relevant to valuation of law practices; to describe and explain the methodology used to value law practices; to suggest various issues to be covered in cross-examination of a valuation expert; and to address certain practical problems arising in the context of valuing law practices.

I. Rule 1.17 *(the text of the rule appears in the Appendix to these materials)*

a. History of the Rule

Before Rule 1.17 ethical restrictions existed which, by their practical effect, made it impossible for solo or individual practitioners to "sell" their practices. Restrictions on fee-splitting, on sharing fees with non-lawyers, on transfers of client papers and property, and regarding client confidentiality all coalesced to create an environment within which individual lawyers could not ethically "sell" an ongoing practice to another lawyer.¹ In our state, the Office of Chief Disciplinary Counsel had issued various advisory opinions, both formal and informal,

which taken together made it practically impossible to sell one's law practice to another lawyer.

This ethical prohibition was inequitable and discriminated against the individual practitioner by prohibiting him or her from selling an business asset built over time, like any other entrepreneur. Attorneys practicing with others had no such restriction; a buy-sell agreement in a group practice or professional corporation was, and is, allowed.

The Model Rules of Professional Conduct did not affirmatively provide for the sale of a law practice before the ABA House of Delegates passed Model Rule 1.17. "While the model rules of professional conduct [did] not necessarily specifically prohibit the sale of a law practice, they [had] been interpreted by state supreme courts and disciplinary bodies not to allow a law practice to be sold if you are a solo practitioner."ⁱⁱ In 1988, the State of California passed a statute expressly allowing the sale of a law practice, and in 1990, the ABA followed suit in passing Model Rule 1.17.ⁱⁱⁱ The General Practice Section of the Missouri Bar adopted a variant of the Model Rule in April, 1990, and the resolution sat with the Board of Governors of the Missouri Bar from April 1990 until its ultimate adoption by the Missouri Supreme Court in August, 1994.^{iv} Our Missouri Rule 1.17 substantially follows the model rule. The adoption of Rule 1.17 creates the ability for any lawyer to sell his or her practice in

its entirety, including goodwill.

The Missouri Supreme Court did not, at the time it enacted Rule 1.17, make changes to the other rules of professional conduct contemplated by the model rule. For instance, Rule 5.4 prohibits lawyers or law firms from sharing legal fees with nonlawyers. The Model Rule and the Missouri rule anticipate that the estate of a deceased lawyer may be the seller of the practice; however, only the Model Rule amends Rule 5.4 to provide:

...a lawyer who undertakes to complete unfinished legal business of a deceased lawyer may pay to the estate of the deceased lawyer that proportion of the total compensation which fairly represents the services rendered by the deceased lawyer; and

a lawyer who purchases a practice from the estate of a deceased lawyer, or from any person acting in a representative capacity for a disabled or disappeared lawyer, may, pursuant to the provision of Rule 1.17, pay to the estate or other representative of that lawyer the agreed upon price...^v

Missouri Rule 5.6, consistent with the existing Model Rule 5.6, bars restrictions upon the right of a lawyer to practice law after termination of a partnership or employment agreement. However, ABA Model Rule 5.6 was amended to give Model Rule 1.17 wide berth: "This Rule does not apply to prohibit restrictions that may be included in the terms of the sale of a law practice pursuant to Rule 1.17." The Missouri Rule expresses a similar sentiment: "The seller and purchaser may agree to restrictions on the practice of law by the seller, which shall be set forth in a written agreement."^{vi}

The effective date of the new Missouri rule is July 1, 1995.

II. WHAT ARE WE VALUING?

Law practices, like other professional practices and business entities, are comprised of both tangible and intangible assets. It is the valuation of the intangibles which leaves the most room for subjectivity on the part of the appraiser. The article will first address the tangibles and suggest specific considerations which should be made in the valuation; the appraisal of the intangibles will be considered thereafter.

a. Cash or Accrual Accounting.

If the records of the practice are maintained on a cash, rather than accrual basis, the balance sheet will have to be adjusted by the evaluator in order to more accurately reflect the financial status of the practice at the time of the appraisal.

"Cash basis" accounting means income collected by the practice is reported as earned, and expenses are recorded after they are paid. "Accrual basis" accounting means income to the practice is reflected as earned, whether collected or not, and expenses are recorded when incurred, whether or not paid. This is an all-important distinction in reviewing the tangible assets of the practice, because if you are limited to a cash basis review, your evaluation will suffer from acute myopia. In addition to creating a more accurate "big picture" for the financial status of the practice, accrual accounting limits the opportunities which are otherwise available for misrepresentation.

b. Which are the tangibles?

