Personal Goodwill: Does the Non-Propertied Spouse Really Lose the Battle?

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Introduction

From 1991, when the Supreme Court of Florida ruled that professional (personal) goodwill was not a marital asset, through 2005, when the District Court of Appeals of Florida ruled in the *Held*[1] decision that a non-solicitation agreement should be treated the same as a non-competition agreement, which could be an indication of personal goodwill, the question of what personal goodwill actually is, and how it can be quantified has troubled attorneys and their valuation experts. Without proper valuation techniques being employed, the non-propertied spouse may come out as the big loser in the equitable distribution of the marital business.

To put things into perspective, this paper will begin with a brief overview of what goodwill is, and where Florida case law has taken us through today. After we perform this review, we will provide you with some suggestions as to what the business valuer needs to consider in valuing the personal portion of goodwill, i.e. the portion of the marital pot that the non-propertied spouse may not get a piece of if valued incorrectly.

Goodwill

Let's start off with some basics. What is Goodwill? Goodwill is defined as ""…the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor…" [See IRS Publication 535: Business Expenses, Chapter 9, Cat. No. 15065Z]. A subset of goodwill is personal goodwill which represents the value of the enterprise stemming from an individual's personal service to that business. It is owned by the individual, not the business itself.

When performing a business valuation, the business valuer has to make two determinations regarding goodwill. First, is there any? Second, if there is goodwill, what value does it have? Of course, the valuer has to go much further after there is a determination made that there is goodwill value, as he or she will have to separate goodwill value into two separate components, enterprise and personal goodwill.

Very often, we hear someone say that this business has a lot of goodwill. That may be the case, but that does not mean that the goodwill has goodwill value. For goodwill to have value, the business must generate earnings above the return on its other assets. For example, if the business owner invests $100,000 in equipment, he or she expects to get a return on investment. If we assume that a 10 percent return is reasonable, the first $10,000 of profit would be attributable to the equipment. If there is additional profit, that profit would be the result of other assets. After all other assets are accounted for, anything leftover is attributable to goodwill.

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[1] *Held v. Held,* 2005 Fla. App. LEXIS 14138 (Fla. 4th DCA 2005)

Then comes the hard part. Valuation theory regarding separating goodwill into its component parts is something relatively new, mainly due to various types of litigation around the country. Valuation treatises have not caught up with a definitive methodology of how the valuer is supposed to make the separation between enterprise goodwill and personal goodwill. We can only use case law and common sense to try to help us.

Overview of Florida Case Law

We cannot possibly cover every case on this subject, so we are going to give you our appraisers' view on the subject. A brief summary of the leading cases in Florida involving this issue is contained on the next several pages:

Florida's standard arises from *Thompson v. Thompson,* 576 So. 2d 267 (Fla. 1991). Following in the footsteps of *Thompson* are:

> *Young v. Young*, 600 So. 2d 1140 (Fla. 5th DCA 1992)
> *Weinstock v. Weinstock*, 634 So. 2d 775 (Fla. 5th DCA 1994)
> *Walton v. Walton*, 657 So. 2d, 1214 (Fla. 4th DCA 1995)
> *Williams v. Williams*, 667 So. 2d 915 (Fla. 2nd DCA 1996)
> *Christians v. Christians*, 732 So. 2d 47 (Fla. 4th DCA 1999)
> *Held v. Held*, 2005 Fla. App. LEXIS 14138 (Fla. 4th DCA 2005)

Thompson v. Thompson

The issue in this appeal from the 4th District was "In marriage dissolution proceedings to which an owner of a professional association is a party, may the value of the professional association's goodwill be factored in determining the professional association's value?"

Mr. Thompson was a plaintiff's attorney specializing in personal injury and medical malpractice and was the sole owner of a professional association. Since this was the first time that the Florida Supreme Court had dealt with this issue, it relied on case law from many other states that had already addressed this topic. Relying on the Missouri case of *Hanson,*[2] The Court stated, "Irrespective of the setting in which it is found, the meaning of goodwill does not change. It is property which attaches to and is dependant 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."

