

Winter 1990

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Recommended Citation

Wm. David Taylor III, *Minnesota Key Person Discount Rule: A Useful Tool for Missouri Divorce Cases Involving Closely Held Businesses, The*, 55 Mo. L. REV. (1990)

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COMMENTS

THE MINNESOTA KEY PERSON DISCOUNT RULE: A USEFUL TOOL FOR MISSOURI DIVORCE CASES INVOLVING CLOSELY HELD BUSINESSES

I. INTRODUCTION

When a divorcing spouse owns all or part of a business, attorneys for both spouses must deal with complex issues of business valuation. With increasing frequency, courts in Missouri and elsewhere are applying sophisticated valuation concepts from the fields of accounting, tax, and corporate law in such situations, particularly when the business is a closely held corporation. The legal complexities thus created insure that few divorces involving closely held, spouse-owned businesses will be simple ones. These complexities, however, also offer the well-prepared attorney opportunities for successful advocacy.

During the 1980's, the courts of Minnesota have taken the position that, in divorces, key person discounts must be used in valuing businesses if the owner-spouse has key person status in the business.¹ The Missouri courts have not addressed yet the use of such discounts in marital dissolution cases. Recent Missouri decisions, however, have paid increased attention to valuation of spouse-owned businesses during divorce, using analytical approaches similar to those frequently used in Minnesota cases.² These opinions suggest that Missouri courts might look favorably on the use of key person discounts in appropriate cases. The two states also have similar statutory provisions regarding property distribution in divorce, and are among the minority of states which have

1. For discussion of key person discounts, *see infra* notes 21-35 and accompanying text. For discussion of Minnesota's key person discount rule, *see infra* notes 36-98 and accompanying text.

Although "key person" is the preferable term, many courts still refer to this discount as a "key man" discount, something which must be kept in mind for research purposes.

2. *See infra* notes 110-44 and accompanying text.

adopted the Uniform Marriage and Divorce Act.³ Thus, Minnesota's common law rule on the use of key person discounts constitutes a potentially useful tool for family law practitioners in Missouri.

3. Missouri and Minnesota are two of the four common law, equitable distribution states which have adopted the Uniform Marriage and Divorce Act (the others are Illinois and Kentucky). UNIF. MARRIAGE AND DIVORCE ACT, 9A U.L.A. 4 (Supp. 1989).

The Missouri statute governing property distribution in marital dissolution cases reads in pertinent part as follows:

1. In a proceeding for dissolution of the marriage . . . the court shall set apart to each spouse his nonmarital property and shall divide the marital property in such proportions as the court deems just after considering all relevant factors including:

(1) The economic circumstances of each spouse at the time the division of property is to become effective, including the desirability of awarding the family home or the right to live therein for reasonable periods to the spouse having custody of any children;

(2) The contribution of each spouse to the acquisition of the marital property, including the contribution of the spouse as a homemaker;

(3) The value of the nonmarital property set apart to each spouse;

(4) The conduct of the parties during the marriage; and

(5) Custodial arrangements for minor children.

MO. REV. STAT. § 452.330.1 (Supp. 1989)

Minnesota's statute reads in pertinent part as follows:

Upon a dissolution of a marriage . . . the court shall make a just and equitable division of the marital property of the parties without regard to marital misconduct, after making findings regarding the division of the property. The court shall base its findings on all relevant factors including the length of the marriage, any prior marriage of a party, the age, health, station, occupation, amount and sources of income, vocational skills, employability, estate, liabilities, needs, opportunity for future acquisition of capital assets, and income of each party. The court shall also consider the contribution of each in the acquisition, preservation, depreciation or appreciation in the amount or value of the marital property, as well as the contribution of a spouse as a homemaker. It shall be conclusively presumed that each spouse made a substantial contribution to the acquisition of income and property while they were living together as husband and wife.

MINN. STAT. § 518.58(1) (1988).

The major difference between the two statutes is their treatment of marital misconduct. The Uniform Act and the Minnesota statute bar consideration of marital misconduct in the distribution of property. The Missouri legislature declined to adopt a pure "no-fault" system of divorce, and mandated consideration of marital misconduct in the context of property distribution.

II. VALUING CLOSELY HELD BUSINESSES IN DIVORCE CASES

In marriage dissolution cases, Missouri courts must determine the fair market value of spouse-owned businesses in order to fulfill their judicial duty to equitably distribute the property of the spouses.⁴ This

4. See MO. REV. STAT. § 452.330.1 (Supp. 1989). Equitable distribution requires the court to consider each asset belonging to the spouses in the light of four legal issues: (1) identification, (2) characterization, (3) valuation, and (4) distribution. Levy, *An Introduction to Divorce-Property Issues*, 23 FAM. L.Q. 147 (1989); see also C. FOOTE, R. LEVY & F. SANDER, *CASES AND MATERIALS ON FAMILY LAW* 619 (3d ed. 1985). In other words, the court must determine (1) whether the asset is in fact "property" for purposes of divorce, (2) whether the asset is marital or nonmarital, (3) how much the asset is worth, and (4) how much of the asset each spouse should get. The valuation issue is discussed *infra* at notes 4-20 and accompanying text.

One example of the identification issue is the question of whether goodwill in a professional practice belonging to a spouse is property which should be distributed in divorce. Compare *Golden v. Golden*, 270 Cal. App. 2d 401, 75 Cal. Rptr. 733 (1969) (goodwill in a solo professional practice is property subject to distribution in a dissolution action) with *Holbrook v. Holbrook*, 103 Wis. 2d 327, 309 N.W.2d 343 (1981) (professional goodwill is not property divisible in a divorce) and *Hanson v. Hanson*, 738 S.W.2d 429 (Mo. 1987) (en banc) (goodwill in a professional practice is property subject to division in dissolution proceedings, but only where evidence establishes that other professionals are willing to pay for its presence). Another much-litigated example is the question of whether a professional degree is property subject to distribution. Compare *Woodworth v. Woodworth*, 337 N.W.2d 332 (Mich. Ct. App. 1983) (a professional degree earned during marriage is property subject to division) with *In re Marriage of Goldstein*, 97 Ill. App. 3d 1023, 423 N.E.2d 1201 (1981) (professional degrees are not property to be distributed in divorce) and *DeLa Rosa v. DeLa Rosa*, 309 N.W.2d 755 (Minn. 1981) (denying distribution of the value of a professional degree as property, but awarding restitution for the non-degree holding spouse's financial contribution to the cost of the degree).

The characterization issue is presented in states, like Missouri and Minnesota, which distinguish nonmarital or separate property from marital or community property, and distribute only the latter when a marriage is dissolved. See MO. REV. STAT. § 452.330 (Supp. 1989); MINN. STAT. §§ 518.54, 518.58(1) (1988). For an example of the litigational complexities which can arise, see *Van de Loo v. Van de Loo*, 346 N.W.2d 173 (Minn. Ct. App. 1984) (a spouse's personal injury award from a prior accident must be split between special damages for lost income, which are marital property, and amounts recovered for pain and suffering, which are nonmarital).

The distribution issue is presented by the judicial discretion inherent in statutes calling for equitable rather than necessarily equal distribution. See, e.g., MO. REV. STAT. § 452.330 (Supp. 1989); see also *Sarandos v. Sarandos*, 643 S.W.2d 854, 856 (Mo. Ct. App. 1982) (approving a 60-40 or even a 70-30 split);

is no simple task, since the fair market value of a company "is not susceptible of determination by any precise mathematical computation and no one formula or figure is binding or conclusive."⁵ Since the court must make an "informed judgment," the valuation must take into account all of the relevant facts and circumstances of the case.⁶

Valuation of a company is more difficult if the business is closely rather than publicly held. A closely held corporation is one "in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying and selling."⁷ Because stock in public corporations is regularly traded in recognized markets, calculating the value of an interest in such a corporation is relatively simple. The absence of a similar, value-setting market mechanism for closely held businesses means that their value must be established through other methods.⁸

Arp v. Arp, 572 S.W.2d 232, 235 (Mo. Ct. App. 1978) (approving a 72-28 split).