The tangible assets are relatively uncomplicated, and generally appear on the balance sheet. They are typically cash in the bank, furniture, equipment and investments. Note that the accounts receivable will not appear on the balance sheet of a cash-basis entity. The reason is that cash basis accounting records income when it is actually *received*, rather than when the lawyer becomes *entitled* to receive it. The same holds true for payables. Most law smaller law firm accounting is done on a cash basis. Therefore, the evaluator needs to request separately the accounts receivable records.

1. Cash-In adjusting the balance sheet to the accrual basis, the cash picture will become clearer. The evaluator should make certain that none of the funds in the firm's trust account have been earned; to the extent earned monies remain in the trust account, adjustments should be made.

2. Accounts receivable-In reviewing these accounts, the appraiser should confirm the accounts sent out for collection are included in the list. Many times such accounts are written off the books of the firm as bad debts when they are sent out, when in fact they may be of some value if pursued. If you are representing the attorney selling the practice, make sure he or she has written the bad debts off of the books before the evaluation is performed. We are attorneys and not businesspeople; sometimes bad debts remain on the books for years, even though there is no prospect for collection. Such accounts should not be

included in a valuation of the practice.

After the write-offs, accounts receivable should also be adjusted for their collectability. This can be done in two different ways. It may be that the practice has experienced a history of write-offs capable of being quantified on a percentage basis. Alternatively, the accounts receivable may be aged, and a discount factor applied by the evaluator for older receivables in an effort to estimate their true collectability. Either way, it would be inequitable to assume that the receivables on the books of the firm represent 100-cent dollars, and some method must be agreed-upon to fairly reflect this.

Finally, but perhaps most importantly, receivables should be considered in conjunction with, and offset by, the accounts payable. The payables will not appear on the balance sheet of a cash-basis entity, but must be obtained to insure a fair evaluation.

3. Work in process- These are also sometimes called "unbilled accounts receivable" and are unique to professional practices in which compensation is based upon time, such as in the legal or the accounting realms. These are reflected in time records. Further, many law office accounting or billing software packages have the capability to prepare detailed work-in-process reports. Where matters are handled on a contingent fee arrangement, their worth may be estimated based upon the history experienced by the firm or lawyer, or on a case by case basis.

4. Prepaid expenses- In the adjustment from cash basis to accrual basis, prepaid expenses will become clear. This most frequently appears with respect to professional liability insurance. To the extent expenses have been prepaid, a corresponding adjustment should appear which eliminates the future liability to the extent of the prepayment, and accordingly increases the value of the enterprise.

5. Equipment-Examine depreciation schedules to determine what equipment exists; independent walk-through appraisal may be necessary. Some equipment may already have been depreciated off the books, but still have value. "Book value" does not reflect the fair market value of the asset- "book value" is only an accounting construct.

6. Leasehold improvements- In some circumstances, the leasehold improvements may increase the value of the enterprise, even though they remain with the landlord at the conclusion of the lease.

c. What about the liabilities?

Liabilities against the firm should also be fairly reflected in any appraisal of the value of the practice.

1. Payables- As noted above, the payables should offset the receivables to fairly reflect the expected cash flow.

2. Accrued liabilities-Unpaid payroll and payroll taxes, interest due on notes, and other miscellaneous obligations of the lawyer related to the practice should be reflected.

3. Leasehold obligations and Contingent liabilities- These ongoing obligations of the practice must be addressed. Outstanding professional liability suits should also be listed and factored in some manner by the appraiser. Such a consideration will more likely affect the goodwill value, rather than the tangible asset value of the firm.

d. What are the intangibles?

The most controversial area of professional practice valuation is the subject of appraising the intangible value of the enterprise. This subject is most often lumped into the topic of "goodwill"; however, goodwill is merely a component, albeit the most readily identifiable and recognized component, of the value of a professional practice.

Definitions of "intangible worth" and "goodwill" vary widely and the discrepancy most frequently has to do with the breadth of the definition. Accountants have a different perspective from appraisers, and both may have a different perspective from people in the business. In divorce cases, the goodwill of a professional practice is as defined by the case law of the jurisdiction.