The Court went on to discuss that if goodwill exists, it would be inequitable to ignore the contribution of the attorney's spouse to the development of that goodwill during the marriage. However,

> It should be emphasized that such goodwill, to be a marital asset, must exist separate and apart from the reputation or continued presence of the marital litigant. If goodwill depends on the continued presence of a particular individual, such goodwill, by definition, is not a marketable asset distinct from the individual. Any

2 *Hanson v. Hanson,* 738 S.W.2d429, 434 (Mo. 1987).

> value which attaches to the entity solely as a result of personal goodwill represents nothing more than probable future earning capacity, which, although relevant in determining alimony, is not a proper consideration in dividing marital property in a dissolution proceeding.

The Court concluded as follows:

> If a law practice has monetary value over and above its tangible assets and cases in progress which is separate and distinct from the presence of the individual attorney, then a court should consider the goodwill accumulated during the marriage as a marital asset. The determination of the existence and value of goodwill is a question of fact and should be made on a **case-by-case basis with the assistance of expert testimony** (emphasis added).

It then went on to say,

> Numerous methods for valuing goodwill have been advanced in cases and the literature on this subject. The clearest method would be the fair market value approach, which is best described as what would a willing buyer pay, and what would a willing seller accept, neither acting under duress for a sale of the business. The excess over assets would represent goodwill. We prefer this method and direct that it be the exclusive method of measuring goodwill of a professional association. Actual comparable sales are not required, so long as a reliable and reasonable basis exists for an expert to form an opinion.

Young v. Young

Dr. Young owned a sole practitioner obstetrics and gynecology practice. The trial court determined that Dr. Young's practice had a marital value of $250,000 and awarded half of that to Mrs. Young. The trial judge stated that she was bound by *Thompson* to make an equitable distribution of the husband's medical practice.

Two expert witnesses presented valuation testimony at the trial. Dr. Young's expert valued the tangible assets at $88,547. Using the excess earnings method, he calculated the value of goodwill at $204,599. The expert testified, "that using the accounting approach required by the supreme court in *Thompson* left him no way to determine what amount of the excess earnings should be allocated to the husband for his personality, presence and reputation. If Dr. Young were taken away from the practice, he testified, then 'there is no data to support any amount as [goodwill] in this $204,000.'"

Mrs. Young's expert used a rule of thumb that he created to calculate goodwill and added this to the tangible assets. He set the value of the goodwill at no less than $400,000. The trial judge did not agree with either expert and set the value of goodwill at $250,000.

On appeal, the appellate court ruled that the trial judge had misconstrued the *Thompson* ruling. It stated, "That decision does not require a finding of goodwill; it merely provides that goodwill may be an asset subject to equitable distribution if there is evidence to support its existence apart from the reputation and presence of the practicing party and the tangible assets. Proof of the existence of goodwill is the first step."

The Court went on to state:

> Proof of the existence of goodwill is particularly troublesome in a professional context. This difficulty is a product of the fact that the reputation of the individual practitioner and the goodwill of his enterprise are often inextricable interwoven. 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. Divisions of marital property may not be based on speculation as to the very existence of the property being divided.

The Court reversed the trial court's goodwill award and stated, "even assuming the existence of goodwill had been demonstrated, neither expert gave competent, credible testimony as to the value of that goodwill."

In a concurring opinion, the judge suggests that the fair market value approach adopted in *Thompson* required the court to determine the amount of money that a willing buyer would pay a willing seller. "It is obvious that a willing buyer would not pay for that which he is not getting. A willing seller of the assets of a professional association, once he sells, is no longer part of the business, and therefore the seller's reputation cannot be part of the goodwill a willing buyer is purchasing. Thus, the fair market value method has, by definition, separated professional reputation from the remaining elements of goodwill, such as established patients, referrals, location, associations, and office organizations which may attach to the buyer.