5. *Miranda v. Miranda*, 596 S.W.2d 61, 65 (Mo. Ct. App. 1980) (commenting on valuation of a closely held corporation in a marital dissolution case) (quoting *Flarsheim v. Twenty Five Thirty Two Broadway Corp.*, 432 S.W.2d 255 (Mo. 1968)).

6. *Id.* As the Connecticut Supreme Court observed, "Since valuation of [a closely held business] is, in essence, a prophecy as to the future, it is important that the prognostication be based on an examination of the appropriate financial tea leaves." *Turgeon v. Turgeon*, 190 Conn. 269, 276, 460 A.2d 1260, 1265 (1983) (involving valuation of a spouse's closely held machine shop).

7. *Lavene v. Lavene*, 162 N.J. Super. 187, 192, 392 A.2d 621, 623 (Ct. App. Div. 1978) (outlining various valuation methods applicable in divorce cases involving closely held corporations); see also 2 VALUATION AND DISTRIBUTION OF MARITAL PROPERTY § 22.01[2][a] (J. McCahey ed. 1988) ("A close corporation is generally distinguishable from other business corporations only by the fact that ownership of shares is restricted to a selected group of persons who are usually closely involved with the operation of the business. A close corporation, thus, differs from a public corporation in that the shareholders more often actively participate in the management.")

8. The Court of Claims has noted that "an unlisted closely held stock of a corporation . . . in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public." *Central Trust Co. v. United States*, 305 F.2d 393, 405 (Ct. Cl. 1962); see also *In re Marriage of Hewitson*, 142 Cal. App. 3d 874, 886, 191 Cal. Rptr. 392, 399 (1983) ("closely held corporations possess characteristics which make them inherently different from publicly held corporations, with the primary difference being the lack of marketability, i.e., liquidity of close corporation stock").

For a discussion of the similarities and differences in valuation of public and closely held corporations, see Haynsworth, *Valuation of Business Interests*, 33 MERCER L. REV. 457, 458-60 (1982).

Valuation of a divorcing spouse's closely held business presents additional difficulties.⁹ As the Minnesota Supreme Court noted recently, valuation by the court for equitable distribution purposes "is in essence a forced sale by one spouse to the other in which the court sets the selling price and the terms of payment."¹⁰ As that court described the process,

[W]henever the court is called on to value a [closely held] business, neither any corporate asset nor any fraction of the shares of the corporation will actually be sold to an outsider. Generally . . . the corporate shares are awarded to the spouse more actively engaged in the business of the corporation, and the management and operation of the business continue essentially unchanged. In this context the establishment of a fair market value contemplates nothing more than the assignment of a fair and reasonable value to the family business as a whole to allow equitable apportionment of the marital property.¹¹

In conducting this hypothetical sale, "the court must determine the value of the business as if the transaction were a sale of the entire business by a willing seller to a willing buyer."¹² Since the owner

9. The Missouri Supreme Court has recognized that it is "difficult to evaluate the stock of a closely held corporation" in the context of a divorce. *Hoffman v. Hoffman*, 676 S.W.2d 817, 826 (Mo. 1984) (en banc), discussed *infra* at notes 140-144 and accompanying text. See also *Bowen v. Bowen*, 96 N.J. 36, ---, 473 A.2d 73, 76-77 (1984) ("There are probably few assets whose valuation imposes as difficult, intricate and sophisticated a task as interests in close corporations.") (quoting *Lavene v. Lavene*, 148 N.J. Super. 267, 275, 372 A.2d 629 (Ct. App. Div. 1977)).

10. *Nardini v. Nardini*, 414 N.W.2d 184, 188-89 (Minn. 1987). *Nardini* is a nationally-significant, leading case in the area of the treatment of spouse-owned businesses in marital dissolution cases, and the opinion provides exceptionally thorough and well-written coverage of the issues involved.

11. *Id.* at 189. As the New Jersey Supreme Court put it, "The goal is to arrive at a fair market value for a stock for which there is no market." *Bowen v. Bowen*, 96 N.J. 36, ---, 473 A.2d 73, 77 (1984) (involving divorce valuation and distribution of a spouse's interest in a closely held corporation).

12. *Nardini*, 414 N.W.2d at 189. Another phrasing of this paradigm states that fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *Treas. Reg. § 20.2031-1(b)*; *Flarsheim v. Twenty Five Thirty Two Broadway Corp.*, 432 S.W.2d 245 (Mo. 1968); *Fitts' Estate v. Commissioner*, 237 F.2d 729, 731 (8th Cir. 1956); see also *Lyons & Whitman, Valuing Closely Held Corporations and Publicly Traded Securities With Limited Marketability: Approaches to Allowable Discounts from Gross Values*, 33 BUS. LAW. 2213 (1978) ("The

spouse is rarely willing to actually sell his or her share of the business to a third party, the trial court must arrive at a hypothetical sale value based on valuation evidence presented by the parties, which normally includes expert opinion.¹³ The trial court's rulings on valuation receive deference from the appellate courts, and are reviewed under an abuse of discretion standard.¹⁴

The difficulties inherent in divorce valuation of closely held companies also present opportunities for well-prepared advocacy. The attorney likely to "win" on the valuation issue is the one who persuades the court that her client's approach to valuation and her expert's evidence most completely account for all the individual circumstances of the case. As will be seen below, the understanding and use of key person discounts can aid this effort in many cases.

In general, valuation of a closely held business involves three steps. As one scholar describes the process,

The first step is to examine the company's balance sheets and profit and loss statements to ascertain the assumptions and accounting methodology utilized in their preparation. Often this will result in adjustments to the company's financial statements to make them conform to generally accepted accounting principles (GAAP) and to make them useful for comparative purposes. The second step is to use the revised financial statements and other relevant data to determine the overall value of the business. This usually necessitates the use of a series of different values calculated according to formulas [or methods] approved by courts and other recognized authorities. The

Treasury, courts, and most professionals agree that fair market value means the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.")

13. The trial court properly may rely on valuations by expert witnesses. *Gulbranson v. Gulbranson*, 343 N.W.2d 715, 716 (Minn. Ct. App. 1984) ("the opinion of an experienced appraiser regarding valuation questions may be given greater weight by the trial court than the lay opinion of an interested party"). The court's valuation need not correspond exactly with expert valuations, so long as it lies within the range established by them. According to the Minnesota Supreme Court,

valuation is necessarily an approximation in many cases, and it is only necessary that the value arrived at lies within a reasonable range of figures. Thus, the market valuation determined by the trier of fact should be sustained if it falls within the limits of credible estimates made by competent witnesses even if it does not coincide exactly with the estimate of any one of them.

Hertz v. Hertz, 229 N.W.2d 42, 44 (Minn. 1975).