The seminal Missouri case is Hanson v. Hanson.^{vii} Hanson was a consolidation of two cases in which the husbands were the sole partners in an oral surgery partnership. In Hanson, the Missouri Supreme Court granted transfer to determine whether Missouri law recognized the existence of goodwill in a professional practice as

a marital asset and to determine the extent to which those laws permit the division of such goodwill upon dissolution of the marriage.

The Hanson court defined goodwill as "...the value of the practice which exceeds its tangible assets and which is the result of the tendency of clients/patients to return to and recommend the practice irrespective of the reputation of the individual practitioner."^{viii} This is an important definition, because by its terms it excludes all definitions of goodwill which are inconsistent therewith. In defining goodwill, the court specifically stated "[i]t is property which attaches to and is dependent upon an existing business entity; the reputation and skill of an individual entrepreneur-- be he a professional or a traditional businessman-- is not a component of the intangible asset we identify generally as goodwill." Thus, the commonly held perception that goodwill reflects the reputation and skill of the professional, is inconsistent with Hanson.^{ix}

On this subject, one consideration is the effect of a covenant of non-competition. In appraising a professional practice, the various available methodology should seek to replicate the value of the practice on the open market. It stretches credulity to suggest that one professional would buy the practice of another professional without obtaining a covenant of non-competition in the bargain. The absence of such a covenant would surely deflate the fair market value of the practice.

However, under Hanson goodwill should not be representative of the reputation and skill of the professional but rather it should be some intangible value in excess of the worth of the tangible hard assets. In Theilen v. Theilen^x, the court held that the value of a covenant not to compete should be excluded from a determination of the existence of goodwill. "Perhaps a reason for this rule is that no professional practitioner is required to give up his profession in order to be divorced. Therefore, any value attributable to a theoretical non-competition covenant should be excluded from the calculation."^{xi} The author interprets this language as meaning the value of a covenant of non-competition should not be considered on the precise question of valuation; however, as a practical matter if value is intended to reflect fair market value, it is inconceivable that the effect of a covenant of non-competition should not be considered in determining value.

III. THE METHODOLOGY OF VALUATION

All approaches to value must in some manner relate to future cash flow. Buyers are interested in paying a seller an amount based not on what was generated in the past, but rather based upon what the buyer considers a likely future return on his/her investment.

The primary approaches to the valuation of a professional practice are variations of the following:

1. Fair market value based upon the comparable

transactions;

2. Asset based approaches;
3. Earnings based approaches, including excess earnings or the "formula" approach.

These approaches will be discussed in order below:

A. Fair market value based upon comparable transactions--

The fair market value approach is the most widely employed standard of value. It represents the present value of the expected cash flow a willing buyer is willing to purchase and a willing seller is willing to sell.^{xii} In the Hanson decision, the Supreme Court of Missouri demonstrated a clear preference for the fair market value approach:

Because of the difficulties inherent in separating the reputation of the professional from that of his enterprise, evidence that other professionals are willing to pay for goodwill when acquiring a practice is, in our view, the only acceptable evidence of the existence of goodwill. Thus, as a matter of proof, the existence of goodwill is shown only when there is evidence of a recent actual sale of a similarly situated professional practice, an offer to purchase such a practice, or expert testimony and testimony of members of the subject profession as to the existence of goodwill in a similar practice in the relevant geographic and professional market. Absent such evidence, one can only speculate as to the existence of goodwill.^{xiii}

According the Hanson court, the fair market value method is most likely to avoid the "disturbing inequity in compelling a professional practitioner to pay a spouse a share of intangible assets at a judicially determined value that could not be realized by a sale or another method of liquidating value."^{xiv}

The standard of proof established by the Hanson court is a heavy one indeed, especially where comparable sales of law practices are concerned. In all likelihood, there are none.

B. Asset-based approaches--

Valuation approaches based upon the book value of an asset are inherently unreliable in this context, but are approved nonetheless. The standard of valuations everywhere, Revenue Ruling 59-60, approves the approach. However, the approach may not be germane where human capital, not fixed assets such as in a manufacturing business, generate the revenue.

It is important to remember that book value is an accounting construct, not an economic one. It represents the difference between the accounting measurement of the assets and the reported liabilities. Such calculations may bear no relationship whatsoever to actual value, and represent only figures reported on the books according to prescribed accounting conventions. Such an approach is a poor indicator of fair market value, its primary flaw being that it is not designed to capture or illustrate the value of a professional practice's expected cash flows.^{xv} Such approaches more closely approximate liquidation, rather than fair market value.