Therefore, the *Young* court established a two-prong test. There must be proof of the existence of goodwill, separate and apart from reputation. If that proof exists, then there must be proof of its value.

Weinstock v. Weinstock

Dr. Weinstock owned and operated a dental practice. Dr. Weinstock used the same appraiser as Dr. Young had. The appraiser used the same methodology to determine the value of Dr. Weinstock's practice and came to the same conclusion (there was no way to separate the value of Dr. Weinstock's personal goodwill from the goodwill of the practice).

Mrs. Weinstock's expert was a dentist who had become a consultant to dentists who needed a valuation for sales, purchases, loans and dissolution proceedings. This expert valued the practice at $405,000; of that amount, $300,000 was goodwill. This expert utilized sales of 11 Florida dental practices that had sold in 1991 and 1992.

In his testimony, Mrs. Weinstock's expert indicated that in the sales data that he utilized, the selling dentist remained with the practice for a year or two after the sale. The selling dentist's presence was not discontinued immediately after any of the sales.

The appellate court concluded,

> The comparables used cannot serve as competent evidence of value in view of the language of *Thompson* that 'such goodwill, to be a marital asset, must exist separate and apart from the reputation or continued presence of the marital litigant.' The wife's expert opinion also would not be competent evidence under Judge Goshorn's reasoning in Young since there was no attempt to deal with the problem of the continued presence of the dentists after the comparable sales took place.
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> We believe that husband's counsel asked appropriate questions upon cross-examination of the witness that may have ferreted out the proper method for determining the value of goodwill. She asked whether any of the comparables were for a dentist who 'just quit.' The purest form of comparable in the sale in any business would be a sale in which, on the day of closing, the seller picks up the sales proceeds and retires or moves out of the area, thus eliminating any further influence the seller could have on the business.
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> The inclusion of goodwill as a marital asset was improper because the evidence failed to establish a value for this goodwill apart from the husband's continued presence.

Judge Sharp issued a dissenting opinion indicating that the evidence at trail was sufficient to support the trial court's opinion. He stated, "the findings that goodwill existed in this professional practice was based on expert testimony consistent with *Thompson v. Thompson*. Indeed, if the finding was erroneous in this case, I question whether such a finding can be sustained in any case involving a sole professional practice." He went on to state,

> In my view, I do not consider the necessity for a non-compete and non-solicitation agreement in order to produce a willing purchaser of a dental practice as fatal to the trial judge's conclusion that this dental practice had goodwill value. Nor do I think Griggs' comparable sales data should be thrown out as insufficient because in most of the sales, the selling dentist remained with the practice for a short period of time. Based on his testimony, the only essentials were a non-compete and non-solicitation agreement, to prevent a seller from being able to destroy a dental practice, after having sold it.

Walton v. Walton

Mr. Walton operated a sole proprietorship CPA firm that employed two other CPAs and two support staff. However, most contact with the clients was by Mr. Walton and Mr. Walton brought in most of the new clients.

The husband's expert used a liquidation value method, which values the tangible assets of the business. He did not find any professional goodwill attributable to the practice other than the personal reputation and efforts of the husband. However, several years earlier, the husband had submitted a loan application that included a value of $300,000 for the practice, substantially greater than the tangible assets.

The wife's expert used an excess earnings method and what he called a market approach (although he did not use comparable sales). He calculated total goodwill, and then determined that 15 percent of this goodwill was institutional goodwill. He did not explain how he derived the 15 percent.

Neither expert used comparable sales of similar businesses, and the wife's expert testified, "Most of the time if one is going to sell his practice there is going to be a non-compete agreement. Nobody is going to buy a practice and let that accountant go across the street and practice basically."

At the trial court level, the court found the wife's expert's value to be correct, finding that the husband's own valuations gave evidence that the practice had value in excess of the tangible assets. However, the appellate court found that the trial court "did not make the key distinction that only that part of the value independent of the husband's continued presence in the business amounted to a marital asset."