14. *Hoffman v. Hoffman*, 676 S.W.2d 817, 826 (Mo. 1984) (en banc); *Hertz*, 229 N.W.2d at 44.

final step is to adjust the overall value to take into account any applicable discounts and premiums because of the special circumstances involved in the particular case.¹⁵

As the New Jersey Supreme Court has observed, "most experts and courts have used the IRS's Revenue Ruling 59-60 as the guide in valuing the close corporation."¹⁶ The Minnesota Supreme Court

15. Haynsworth, *supra* note 8, at 460. For an informative, layman's introduction to valuation of a going business, see L. SOLOMON, R. STEVENSON, D. SCHWARTZ, *The Old Man And The Tree: A Parable of Valuation*, in CORPORATIONS LAW AND POLICY 83-88 (1982). For additional material on valuation of closely held businesses, see generally J. BONBRIGHT, *THE VALUATION OF PROPERTY* (1937); G. DESMOND & R. KELLEY, *BUSINESS VALUATION HANDBOOK* (1977); B. GOLDBERG, *VALUATION OF DIVORCE ASSETS*, ch. 6 (1984); L. GOLDEN, *EQUITABLE DISTRIBUTION OF PROPERTY*, ch. 7 (1983); G. MCCARTHY & R. HEALY, *VALUING A COMPANY* (1971); S. PRATT, *VALUING A BUSINESS* (1981); Lawinger, *Appraising Closely-Held Stock—Valuation Methods and Concepts*, TR. & EST., Oct. 1971, at 816; Martin, *Factors Used in Valuation of Closely-Held Stock*, NAT'L PUB. ACCT., May 1975, at 12; Mollica, *Evaluating the Stock of a Closely Held Corporation*, CASE & COM., Jan.-Feb. 1982, at 12; Welch, *Discovery and Valuation in a Divorce Division Involving a Closely-Held Business or Professional Practice*, 7 COMMUNITY PROP. J. 103 (1980); Note, *Proving the Value of Goodwill of a Spouse's Closely-Held Commercial Corporation in a Divorce Proceeding*, 25 J. FAM. L. 549 (1986-87).

16. *Bowen v. Bowen*, 96 N.J. 36, ---, 473 A.2d 73, 77 (1984); see Rev. Rul. 59-60, 1959-1 C.B. 237; see also *Dean v. Dean*, No. 87-361, slip. op. at 58 (Ark. Ct. App. Feb. 17, 1988) (LEXIS, States library, Ark. file) (not released for publication) (noting that "many courts have used the factors outlined in Revenue Ruling 59-60," and approving its use in the instant case); *In re Marriage of Hewitson*, 142 Cal. App. 3d 874, 883, 191 Cal. Rptr. 392, 397 (1983) (noting Revenue Ruling 59-60 is applicable in divorce cases involving valuation of closely held corporations); *In re Marriage of Micalizio*, 199 Cal. App. 3d 662, 674, 245 Cal. Rptr. 673, 680 (1988) (in *Hewitson*, the California Court of Appeals "urged the trial court to use the factors listed in the Internal Revenue Service's Revenue Ruling 59-60" in determining the value of an interest in a closely held corporation for divorce purposes); *Turgeon v. Turgeon*, 190 Conn. 269, 276, 460 A.2d 1260, 1265 (1983) (citing Revenue Ruling 59-60 in discussing the importance of examining all appropriate factors in valuing a close corporation for divorce purposes). The court wrote in *In re Marriage of Rossi*, 113 Ill. App. 3d 55, 446 N.E.2d 1198 (1983) (disapproving a valuation used by the trial court because it directly contravened Revenue Ruling 59-60), "The Internal Revenue Service has recognized that the general approach, method and factors outlined in Revenue Ruling 59-60 may be relevant in determining the fair market value of business interests of any type." *Id.* at 60, 446 N.E.2d at 1202; see also *Lavene v. Lavene*, 162 N.J. Super. 187, 193, 392 A.2d 621, 624 (1978) ("Revenue Ruling 59-60, C.B. 1959-1, 237 sets forth the proper approach to use in the valuation of closely held corporate stocks for estate and gift tax purposes. The approach,

recently mandated the use of Revenue Ruling 59-60 in all divorce-case valuations of closely held corporations.¹⁷ Although the Missouri courts have not addressed specifically the use of Revenue Ruling 59-60 in the divorce context, the statutory requirement that the courts consider "all relevant factors"¹⁸ in such cases suggests that they would be receptive to its use.

Revenue Ruling 59-60 lists eight major factors as fundamental to valuation of a closely held business:

- (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

methods and factors set forth therein are equally applicable [in divorce cases.]); *Kaye v. Kaye*, 102 A.D.2d 682, 687, 478 N.Y.S.2d 324, 328 (1984) ("One of the most widely accepted and comprehensive approaches to the valuation of closely-held and professional corporations is that recommended by the Internal Revenue Service's Revenue Ruling 59-60"); *Nehorayoff v. Nehorayoff*, 108 Misc. 2d 311, 316, 437 N.Y.S.2d 584, 588-89 (1981) (observing in a divorce case involving valuation of a closely held professional practice that "The most comprehensive method of valuation available is to be found in the Internal Revenue Service's Revenue Ruling 59-60"); *Briggs v. Briggs*, No. 1427 (Ohio Ct. App. Feb. 17, 1989) (LEXIS, States library, Ohio file) (unpublished opinion) (affirming a valuation based on Revenue Ruling 59-60 and noting the key person status of the owner spouse, although not labelling it as such). *But see Kowalesky v. Kowalesky*, 148 Mich. App. 151, 154, 384 N.W.2d 112, 114-15 (1986) (Defendant "invites this Court to adopt the valuation method contained in Revenue Ruling 59-60 and apply that method to property divisions in divorce actions. We decline that invitation.") ("Defendant "urges this court to be the first to apply the ruling to the valuation of professional corporations in divorce actions," but "neither Revenue Ruling 59-60 nor any other single method should uniformly be applied in valuing a professional practice.").

17. *Nardini v. Nardini*, 414 N.W.2d 184, 190, 190 n.4 (Minn. 1987), discussed *infra* notes 92-98 and accompanying text.

18. MO. REV. STAT. § 452.330.1 (Supp. 1989).

actively traded in a free and open market, either on an exchange or over-the-counter.¹⁹

In discussing and amplifying the second of these factors, the Ruling states that

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.²⁰

III. KEY PERSON DISCOUNTS

"Key person" or "key man" is a term of art in the context of business valuation, denoting a person whose individual abilities, character, efforts, and relationships are critical to the success of a given business. A key person discount reduces the value placed on a closely held business to account for the loss of such an owner or employee due to death or departure from the business.²¹ The key person discount is one of "[t]he four discounts that are most often recognized in closely held business valuations."²²

19. Rev. Rul. 59-60, § 4.01, 1959-1 C.B. 237, 238-39. These factors include both book or net asset value and capitalization of earnings, the two most frequently used methods of valuing closely held corporations. Lyons & Whitman, *supra* note 12, at 2214; Haynsworth, *supra* note 8, at 466-67. Haynsworth states, "As a general rule, earnings are given more weight than other factors in valuing a company that sells goods and services, whereas net asset value is given more weight than the other factors in valuing a company that is an investment or an asset holding company." *Id.* at 484.

20. Rev. Rul. 59-60, § 4.02(b), 1959-1 C.B. 237.

21. Companies often purchase "key person" or "key man" insurance to cover potential losses from such eventualities.

22. Haynsworth, *supra* note 8, at 488. The others are discounts for lack of marketability, for minority interest, and for restrictions on resale imposed by securities laws. According to Haynsworth, "These discounts are not mutually exclusive. Therefore, they may be cumulative, if the facts justify the existence of more than one." *Id.* Courts sometimes discuss more than one discount, but apply one overall discount percentage rather than several smaller percentages. *See, e.g.,* Central Trust Co. v. United States, 305 F.2d 393 (Ct. Cl. 1962); Lowe v. Lowe, 372 N.W.2d 65 (Minn. Ct. App. 1985), discussed *infra* notes 49-54 and accompanying text; Nelson v. Nelson, 411 N.W.2d 868 (Minn. Ct. App. 1987), discussed *infra* notes 73-91 and accompanying text.