C. Earnings-Based Approaches, including Excess Earnings

Commonly called the "formula approach" referring to the formula described in Revenue Ruling 68-609 (see the Appendix, infra) this approach was originally developed by the Internal

Revenue Service in 1920 to value the intangible worth of distilleries forced out of business by the 18th Amendment. The is based upon normalizing the earnings of the business, and applying a capitalization rate to the excess earnings to reach a value. The determination of the capitalization rate is the most subjective part of the process. Once the value is determined by the capitalization of the excess earnings, the known value of the tangible assets is subtracted and *voila!*, you have created a value for both tangible and the intangible assets of the practice.

The primary weakness of this approach is that it separates income derived by or from tangible and intangible assets based upon purely subjective determinations and is based upon data from 1913.^{xvi}

IV. SUGGESTED AREAS FOR CONSIDERATION

An outline of suggested areas for consideration:

Carefully consider the methodology where possible- especially where a capitalization of earnings method was used. Such a method, by the express terms of R.R. 68-609, is the approach of last resort.

Was any consideration given to whether a covenant not to compete would be included in any hypothesized deal to buy the practice?

Were the accounts receivable properly discounted for payables owing? For taxes, overhead, and collectibility?

Were write-offs and write-downs considered on the work in process?

V. CONCLUSION

The valuation of a law practice will always carry with it some level of subjectivity due to the present lack of comparable sales. However, the adoption of Rule 1.17 may create an environment within which more individual practitioners are selling practices. Until this begins to occur, other methods of valuation will be used; although disapproved by the Hanson court, asset-based methods and capitalization of earnings or formula based evaluations will be the rule, rather than the exception. The likelihood of attaching an intangible or goodwill value to a law practice using those methodologies appear to be remote.

APPENDIX

The text of Supreme Court Rule 1.17 is as follows:

SUPREME COURT OF MISSOURI
en banc
IN RE: ADOPTION OF A NEW SUBDIVISION 1.17, ENTITLED
"SALE OF LAW PRACTICE," OF SUPREME COURT RULE
4, ENTITLED "RULES OF PROFESSIONAL CONDUCT"

August 19, 1994
Effective July 1, 1995

ORDER

1. It is ordered that effective July 1, 1995, subdivision 1.17 of Supreme Court Rule 4 be and the same is hereby adopted to read as follows:

RULE 1.17 SALE OF LAW PRACTICE

A lawyer or his or her law firm may sell or purchase a law practice, including good will, if the conditions set forth in this Rule 1.17 are satisfied. The seller and purchaser may agree to restrictions on the practice of law by the seller, which shall be set forth in a written agreement. The estate of a deceased lawyer may be a seller.

(a) The practice shall be sold as an entirety, except in cases in which a conflict is present or may arise, to another lawyer or law firm.

(b) Written notice shall be given to each of the seller's clients stating that the interest in the law practice is being transferred to the purchaser; that the client has the right to retain other counsel; that the client may take possession of the client's file and property; and that if no response to the notice is received within sixty days of the sending of such notice, or in the event the client's rights would be prejudiced by failure to act during that time, the purchaser may act on behalf of the client until otherwise notified by the client.

(1) If the seller is the estate of a deceased lawyer, the purchaser shall cause the notice to be given to the client, and the purchaser shall obtain the written consent of the client to act on the client's behalf. Such consent shall be presumed if no response to the notice is received within sixty days of the date the notice was sent to the client's last known address as shown on the records of the seller or the client's rights would be prejudiced by a failure to act during such sixty day period.

(2) In all other circumstances, not less than sixty days prior to the transfer the seller shall cause the notice to be given to the client and the seller shall obtain the written consent of the client to act on the client's behalf prior to the transfer. Such consent shall be presumed if no response to the notice is received within sixty days of the date of the sending of such notice to the client's last known address as shown on the records of the seller.

(3) The purchaser shall cause an announcement or notice of the purchase and transfer of the practice to be published in a newspaper of general circulation within the county in which the practice is located at least thirty days in advance of the effective date of the transfer.

(c) The fees charged to clients shall not be increased by reason of the sale of the practice. The purchaser may, however, refuse to undertake the representation unless the client

consents to pay the purchaser fees at a rate not exceeding the fees charged by the purchaser for rendering substantially similar services prior to the initiation of the purchase negotiations.