The appellate court went on to say the following:

> First, there was no proof of the existence of goodwill separate from the husband's reputation. The husband's name was the one 'on the door,' and the other C.P.A. employees were there to assist in the work, not garnering clients. The most telling evidence of a lack of any institutional goodwill was the wife's expert's testimony that ***no one* would buy the practice without a noncompete clause**. If the business only has value over and above its assets if the husband refrains from competing within the area that he has traditionally worked, then it is clear that the value is attributable to the personal reputation of the husband. Secondly, the valuation testimony of the expert was not supported by competent substantial evidence.
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> In short, as in *Young* and *Weinstock*, we find no competent evidence from which the trail court could have determined the existence of goodwill separate from the reputation of the husband. Any testimony in that regard is sheer speculation. On remand, we direct the court to exclude any value of goodwill attributable to the business.

Williams v. Williams

The *Williams* case was similar to Walton. Mr. Williams owned a professional practice in which he was the only accountant. At the trail level, the court found that $43,200 of goodwill was subject to equitable distribution.

Citing, *Thompson, Young and Walton*, the appellate court found that the evidence failed to show the existence of goodwill separate and apart from the reputation and continued presence of Mr. Williams.

Christians v. Christians

This was the first case that considered personal goodwill in a non-professional practice setting. Mr. Christians' business called Flying Trapeze, constructed and serviced trapeze equipment for lease or sale exclusively to Club Med. The trial court, based on expert testimony, determined that the fair market value of Flying Trapeze included only its tangible assets and inventory and that the business had no goodwill value for the purposes of marital distribution. The wife appealed the decision.

Although there was an error in the calculation of the tangible assets of the business which the court corrected, it determined that the trial court's failure to assign goodwill value was not in error. Citing *Williams* and *Young*, the court ruled that "The record contains competent evidence to support the trial court's conclusion that any goodwill of Flying Trapeze 'rests solely on the Husband's well-known reputation and abilities and the continued existence and involvement [in the business].'"

Held v. Held

This was another case of a non-professional practice. Mr. Held owned an insurance agency that specialized in selling high-risk hazard insurance to beachfront condominium associations in Florida. At the time of the original hearing, the company maintained 60 customer accounts, which generated large commissions.

The trial court determined that the entire value of the company was a marital asset. Central to this determination was the court's assumption that

> in any sale of the business, the husband would sign a non-solicitation/non-piracy agreement preventing him from doing business with the Company's existing customers. The trial judge reasoned that the non-solicitation agreement had nothing to do with personal goodwill of the business, but was part of enterprise goodwill. The court wrote that
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> [A]s part of the sale of enterprise goodwill, ... a non-solicitation/non-piracy agreement would need to be signed by Husband but not a covenant not to compete. *Contrary to the Husband's assertions, such a requirement is not indicative of personal goodwill, as a non-compete clause might be. The non-solicitation/non-piracy clause prevents the seller from soliciting only those clients which he has just sold, but enables him to continue in the same trade or business, even if across the street.* Specifically, a non-solicitation/non-piracy clause is a clause that prevents the Husband from stealing back the book of business to be sold as part of the ... ($10,500,000) to the theoretical buyer.

The trial court based its valuation of enterprise goodwill on expert testimony. The expert utilized sales of insurance companies that it obtained from a transaction database. However, the expert could not state whether the comparables used were predicated on the principal's continued involvement in the business or, alternatively, upon the principal's agreement to refrain from participating in a like business, by way of a non-solicitation, non-competition, or non-piracy agreement.

The trial judge made her ruling by attempting to distinguish between a non-solicitation/non-piracy agreement and a covenant not-to-compete. However, **the appellate court ruled, "For the purpose of distinguishing enterprise goodwill from personal goodwill in the valuation of a business, there is no distinction between 'a non-solicitation/non-piracy agreement' and a covenant not to compete.**"

The court continued as follows:

> Both limit a putative seller's ability to do business with existing clients of the business. In this case, the husband's personal relationship with his clients allows him to obtain their repeat business. The trial court's valuation method inserted into enterprise goodwill an aspect of personal goodwill, the value of the husband's personal relationship with the 60 clients. This method of valuation contravened *Thompson*, which emphasized that to be a marital asset, goodwill 'must exist separate and apart from the reputation or continued presence of the marital litigant.'