Scholars have described the reasons for the discount as follows:

[Since a person with key man status is] [u]sually the driving force behind the business and the controlling stockholder, the loss of a key man may have a depressing effect upon the value of the closely held stock, as future prospects for the corporation are no longer as bright as they once were. This is especially so in those instances where there is a lack of competent personnel available for management succession.

When a key man is lost, the valuator ought to consider capitalizing the average recurring earnings at a lower rate or depress the gross value of the stock by a percentage discount to reflect this loss.²³

In other words, "when the success of a business is highly dependent upon one person, the likelihood of the business being a continued success in the hands of a willing buyer is significantly decreased."²⁴

Commentators note several factors relevant to determining the appropriateness and amount of key person discounts in individual cases.²⁵ Valuators should determine whether customers or suppliers have a relationship primarily with a key person in the company or with the company itself, since departure of a key person will reduce the value of the business more sharply in the former case.²⁶ They should ascertain whether the company has other personnel capable of filling the role of the key person, since this will magnify or reduce the effect of

23. Lyons & Whitman, *supra* note 12, at 2220; see also 2 VALUATION & DISTRIBUTION OF MARITAL PROPERTY § 22.08(2)(c) (J. McCahey ed. 1988) ("In evaluating future potential [of a business], the effect of the loss of a manager of a 'one-man' business must be considered, as well as the availability of trained personnel capable of succeeding to management of the business. Although this consideration is strongest in a true 'one-man' business, it may also be significant in other enterprises operated by a limited number of participants." (citation omitted)).

24. Fishman, *The "Key Man" Concept in Business Valuation Upon Divorce*, FAIRSHARE, June 1982, at 3.

25. See 2 VALUATION & DISTRIBUTION OF MARITAL PROPERTY § 22.08(2)(c) (J. McCahey ed. 1988).

26. *Id.* Another author has remarked:

[A] business with a long history and institutionalized relationships with its customers, suppliers and key employees will be more able to survive a change in top management, i.e. the loss of a key man. Conversely, a relatively new business, or one which has not institutionalized such relationships, will usually be more dependent on and more vulnerable to the loss of a key person.

Fishman, *supra* note 24, at 3.

the key person's departure.²⁷ Finally, they should take into account whether services or tangible goods constitute the company's principal product, since the effect of a key person's departure is normally greater in the case of services.²⁸

Authorities on key person discounts suggest that the amount of the discount should depend on the replaceability of the key person. When a key person departs, but can be replaced by other competent personnel within the company, valuation experts suggest a key person discount of 10% to 15%.²⁹ When replacements are not available within the business, experts suggest a substantially higher discount.³⁰

In categorizing businesses for valuation purposes, Arthur Dewing's influential treatise on corporate finance assigns the highest discounts for income capitalization to companies which depend on one or more key persons.³¹ Dewing divides companies into seven categories for purposes of valuation. His sixth category is "[i]ndustrial businesses, large and small, which depend on the special, often unusual skill of one, or of a small group of managers."³² His final category is "[p]ersonal service businesses," in which

The manager must have a special skill coupled with an intensive and thorough knowledge of his subjects. The earnings of the enterprise are the objective reflection of his skill; and he is not likely to be able to create "an organization" which can successfully "carry on" after he

27. See 2 VALUATION & DISTRIBUTION OF MARITAL PROPERTY § 22.08(2)(c) (J. McCahey ed. 1988).

28. *Id.* As another scholar put it,

As a general proposition, businesses that provide a service, as opposed to a tangible product, are highly dependent upon specific key people, and, therefore, more vulnerable to their loss than a business which provides a tangible product. In the service business, it is common for individuals to have a unique personal relationships [sic] with the key sources of business.

Fishman, *supra* note 24, at 3.

29. Lyons & Whitman, *supra* note 12, at 2221; see, e.g., Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976) (allowing discounts of 12% and 9% in valuation of two companies in which a decedent had played a key person role, but which had competent officers capable of assuming his duties); see also Haynsworth, *supra* note 8, at 496-97.

30. Lyons & Whitman, *supra* note 12, at 2221.

31. 1 A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 390-91 (5th ed. 1953), cited in *Nehorayoff v. Nehorayoff*, 108 Misc. 2d 311, 437 N.Y.S.2d 584 (N.Y. Sup. Ct. 1981). Haynsworth states that "One of the most influential sets of [capitalization] rates is that devised by Professor Dewing." Haynsworth, *supra* note 8, at 476.

32. 1 A. DEWING, *supra* note 31, at 391.

is gone. He can sell the business, including the reputation and the "plan of business," but he cannot sell himself, the only truly valuable part of the enterprise.³³

While Dewing advises capitalization of the earnings of other types of businesses at rates ranging from 10% to 25%, in the key person categories he calls for capitalization rates of 50% and 100%, respectively.³⁴ The additional percentage amounts constitute a key person discount.

Although courts in a number of states have referred to key person status in discussing the valuation of closely held businesses, or have emphasized the principles underlying discounts for that status,³⁵ Minnesota is the only state whose decisions have established a common law rule concerning key person discounts. The Minnesota cases on the subject, thus, are critical to an argument for the use of such discounts in Missouri.

IV. THE MINNESOTA KEY PERSON DISCOUNT RULE

During the 1980's the Minnesota appellate courts decided a line of marital dissolution cases involving business valuation, which turned in part on the issue of discounting for key person status. Minnesota's common law as established in these cases requires that, when one marriage partner has key person status in a business owned by one or both spouses, valuation of the business for the purpose of distribution must include a key person discount.

The leading Minnesota case on key person discounts is *Rogers v. Rogers*.³⁶ Mr. Rogers owned 85% of a closely-held Subchapter S corporation engaged in engineering services. It was formed during the marriage.³⁷ The trial court's valuation of Rogers' share of the business followed in large part the conclusions of Mrs. Rogers' expert, who had averaged the results of three methods of valuation.³⁸ One of these methods used an arbitrary 25% discount for the company's dependence on a few key people, and a second lowered this discount to 12.5% on the assumption that some key people would remain with the business.³⁹ The third method, which assumed that Mr. Rogers was the single key man in the company, applied no key person discount, and included in

33. *Id.*

34. *Id.* at 390-91.

35. See *infra* notes 99-109 and accompanying text.

36. 296 N.W.2d 849 (Minn. 1980).

37. *Id.* at 850.

38. *Id.* at 850-51.

39. *Id.* at 851.

its calculation of the corporation's value the present value of eleven future years of work for the company by Mr. Rogers.⁴⁰

The Minnesota Supreme Court reversed the trial court's findings regarding the company's value, partly because the lower court had failed to apply a key person discount.⁴¹ According to the court,

a major defect in [this] methodology is [its] apparent failure to take into account appellant's importance to [the business] . . . While the testimony did not establish that [the company] would be worthless without appellant, it is clear that appellant is a key man—if not *the* key man—in [the business], and the profitability of the corporation could be substantially reduced if he were to leave.⁴²

The Supreme Court mandated consideration of this factor in the revaluation of the business it ordered on remand.⁴³

The court required application of a key person discount because the portion of the company's value which depended on Mr. Rogers' continued services was not marital property. As the court put it:

[V]aluation of appellant's share of [the business] should not be based upon the assumption that appellant will remain [with the company]. Such an assumption would compel appellant to continue with [the business], perhaps against his wishes, simply in order to earn enough money to pay for the award to respondent.

The property acquired during marriage should be limited to that portion of the value of [the business] that is not dependent upon appellant's continued services. To capitalize the earnings of [the business] on the assumption that appellant will continue to contribute his talents and services is, essentially, to capitalize appellant. An award made on this basis would, in effect, give respondent a forced share of appellant's future work.⁴⁴

Under *Rogers*, therefore, valuation of a key person spouse's company which does not include a key person discount causes improper distribution of the key person's nonmarital property to his or her spouse. In the court's words, "Respondent is entitled to property acquired during the marriage, but she is not entitled to a lien on appellant himself."⁴⁵

40. *Id.*

41. *Id.* at 852-53.