(d) If substitution of purchasing lawyer or law firm in a pending matter is required by the tribunal or this Rule 1.17, the purchasing lawyer or law firm shall provide for same promptly.

(e) Admission to or withdrawal from a partnership or professional corporation, retirement plans and similar arrangements or a sale limited to the tangible assets of a law practice is not a sale or purchase for purposes of the Rule 1.17.

3. It is ordered that notice of this order be published in the Journal of The Missouri Bar.

4. It is ordered that this order be published in the South Western Reporter.

Day-to-Day
JOHN C. HOLSTEIN
Acting Chief Justice

REVENUE RULING 59-60

REVENUE RULING 59-60

In valuing the stock of closely-held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach,

methods and factors which must be considered in valuing such securities are outlined.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely-held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

SECTION 2. BACKGROUND AND DEFINITIONS.

.01 All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032 and 2512(a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

.02 Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations 108) define fair market value, in effect, 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 willing, to trade and to be well informed about the property and concerning the market for such property.

.03 Closely-held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock is issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no establisher market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

SECTION 3. APPROACH TO VALUATION.

.01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable

attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02 The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03 Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or similar line of business are selling in a agree and open market.

SECTION 4. FACTORS TO CONSIDER.

.01 It is advisable to emphasize that in the valuation of the stock of closely-held corporation where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

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

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

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

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of

stock to be valued.

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

.02 The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

(b) A sound appraisal of a closely-held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries.

Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of

management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services.

These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, (3) preference as to assets in the event of liquidation.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are

made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five- or ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded that most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have relation to dividend-paying capacity. Specifically, the dividends paid by a closely-held family company may be measured by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends, is discretionary with the controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders.

The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understanding the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria for fair market value than other applicable factors.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

(g) Sales of stock of a closely-held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely-held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(h) Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stacks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed in an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-

counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issue of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

SECTION 5. WEIGHT TO BE ACCORDED VARIOUS FACTORS.

The valuation of closely-held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To Illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

(b) the value of the stock of the closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely-held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend-paying capacity.

SECTION 6. CAPITALIZATION RATES.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of the corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely-held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

SECTION 7. AVERAGE OF FACTORS.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

SECTION 8. RESTRICTIVE AGREEMENTS.

Frequently, in the valuation of closely-held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bonafide

business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2,255, and Rev. Rul. 189, C.B. 1953-2,294.

SECTION 9. EFFECT ON OTHER DOCUMENTS.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.

REVENUE RULING 65-192

(*excerpted*)

The general approach, methods and factors outlined in Revenue Ruling 59-60, C.B. 1959-1, 237, for use in valuing closely-held corporate stocks for estate and gift tax purposes are equally applicable to valuations thereof for income and other tax purposes and also in determinations of the fair market values of business interests of any type and of intangible assets for all tax purposes...

REVENUE RULING 68-609

REVENUE RULING 68-609

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the currently outstanding portions of A.R.M. 34, C.B. 2, 31 (1920), A.R.M. 68, C.B. 3, 43 (1920), and O.D. 937, C.B. 4, 43 (1921).

The question presented is whether the "formula" approach, the capitalization of earnings in excess of a fair rate of return on net tangible assets, may be used to determine the fair market value of the intangible assets of a business.

The "formula" approach may be stated as follows:

A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say 15 to 20 percent, is the value of the intangible assets of the business determined under the "formula"

approach.

The percentage of return on the average annual value of the tangible assets used should be the percentage prevailing in the industry involved at the date of valuation, or (when the industry percentage is not available) a percentage of 8 to 10 percent may be used.

The 8 percent rate of return and the 15 percent rate of capitalization are applied to tangible and intangibles, respectively, of businesses with a small risk factor and stable and regular earnings; the 10 percent rate of return and 20 percent rate of capitalization are applied to businesses in which the hazards of business are relatively high.

The above rates are used as examples and are not appropriate in all cases. In applying the "formula" approach, the average earnings period and the capitalization rates are dependent upon the facts pertinent thereto in each case.

The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business. See *Lloyd B. Sanderson Estate v. Commissioner*, 42 F. 2d 160 (1930). Further, only the tangible assets entering into net worth, including accounts and bills receivable in excess of accounts and bills payable, are used for determining earning on the tangible assets. Factors that influence the capitalization rate include (1) the nature of the business, (2) the risk involved, and (3) the stability or irregularity of earnings.