The court ruled that there was no evidence to support a value above the agreed upon adjusted book value of $2,918,000.

Other Florida Cases of Interest

In addition to the six leading cases in equitable distribution discussed above, the following cases are also significant and should be considered:

> *Akins v. Akins*, 659 So. 2d 330 (Fla. 5th DCA 1995)
> *M.A. Hajianpour MD, PA v. Khosrow Maleki*, 932 So. 2d (Fla. 4th DCA 2006)
> *Hough v. Hough*, 793 So. 2d 57 (Fla. 2nd DCA 2001)
> *Makowski v. Makowski*, 613 So. 2d 924 (Fla. 3rd DCA 1993)
> *Spillert v. Spillert*, 564 So. 2d 1146 (Fla. 1st DCA 1990)
> *Swann v. Mitchell*, 435 So. 2d 797 (Fla. 1983)

Akins involves the valuation of a commercial artist where the name was not proven to have value separate and apart from the individual. *M.A. Hajianpour MD, PA* was instituted by Hajianpour's filing of an action for declaratory relief seeking a determination of the parties' respective rights under an employment agreement between Hajianpour and Maleki. Maleki filed a counterclaim for anticipatory breach of contract, fraud, declaratory judgment, and breach of contract. The decisive issue at trial and in this appeal was the value of Hajianpour's medical practice. The key issue that was ultimately addressed by the court was that "Under *Thompson*, a valuation of enterprise goodwill may not be 'predicated on the principal's continued involvement in the business' or the principal's agreement to refrain from participating in any like or competing business."

In *Hough*, the court had to consider the impact of Mr. Hough's personal goodwill in his vending business. In *Makowski,* the court required the fair market approach to be used in the determination of value. *Spillert* involved the valuation of a plastic surgery practice. The court found that one of the experts used an unreliable methodology and the court's averaging of the two experts' values was unacceptable. In *Swann*, the plaintiff instituted this action for wrongful dissolution of a partnership and sought to be paid for a portion of the capital surplus, the value of the goodwill, the stock of the corporate successor to the partnership, and an accounting and damages for wrongful dissolution.

So Where Are We Today?

Florida case law has certainly evolved over the last 15 years. We have witnessed the following:

1991	***Thompson***	Established principal of personal goodwill as non-divisible in equitable distribution
1992	***Young***	Established two-step process to identify and value personal and enterprise goodwill.
1994	***Weinstock***	Established use/misuse of comparable transactions as basis of value
1995	***Walton***	Established concept that personal goodwill may be represented by existence of a non-competition agreement
1999	***Christians***	Broadens concept into non-professional service businesses
2005	***Held***	Endorsed concept of non-competition agreement as indication of personal goodwill and rejected distinction between non-solicitation/non-piracy agreements with non-compete agreements

As a result of these cases, the legal and valuation community must now use this framework to define the marital assets, quantify those assets, and divide the marital estate.

So, What Does All Of This Mean?

The court decisions that have been issued require the business valuer to allocate goodwill value between the enterprise and the individual. This is no easy task since that are no definitive guidelines for the appraiser to follow to accomplish this. Each situation will depend on the facts and circumstances surrounding the appraisal. If we represent the business owner, the task is considerably easier. All we have to do is determine that "she is the business." We can call those business contacts that our client puts us in contact with who will sing the praises of our client. Of course, all of the goodwill is personal! "I would not do business with anyone else. If she goes, so do I." This really puts the nonbusiness spouse at a terrible disadvantage.