42. *Id.* at 853.

43. *Id.* at 854.

44. *Id.* at 853.

45. *Id.* The *Rogers* court also ruled that officer and employee salaries should be excluded from calculation of both the company's past and future income for valuation purposes, unless the salaries reflect profit distribution. *Id.*

The impropriety of distributing a spouse's post-marital efforts and earnings as property is the central idea behind use of key man discounts in divorce cases. When a court bases its valuation of a spouse's closely held company, as it must, on a hypothetical sale of the business,⁴⁶ its hypothesis must include the assumption that the spouse will leave the business. The contrary assumption, as the *Rogers* court noted, leads inexorably to "a lien on [the spouse] himself."⁴⁷ The possibility that the owner spouse may in fact remain with the business can and should be accounted for in awards of spousal maintenance or child support.⁴⁸

The Minnesota Court of Appeals reinforced and extended the *Rogers* key person discount rule in *Lowe v. Lowe*.⁴⁹ Mrs. Lowe was sole owner of a rehabilitation counseling business she started during the marriage.⁵⁰ Since the business could be sold only to a buyer in the relatively narrow field of rehabilitation counseling, it was not readily marketable.⁵¹ The trial court rejected Mr. Lowe's expert's valuation of the business because it did not discount for lack of marketability or for Mrs. Lowe's importance to the company.⁵² The Court of Appeals affirmed the trial court's conclusion that *Rogers* commanded consideration of a party's key person status in valuation of a business.⁵³ The appellate court found that,

the rationale of *Rogers*, that one spouse should not get a forced share of the other spouse's future work, could logically be extended so that one spouse should not benefit from a valuation method that denies or restricts the other spouse's future employment options. Appellant's valuation [which did not discount for either Mrs. Lowe's key person status or for lack of marketability] had that effect. The value was based, in part, on an assumed sale where respondent would be required to sign a non-compete agreement. Respondent is licensed in Minnesota, has the majority of her clients in the metropolitan area, and has built her reputation here. The sale of her business with a non-compete agreement would substantially deprive her of her livelihood.⁵⁴

46. See *supra* note 13 and accompanying text.

47. *Rogers*, 296 N.W.2d at 853.

48. *Nardini v. Nardini*, 414 N.W.2d 184, 198 (Minn. 1987), discussed *infra* notes 92-98 and accompanying text.

49. 372 N.W.2d 65 (Minn. Ct. App. 1985).

50. *Id.* at 66.

51. *Id.*

52. *Id.* at 66-67.

53. *Id.* at 66.

54. *Id.* at 66-67.

In *Nemitz v. Nemitz*,⁵⁵ the parties' major asset was a group of business colleges acquired during the marriage. The appeals court upheld a trial court valuation of the colleges which did not include a key person or limited marketability discount, because the spouse who worked with the colleges lacked key person status.⁵⁶

The court noted, "Typically, a 'key man' performs highly personal or unique services from which the entire business income is derived."⁵⁷ It cited as examples the engineering services company in *Rogers*, dependent on a few key people, and the rehabilitation counseling business in *Lowe*, where the entire business income was produced by the owner-spouse's services.⁵⁸ The court distinguished *Nemitz* from *Rogers* and *Lowe* because

The college system would be salable as a business even without appellant in his role [as college marketer and finance manager], according to his own experts. The business could be sold and appellant could remain an active employee or consultant or he could change careers. This would not substantially deprive appellant of his livelihood [as in *Lowe*] or would not subject him to "a lien on himself" [as in *Rogers*].⁵⁹

Since the *Nemitz* decision was based on the absence of key person status, it is consistent with the Minnesota rule, established in *Rogers*, requiring a key person discount where key person status is present.

*Novick v. Novick*⁶⁰ involved valuation of a husband's majority interest in a privately-held brokerage firm. The husband had based his valuation of the business on "the assumption that he, a key employee, may leave the company and open a competing business."⁶¹ He used the book value of his stock minus a 20% key person discount to arrive at the value of his interest.⁶² In reaching a valuation which was approximately \$200,000 higher, the wife used a 30% discount for lack of marketability, but added a 50% premium for control of the business.⁶³ The trial court accepted the wife's valuation method, although

55. 376 N.W.2d 243 (Minn. Ct. App. 1985).

56. *Id.* at 247.

57. *Id.*

58. *Id.*

59. *Id.*

60. 366 N.W.2d 330 (Minn. Ct. App. 1985).

61. *Id.* at 331.

62. *Id.*

63. *Id.*

it reduced the control premium and thus set the company's value approximately halfway between the spouses' differing figures.⁶⁴

Although the husband argued on appeal that such a valuation was erroneous under *Rogers*, the appeals court upheld the valuation as within the trial court's discretion.⁶⁵ It declared that

[t]he *Rogers* court indicates that a valuation of a company which seems to take into account husband's "key man" status may be appropriate, given the proper analysis. Here the trial court did not figure in [the husband's] salary and his expected stay with the company as the court impermissibly did in *Rogers*. The court simply valued [the husband's] stock at a higher rate because he has a controlling interest in the company.⁶⁶

Thus, *Novick* validates the Minnesota key person discount rule. It also provides a tactical reminder that other adjustments for special circumstances, such as a premium for control, can be used to offset the impact of key person discounts in some cases.

In *Bateman v. Bateman*,⁶⁷ the appeals court rejected a trial court valuation of the husband's one-man insurance agency.⁶⁸ The appeals court held that the lower court improperly had considered valuations of the agency based on capitalization of the husband's key person services as reflected in his net income.⁶⁹ The husband had cited *Rogers* in arguing that, because he was the key person in his insurance agency, his income could not be considered properly in valuing the business.⁷⁰ The *Bateman* court agreed, declaring that, under the Minnesota rule established in *Rogers*, valuation of a business based on the capitalization of its income must exclude the value of the owner's personal services.⁷¹ By contrast, the court said, owner income based on profit generated by the services of other employees could properly be capitalized.⁷²

64. *Id.*

65. *Id.* at 333.

66. *Id.*

67. 382 N.W.2d 240 (Minn. Ct. App. 1986).

68. *Id.* at 242, 246.

69. *Id.* at 246.

70. *Id.* at 245.

71. *Id.*

72. *Id.* at 246. See also *Robinson v. Robinson*, 355 N.W.2d 737, 740 (Minn. Ct. App. 1984) (valuation of a spouse's business as a manufacturer's representative for office equipment product lines) (the key person discount rule was not violated by capitalization of the part of the owner-spouse's earnings which derived from ownership of the business rather than from personal services).

*Nelson v. Nelson*⁷³ involved the valuation of an engineering consulting firm specializing in large commercial heating and ventilation systems.⁷⁴ Mr. Nelson owned 87.6% of the stock, and the parties' children owned the rest.⁷⁵ Mr. Nelson had key person status in the company: he was one of only ninety-five consulting engineers in the country, the sole engineer in the state certified in the firm's field, and the majority of the company's business was generated through his personal relationships with consulting engineers.⁷⁶ The firm's only other employees were three field technicians and one secretary, all employed as his assistants.⁷⁷

At trial, Mr. Nelson's expert based valuation of the company on the book value of the business adjusted to account for assets and liabilities not reflected on the books.⁷⁸ He did not account for the "going concern" nature of the business, or for other factors used by the Internal Revenue Service under Revenue Ruling 59-60⁷⁹ in valuing closely-held service businesses for tax purposes.