The "formula" approach should not be used if there is better evidence available from which the value of intangibles can be determined. If the assets of a going business agree sold upon the basis of a rate of capitalization that can be substantiated as being realistic, though it is not within the range of figures indicated here as the ones ordinarily to be adopted, the same rate of capitalization should be used in determining the value of intangibles.

Accordingly, the "formula" approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefor available.

See also Revenue Ruling 59-60, C.B. 1959-1, 237, as modified by Revenue Ruling 65-193, C.B. 1965-2, 370, which sets forth the proper approach to use in the valuation of closely-held corporate stocks for estate and gifts tax purposes. The general approach, methods, and factors, outlined in Revenue Ruling 59-60, as modified, are equally applicable to valuations of corporate stocks for income and other tax purposes as well as for estate and gift tax purposes. They apply also to problems involving the determination of the fair market value of business interests of

any type, including partnerships and proprietorships, and of intangible assets for all tax purposes.

A.R.M. 34, A.R.M. 68, and O.D. 937 are superseded, since the positions set forth therein are restated to the extent applied under current law in this Revenue Ruling. Revenue Ruling 65-192, C.B. 1965-2, 259, which contained restatements of A.R.M. 34 and A.R.M. 68, is also superseded.

ENDNOTES

i. See generally Rule 4, MRCP, and the following Rules of Professional Conduct set forth therein: Rule 1.16(d) restricting the transfer of client papers and property, which was read in Formal Opinion No. 115 as prohibiting a lien on client papers and inferentially prohibited any such transfer of client papers; Rule 1.6 regarding confidentiality of information, which was cited in a recent informal advisory opinion as prohibiting the sale of client lists; Rule 1.5 restricting fee-splitting between lawyers who are not in the same firm; Rule 5.4 restricting the sharing of fees with non-lawyers (read in the context of the lawyer's surviving spouse); and Rule 5.6, prohibiting any agreement restricting the lawyers right to practice law and its effect upon the likelihood of obtaining a covenant not to compete as part of the sale of a practice.

ii. Alan E. DeWoskin, "End Discrimination Against Solo Practitioners," in 7 Missouri Lawyers' Weekly 803, September 13, 1993. Mr. DeWoskin is the former Chair of the General Practice Section of the American Bar Association and was a member of the ABA House of Delegates at the time this rule was passed. He was a member of the Writing Task Force of the General Practice Section, and the primary drafter of the Model Rule.

iii. See note 2, above.

iv. Interview with Alan E. DeWoskin, December, 1994.

v. ABA Model Rule 1.17, (1990).

vi. Missouri Rule 1.17, (1994).

vii. 738 S.W.2d 429 (Mo. banc 1987).

viii. Id. at 434.

ix. Here is a comprehensive listing of the Missouri cases after Hanson addressing the determination and value of professional goodwill in divorce cases:

Taylor v. Taylor, 736 S.W. 2d 388 (Mo. banc 1987).

Parker v. Parker, 762 S.W. 2d 506 (Mo. App. E.D. 1988).

Johnston v. Johnston, 778 S.W. 2d 674 (Mo. App. W.D. 1989).

Heutel v. Heutel, 803 S.W. 2d 84 (Mo. App. E.D. 1989).

Richardson v. Richardson, 803 S.W. 2d 45 (Mo. App. E.D.1990).

Wilson v. Wilson, 822 S.w. 2d 917 (Mo. App. E.D. 1991).

Cohn v. Cohn, 841 S.W. 2d 782 (Mo. App. E.D. 1992).

Gerard v. Gerard, 825 S.W. 2d 21 (Mo. App. W.D. 1992).

Theilen v. Theilen, 847 S.W. 2d 116 (Mo. App. W.D. 1992).

x. 847 S.W. 2d 116 (Mo. App. W.D. 1992).

xi. Id. at 120.

xii. B. O'Rourke and L. Barenbaum, in Valuing Professional Practices and Licenses: A Guide for the Matrimonial Practitioner, Ronald L. Brown, ed. (2nd ed. 1994), at § 6.02 (herein "Brown").

xiii.Id. at 435.

xiv. Hanson at 436.

xv. Brown, supra, at §6.04.

xvi. Brown, Supra, at §6.