The *Thompson* court wants the valuer to use the "fair market approach" to value the business, but it does not understand the fact that implied in *fair market value* is a covenant not to compete. A business will not sell in the marketplace if the buyer can open up next door and steal what was just sold. However, in most instances, the allocation that is made in the sales contract towards a covenant has no economic reality to it. It is a made up number between the buyer and the seller. With the change in the tax laws regarding amortization of intangible assets, the parties do not have to be as careful as they once did.

Another fallacy in the case law is that the valuation should be conducted as if there would be no transition between the seller and the buyer The vast majority of willing sellers assist in a smooth transition to maximize the selling price that could be achieved in the market. In the rare situation where the seller suddenly dies, the impact of the loss of a key person may be felt, but even that impact is rarely more than 15 percent of the value.

It should be remembered that the concept of *fair market value* assumes a hypothetical willing buyer and a hypothetical willing seller. This concept implies that these two parties would conduct a transaction under normal market conditions with both sides looking out for their own best interests. This means that the willing buyer's attorney would most likely not allow a closing to take place without the proper protection for the client. This protection would include a covenant not to compete if competition is a potential problem. The willing buyer will also require the willing seller to assist in a smooth transition if the circumstances require it. This is the real world. Many of these transactions require either an employment contract or a consulting contract that assists in the creation of the transition to the new owner. To assume anything to the contrary, flies in the face of the manner in which the marketplace operates.

The *Held* court took covenants not to compete one step further by considering non-solicitation agreements to be the same. Once again, the willing buyer will almost always require the seller to either not solicit customers or employees as part of the deal. Although the court has indicated that the facts need to be addressed on a case by case basis, the lack of a covenant and a non-solicitation agreement would render every business worth not much more than the value of the tangible and the separately identifiable intangible assets, other than goodwill.

Many businesses have intangible assets other than goodwill that need to be included in the valuation process. However, in most instances, these types of assets are not separately valued in the process. Most of the time, there is no reason to have to allocate the value among its components. Financial and tax reporting requirements call for the allocation of a purchase price to different classes of assets in order for depreciation and amortization to be properly measured. It is rare that this "slicing and dicing" of the overall value has to be performed by the appraiser. However, n order for personal goodwill to be properly estimated, the allocation of value becomes a critical step in the valuation process.

Allocation of Purchase Price

Addressing the allocation of goodwill and other intangible assets is something that we have to deal with in the accounting field on a regular basis. In financial reporting, the allocation of intangible value falls under Statement of Financial Accounting Standards No. 141 ("FAS 141"). Effective July 1, 2001, the rules regarding business combinations were changed, and the purchase method of accounting is now required. This means that the amount paid for the business must be allocated to the assets and liabilities that were part of the combination. These are to be recorded at fair value.

The purchase price is allocated in the following order:

- Net Working Capital Assets
- Fixed and Tangible Assets
- Other Tangible Assets
- Identifiable Intangible Assets
- Goodwill

Assets that are of an intangible nature must meet the separability criterion. They generally have to arise from a contract, or if non-contractual, they must be capable of being separated or divided. Separability is based upon specific facts and circumstances.

Identifiable Intangible Assets are categorized as follows:

- Marketing Related
- Customer Related
- Artistic Related
- Contract Based
- Technology Based

Non-competition agreements fall into the category of Marketing Related Intangible Assets. This group consists of:

- Trademarks and tradenames
- Service marks, collective marks, certification marks
- Trade dress (unique color, shape, or package design)
- Newspaper masthead
- Internet domain names
- Non-competition agreements

In addition to financial reporting requirements, there are also tax reporting requirements. Internal Revenue Code ("IRC") Section1060 provides guidance for the allocation of purchase price among the business assets acquired (see also IRC Section 338 for stock acquisitions with asset elections).

Non-Competition Agreements Under Florida Law

There have been many cases in Florida that address how to handle the value of covenants not to compete and personal goodwill. "…In *Held*, as in *Walton*, no attempt was made to subtract a fair value for the covenant from other evidence of value……It might still be possible, however, for another expert in a future case to begin with the mixture, subtract the value of the covenant, and testify that the difference is enterprise goodwill."