Mrs. Nelson's expert determined the company's value by averaging the results of three valuation methods.⁸⁰ These methods considered, respectively, tangible asset value, goodwill value, and going concern value; the present value of a projected income stream; and cashflow capitalization of pretax net profits.⁸¹ They incorporated the factors listed in Revenue Ruling 59-60, but did not apply a key person or lack of marketability discount.⁸² They also included Mr. Nelson's salary "in excess of the industry average," capitalized as profit.⁸³

The trial court rejected the valuation approach offered by Mr. Nelson because it did not account for "going concern" value.⁸⁴ The court basically accepted the approach offered by Mrs. Nelson, but modified it to include key person and lack of marketability discounts.⁸⁵ The trial judge applied a 30% discount to reflect these factors.⁸⁶

73. 411 N.W.2d 868 (Minn. Ct. App. 1987).

74. *Id.* at 869.

75. *Id.*

76. *Id.*

77. *Id.* at 869-70.

78. *Id.* at 870.

79. Rev. Rul. 59-60, § 4.01, 1959-1 C.B. 237, discussed *supra* notes 16-20 and accompanying text.

80. *Nelson*, 411 N.W.2d at 871.

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* It also undervalued the company airplane. *Id.*

85. *Id.*

86. *Id.*

The Minnesota Court of Appeals held that under the facts in *Nelson* the 30 percent discount employed by the trial court was arbitrarily low, and reversed and remanded on this issue.⁸⁷ In affirming the *Rogers* rule, the court rejected a 25% discount "when it did not accurately reflect the appellant's importance to the corporation."⁸⁸ The *Nelson* court concluded that

[A]s in *Rogers*, the trial court's discount in this case simply does not accurately reflect appellant's importance to the corporation. Here the trial court was presented with evidence that: (a) [the company] would cease operation if appellant left the business; (b) appellant is the sole fee generating professional employed by the corporation; (c) appellant is specially certified as a test balance engineer (one of only 95 in the country and the only one so certified in Minnesota, North and South Dakota); and (d) the corporation derives the majority, if not all, of its business through appellant's personal contacts with mechanical contractors in the area

This evidence, particularly in the absence of expert testimony establishing 30% as a reasonable key man/marketability discount, compels the conclusion that the trial court's discount was arbitrarily low.⁸⁹

Nelson added the requirement to the Minnesota rule that evidence or judicial findings sufficiently demonstrate that the discount employed "accurately reflect[s] the [key person spouse's] importance to the corporation."⁹⁰ While the *Nelson* court reaffirmed the basic *Rogers* ban on capitalization of the key person spouse's salary, it allowed capitalization of "excess salary" above an industry average attested by such evidence as revenue and salary figures from industry publications.⁹¹

87. *Id.* at 874-75.

88. *Id.* at 874.

89. *Id.* at 875.

90. *Id.*; see also *Bateman v. Bateman*, 382 N.W.2d 240 (Minn. Ct. App. 1986) (reversing the trial court valuation of the husband's one-man insurance agency, in part because the trial court's "inadequate explanation" of the appropriateness of its valuation was "particularly troublesome" and "arbitrary"), discussed *supra* notes 67-72 and accompanying text. *Balogh v. Balogh*, 356 N.W.2d 307 (Minn. Ct. App. 1984) (husband owned 20% of a Subchapter S corporation in which another partner had key person status. The trial court was reversed for having set the value of the husband's share halfway between the husband's figure, which discounted for the other partner's key person status, and the wife's figure, which did not, without documentary or testimonial evidence or judicial findings supporting its valuation).

91. *Nelson*, 411 N.W.2d at 874. The *Nelson* court also declined to hold that valuation by the adjusted book value method is mandated where the key person spouse is the sole fee-generating professional in the business. *Id.* at 872. The

*Nardini v. Nardini*⁹² was a major Minnesota Supreme Court pronouncement on the treatment of spouse-owned businesses in marital dissolution cases. While the central issue in the case was whether increases in the value of a spouse's business which occur during marriage constitute marital property, *Nardini* does bear tangentially on the Minnesota key person discount rule. The *Nardini* court held that increases in the value of nonmarital property attributable to the efforts of one or both spouses *during the marriage* are marital property.⁹³ The

court distinguished *Bateman*, 382 N.W.2d at 240, which disapproved of valuation of a self-owned insurance agency by a capitalization of income method, on the ground that the key person spouse in *Bateman* was the sole employee, whereas Mr. Nelson had four additional, if non-fee-generating, employees. *Nelson*, 411 N.W.2d at 872-73. The *Nelson* court said that a rule rejecting capitalization of income where there is only one fee-generating employee was "reasonably attractive," but concluded that the issue was "one of policy and thus better suited for extensive comment by the supreme court." *Id.* at 873.

92. 414 N.W.2d 184 (Minn. 1987).

93. *Id.* at 192 (emphasis added). By contrast, the court held increases attributable to inflation or market forces or conditions are nonmarital property. *Id.*

Mr. Nardini had purchased 50% of a fire protection equipment business while still single, and the parties had acquired the other half during the early years of their 31-year marriage. *Id.* at 186. When the marriage was dissolved, Mr. Nardini held 60% of the shares, and Mrs. Nardini held the other 40%. *Id.* Mr. Nardini called on customers and managed the business, while Mrs. Nardini helped with the company books on a periodic basis. *Id.* He claimed that the majority of the company's sales resulted from his personal relationships with customers, and therefore attributed most of the financial success of the company to his key person status. She attributed much of the company's success not only to her periodic work for the business but also to her extensive civic and social activities and her "provision of a traditional marital home." *Id.*

Since it was not disputed that most of the company's value resulted from the parties' efforts during the marriage, and because Mr. Nardini's premarital investment in the business was dwarfed by reinvestment during the marriage, the court found that nearly the entire present value of the company was marital property. *Id.* at 195.

The Missouri Supreme Court considered this issue, among others, in *Hoffman v. Hoffman*, 676 S.W.2d 817 (Mo. 1984) (en banc), discussed *infra* notes 140-44 and accompanying text. However, the *Hoffman* court did not decide the question, since it found that the facts before it did not involve any increases in the value of nonmarital property which were attributable to the efforts of a marital partner. *Id.* at 825. The court noted that under MO. REV. STAT. § 452.330.2(5) (Supp. 1989), increases in the value of property acquired before marriage are also nonmarital. *Id.* at 823. Nevertheless, it observed that the wife's argument that she should "share in the enhanced value of the corporation brought about by the husband's efforts" was "a legitimate theory to pursue," even though it failed under the facts involved. *Id.* at 825.

key person discount rule established in *Rogers* treats that portion of a spouse-owned company's value attributable to the *post divorce* efforts of a key person spouse as nonmarital property.⁹⁴ Key person discounts, thus, look to the post-marital future rather than the marital past.⁹⁵

The *Nardini* court also ruled that proper valuation of closely held businesses for purposes of divorce distribution should include the factors set out in Revenue Ruling 59-60⁹⁶ and used by the Internal Revenue Service in valuing such businesses for estate and gift tax purposes.⁹⁷ Revenue Ruling 59-60 approves the use of key person discounts in appropriate cases.⁹⁸

94. See *supra* notes 36-45 and accompanying text.

95. The *Nardini* court also noted that a trial court which considers key person status in deciding which spouse should be awarded the business in the distribution of property should sometimes adjust spousal maintenance accordingly. In its distribution of assets, the trial court had awarded the business itself to Mr. Nardini. The supreme court added a cautionary note:

That may be a sensible allocation . . . because it leaves the corporation's key man in place. It must be recognized, however, that the distribution made here involves something more than allocating the corporate shares to [Mr. Nardini] as his sole property. It permits [him] to retain the vehicle which enhances his earning power and it affords him the opportunity to continue building the value of his interest in the business while receiving [a high] annual salary . . . plus substantial prerequisites.

At the same time, however, that [Mr. Nardini's] career is left intact and basically undisturbed, the distribution alters the course of [Mrs. Nardini's] life. While [he] continues his gainful employment, [she] is deprived of any interest in the ongoing business which has until now been the focus of her efforts and the source of her income as well as of [his], and after foregoing the opportunity to carve out a separate business career which might survive a marriage dissolution

Nardini, 414 N.W.2d at 198. Partly for this reason, the supreme court reversed the lower court award of temporary maintenance, and remanded for an award of permanent maintenance which took into account the retention of the business by its key man. *Id.* at 198-99.

96. Rev. Rul. 59-60, 1959-1 C.B. 237, discussed *supra* notes 16-20 and accompanying text.

97. *Nardini*, 414 N.W.2d at 190 n.4.

98. See *supra* note 20 and accompanying text. For additional Minnesota applications of the key person discount rule, see *Bury v. Bury*, 416 N.W.2d 133 (Minn. Ct. App. 1987) (affirming a ruling employing use of a key person discount in the valuation of a spouse's solely-owned asphalt and road construction company); *Duffey v. Duffey*, 416 N.W.2d 830 (Minn. Ct. App. 1987) (the husband did not have key person status in the parental-family business where he was employed. Since the spouse was not a key person, his efforts did not contribute

V. SUPPORT FROM OTHER STATES

As we have seen, the impropriety of capitalizing the post-dissolution work and earnings of the key person spouse and distributing them as property is a fundamental basis of the Minnesota key person discount rule.⁹⁹ The same principle underlies most of the decisions in other states which have touched on the key person concept.

According to the California Court of Appeals, it is a basic concept of the community property system that a community interest can be acquired only during marriage, and distributing a community interest based on post-marital efforts by a spouse would violate that concept.¹⁰⁰ The California Court of Appeals approved the exclusion from distribution of the portion of a consulting agreement fee which was compensation for future services of a key person spouse.¹⁰¹

In *In re Marriage of Foley*,¹⁰² the Illinois Court of Appeals approved a trial court valuation of a spouse's closely held corporation because the valuation distinguished enterprise goodwill, which was distributed, from personal goodwill, which was not.

The North Dakota Supreme Court held in *Jondahl v. Jondahl*¹⁰³ that a "trial court's failure to distinguish the entrepreneurial skill or potential future earnings of a spouse and the goodwill of a spouse's business interests results in a finding that is clearly erroneous."¹⁰⁴ It ruled in *Gooselaw v. Gooselaw*¹⁰⁵ that "income-producing ability of the principal in a service business may not be used in valuing that business," and stated in *Nastrom v. Nastrom*¹⁰⁶ that "[e]arning power is not, however, property that a court may divide as it would a parcel of land or a collection of household goods."¹⁰⁷

The Ohio Court of Appeals recently upheld a valuation of a spouse's business which excluded from distribution the business value that

to the increase in the value of the business during the marriage, and therefore all of his stock acquired before marriage or through gift or inheritance was his nonmarital property, despite *Nardini*).

99. See *supra* notes 44-47 and accompanying text.

100. *In re Marriage of Fortier*, 34 Cal. App. 3d 384, 388, 109 Cal. Rptr. 915, 918 (1973).

101. *In re Marriage of Vanderbeek*, 177 Cal. App. 3d 224, 232-33, 222 Cal. Rptr. 832, 838 (1986).

102. 163 Ill. App. 3d 1, 516 N.E.2d 455 (1987).

103. 344 N.W.2d 63 (N.D. 1984).

104. *Id.* at 71.

105. 320 N.W.2d 490, 492 (N.D. 1982).

106. 262 N.W.2d 487 (N.D. 1978).

107. *Id.* at 493.

depended on "the personal contacts and relationships of [the spouse]."¹⁰⁸

The Texas Court of Appeals has held that it is error to fail to exclude from property distribution the value of a spouse's companies attributable to "the personal good will of the [owner spouse] and/or . . . the time, toil and talent of the [spouse] to be expended following the divorce."¹⁰⁹

VI. RELEVANT MISSOURI CASES

The only Missouri marital dissolution case to mention key person status is *Boling v. Boling*,¹¹⁰ which involved the valuation of a concrete construction company.¹¹¹ The expert called by the non-owner spouse valued the business by capitalizing its income.¹¹² The owner-spouse's expert used a net worth/net assets method "because the company was small, centered on one man, the husband, and the construction business was volatile."¹¹³ The trial court found that the net assets method was appropriate in the circumstances.¹¹⁴ The Court of Appeals agreed, although it reversed and remanded because the evidence supporting the net asset valuation was insufficient.¹¹⁵ The court declared that "[t]he nature of the construction business, *the husband's key-man position* in the successful operation of the company and the volatility of the two support the trial court's judgment as to the appraisal form in the present case."¹¹⁶

108. *Briggs v. Briggs*, No. 1427 (Ohio Ct. App. Feb. 17, 1989) (LEXIS, States library, Ohio file).

109. *Rathmell v. Morrison*, 732 S.W.2d 6, 18 (Tex. Ct. App. 1987) (the husband played a key person role in the success of his insurance agencies, and while some of the good will value of the agencies was attributable to the two companies, much of it was personal to the husband). *But cf.* *Turgeon v. Turgeon*, 190 Conn. 269, 273, 460 A.2d 1260, 1264 (1983) (the fact that a business may be unlikely to continue without the owner-spouse's "knowledge, local contacts and management skills" does not entirely bar valuation by the capitalization of income method).

110. 683 S.W.2d 661 (Mo. Ct. App. 1984).

111. *Id.* at 662-63.

112. *Id.* at 663.

113. *Id.*

114. *Id.*

115. *Id.* The trial court had considered only the company's vehicles and equipment and the loans affecting them, and "[t]here was no balance sheet evidence, asset statements nor any other evidence from which the court could determine all of the assets and liabilities of [the company]." *Id.*

116. *Id.* (emphasis added).

Thus, *Boling* stands for the proposition that a spouse may have key person status in a family-owned business, and that the divorce valuation of the business should take this status into account. The *Boling* opinion suggests that Missouri courts would have little difficulty in accepting the use of key person discounts in appropriate cases.

In *Hanson v. Hanson*,¹¹⁷ the Missouri Supreme Court made one of its most significant rulings to date concerning the valuation of businesses in the context of marital dissolution proceedings. Examination of the court's concerns in *Hanson* also suggests that Missouri courts are likely to look with favor on key person discounts.

The business in question in *Hanson* was an oral surgery partnership.¹¹⁸ Each of the two partners was involved in divorce proceedings.¹¹⁹ Two circuit courts placed significantly different values on the business, chiefly because only one court included an amount for goodwill.¹²⁰ In a first-impression ruling, the Supreme Court held that "goodwill in a professional practice is a marital asset subject to division in dissolution proceedings."¹²¹ The court noted, however, that business goodwill "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."¹²²

The *Hanson* court also limited the means of proving and valuing the goodwill component of a professional practice. It ruled that "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."¹²³ The court stated a "strong preference" for a fair market value method of determining the value of professional practice goodwill.¹²⁴

117. 738 S.W.2d 429 (Mo. 1987) (en banc).

118. *Id.* at 430.

119. *Id.* at 430, 432.

120. *Id.*

121. *Id.* at 431; *see also id.* at 439.

122. *Id.* at 434.

123. *Id.* at 435. According to the court, this evidence can take three forms: proof 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." *Id.*

124. *Id.* at 435-36. The court discussed four other methods for determining goodwill value: capitalization of net profits, capitalization of excess earnings, the Internal Revenue Service variation of capitalization of excess earnings, and application of the provisions of a buy-sell agreement. *Id.* It noted that the buy-sell agreement method could be appropriate in certain circumstances. *Id.* While the court "reject[ed] the use of capitalization formulae as a substitute for fair

While the *Hanson* decision did not discuss the use of key person discounts, the Supreme Court's analytical approach and language indicate that the court may be receptive to the use of such discounts in appropriate cases. The court took pains to emphasize that the future earning capacity of the owner-spouse may not be included in the valuation of the business. The court declared that

[p]rofessional goodwill may not be confused with future earning capacity. We have not declared future earning capacity to be marital property. We do not now do so. Instead, we leave to the trial court broad discretion in striking an appropriate balance between husband and wife in the division of property and any award of maintenance.¹²⁵

The court repeated this point twice.¹²⁶ It also reiterated no less than six times that the business goodwill that constitutes property divisible in divorce is the goodwill of the business itself, which must be distinguished from the goodwill of the owner-spouse.¹²⁷

market value evidence," *id.* at 436, it conceded that capitalization methods may be included in a determination of fair market value. *Id.* at 436 n.2.

125. *Id.* at 435.

126. *Id.* at 436 ("As we have previously said, in Missouri, the future earning capacity of one of the marital partners is not *per se* property.") ("And as we have said previously, the future earning capacity of the individual professional is not, *per se*, an item of marital property subject to division in a dissolution proceeding.")

127. Consider the following statements by the court: "[T]he goodwill which can be sold, and is therefore property, attaches not to an individual but to a business entity." *Id.* at 433. "[A leading case from another state] has been criticized, and properly so in our view, for its failure to distinguish between the reputation of the professional as an individual and the reputation of the professional practice as a business entity." *Id.* "[Decisions approved by the *Hanson* court] recognize[] that goodwill is marital property, but only insofar as it exists independently of the individual professional's reputation." *Id.* at 434.

Irrespective of the setting in which it is found, the meaning of goodwill does not change. It 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.

Id. "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 . . . is . . . the only acceptable evidence of the existence of goodwill." *Id.* at 435. "Going concern value contemplates an ongoing business entity; it obviously cannot attach to an individual practitioner." *Id.* at 437.

This concern on the part of the Missouri Supreme Court parallels the concern that led the Minnesota courts to require the use of key person discounts in appropriate cases. As noted above, the policy basis for the Minnesota key person discount rule is the inequity of treating the owner-spouse's future earning capacity as property.¹²⁸

Taylor v. Taylor,¹²⁹ handed down by the Missouri Supreme Court on the same day as *Hanson*, also suggests potential judicial receptivity toward key person discounts. In *Taylor*, the court upheld a trial court valuation of a chiropractic practice which included no goodwill component.¹³⁰ The Supreme Court agreed with the trial court that no permissible evidence of goodwill had been offered.¹³¹ It did so in part because the non-owner spouse's expert included in his valuation of the business the assumption that the owner-spouse would continue working there.¹³² The expert had testified that the effect of his valuation was a sale of the owner-spouse herself.¹³³ The Supreme Court also noted that the expert had used a capitalization formula which *Hanson* had rejected for use in professional practice cases because of its "focus on placing a present value on the future earning capacity of the individual professional."¹³⁴ As we have seen, the same concerns form the basis of the Minnesota key person discount rule.

In *In re Marriage of Brooks*,¹³⁵ the Missouri Court of Appeals for the Southern District interpreted *Hanson* and *Taylor* in the context of the divorce valuation of a family machine and tooling business. It held that, while *Hanson* had rejected the use of capitalization formulas in valuing professional practices, it had not barred the use of capitalization formulas to value goodwill "as an intangible asset of a commercial corporation or other business organization, no matter the nature of the business involved."¹³⁶ The court, therefore, approved a trial court valuation of the owner-spouse's business based on capitalization of excess earnings.¹³⁷

It is not entirely clear whether the *Brooks* decision properly reflected the Missouri Supreme Court's insistence that the future earning capacity of the owner-spouse be excluded from valuation of the business. The capitalization of excess earnings formula used in *Brooks*

128. See *supra* notes 44-47 and accompanying text.

129. 736 S.W.2d 388 (Mo. 1987) (en banc).

130. *Id.* at 389-90, 392.

131. *Id.* at 390.

132. *Id.* at 389-90, 389 n.1.

133. *Id.* at 389 n.1.

134. *Id.* at 390.

135. 742 S.W.2d 585 (Mo. Ct. App. 1987).

136. *Id.* at 586; see also *id.* at 589-90.

137. *Id.* at 589.

did adjust downward for "salary and expenses" in determining the yearly net earnings figures used in the valuation.¹³⁸ The opinion states, however, that net income "was then averaged out and capitalized on a 20 percent basis, including a salary of \$96,350 for a managing operator [the position of the owner-spouse]."¹³⁹ If that language means that the future earning capacity of the owner-spouse was included in the value of the business, *Brooks* was wrongly decided in light of *Hanson*. Application of a key person discount in the value calculation would prevent such errors.

In *Hoffman v. Hoffman*,¹⁴⁰ the Missouri Supreme Court approved the use of appropriate discounts as within the discretion of Missouri trial courts.¹⁴¹ The marital dissolution in *Hoffman* involved the valuation of stock in a closely held corporation which built cooling towers.¹⁴² Both spouses' experts calculated the company's value by capitalizing its income, and one also discounted for lack of marketability, minority interest, and the single-product nature of the business.¹⁴³ The trial court accepted the discounted valuation, and the Supreme Court approved.¹⁴⁴

Missouri courts already are accustomed to the divorce-case use of discounts in business valuations. Therefore, use of key person discounts would be merely an incremental step in a familiar direction.

VII. CONCLUSION

The equitable distribution statute which governs property distribution in Missouri divorce cases requires that courts must consider all the applicable circumstances when they value closely held businesses belonging to divorcing spouses.¹⁴⁵ In many cases where a divorcing spouse owns a closely held business, the spouse plays a key person role in the company.¹⁴⁶ Where this is so, a court valuing the business must consider the effect on the company's value of the departure of the

138. *Id.*

139. *Id.*

140. 676 S.W.2d 817 (Mo. 1984) (en banc). *Hoffman* is the landmark case in which the Supreme Court adopted the "source of funds" rule for determining whether or to what extent an asset is marital property. *Id.* at 825.

141. *Id.* at 826.

142. *Id.* at 821.

143. *Id.* at 826.

144. *Id.*; see also *Miranda v. Miranda*, 596 S.W.2d 61, 63 (Mo. Ct. App. 1980) (approving a valuation which included a discount for lack of marketability).

145. See *supra* notes 4-6 and accompanying text.

146. See *supra* note 19 and accompanying text.

key person spouse. Valuations which ignore this factor improperly distribute the key person spouse's future efforts and earnings as property.¹⁴⁷

In order to take key person status into account, the Minnesota courts have established a common law rule requiring use of key person discounts in appropriate cases.¹⁴⁸ While this rule represents the cutting edge of legal development regarding this issue, courts in other states are moving toward employment of similar analyses and reasoning.¹⁴⁹

Recent Missouri cases addressing the valuation of closely held businesses in divorce cases suggest that the Missouri courts share the concerns of Minnesota and other states, and would be receptive to the use of key person discounts in appropriate circumstances.¹⁵⁰ For Missouri attorneys whose divorce clients own closely held businesses, the Minnesota key person discount rule presents an opportunity for successful and innovative advocacy.

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147. See *supra* notes 44-48 and accompanying text.

148. See *supra* notes 36-96 and accompanying text.

149. See *supra* notes 99-109 and accompanying text.

150. See *supra* notes 110-44 and accompanying text.