There seems to be uniform agreement that the value attributable to a covenant not to compete is attributable to personal goodwill.

> To avoid these abuses, courts in states which treat individual goodwill as separate property must begin to adopt more realistic principles for determining the effect of a covenant not to compete upon the valuation of enterprise goodwill. When a sale price includes a covenant, or another valuation method assumes a covenant, the burden should certainly be upon the spouse who relies upon the sale or offer to prove and exclude a fair value for the covenant. **But, the mere presence of a covenant does not justify a finding that no enterprise goodwill is present**.[3]

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[3] Brett R. Turner, Covenants Not to Compete and Valuation of Marital Businesses," *Divorce Litigation* 18, no. 2 (September 2006): 149.

Florida Statute Section 542.335, effective for non-compete clauses entered into after July 1, 1996, provides for "valid restraints of trade or commerce." In order to be binding, the contract must be reasonable in terms of *time*, *area* and the *line of business*. It is only enforceable if committed to writing.

The term 'legitimate business interest' includes, but is not limited to:

1. Trade secrets, as defined in s. 688.002(4).
2. Valuable confidential business or professional information that otherwise does not qualify as trade secrets.
3. Substantial relationships with specific prospective or existing customers, patients, or clients.
4. Customer, patient, or client goodwill associated with:
    a. An ongoing business or professional practice, by way of trade name, trademark, service mark, or "trade dress";
    b. A specific geographic location; or
    c. A specific marketing or trade area.
5. Extraordinary or specialized training.

Any restrictive covenant not supported by a legitimate business interest is unlawful and is void and unenforceable.

The statute provides minimum and maximum time periods for the covenant to be deemed reasonable. These are:

	Reasonable Period	**Unreasonable Period**
1. In the case of a restrictive covenant sought to be enforced against a former employee, agent, or independent contractor, and not associated with the sale of all or a part of: a. The assets of a business or professional practice, or b. The shares of a corporation, or c. A partnership interest, or d. A limited liability company membership, or e. An equity interest, of any other type, in a business or professional practice	6 months or less	More than 2 years

	Reasonable Period	Unreasonable Period
2. In the case of a restrictive covenant sought to be enforced against a former distributor, dealer, franchisee, or licensee of a trademark or service mark and not associated with the sale of all or a part of: a. The assets of a business or professional practice, or b. The shares of a corporation, or c. A partnership interest, or d. A limited liability company membership, or e. An equity interest, of any other type, in a business or professional practice,	1 year or less	More than 3 years
3. In the case of a restrictive covenant sought to be enforced against the seller of all or a part of: a. The assets of a business or professional practice, or b. The shares of a corporation, or c. A partnership interest, or d. A limited liability company membership, or e. An equity interest, of any other type, in a business or professional practice,	3 years or less	More than 7 years

Personal Goodwill And Non-Competition Agreements Are Not Just An Equitable Distribution Concept

The issue of personal goodwill has been addressed in non-matrimonial circumstances. The Internal Revenue Service has caused this area to be addressed in the income tax arena. According to *Revenue Ruling 64-235*, C.B. 1964-2, 18:

> …It is well established that personal skill is not a salable capital asset. See *Providence Mill Supply Co. v. Commissioner*, 2 BTA 791 (1925). However, a number of court decisions indicate that in appropriate factual circumstances a professional practice or other business may possess salable goodwill even though its success is solely attributable to the skill, integrity and other characteristics of the owner. See, for example, *Merle P. Brooks, et ux. v. Commissioner*, 36 TC 1128 (1961), acquiescence in result only, C.B. 1959-2, 5; and *James M. Herndon, et ux. v. Commissioner*, TC Memo 1962-184. In light of these decisions, the Service will no longer take the position that, as a matter of law, a one-man professional practice or any other one-man business can not have salable goodwill. In disposing of cases involving the sale of an entire professional practice, the extent to which the proceeds of sale can be allocated to goodwill will be determined on the facts rather than by whether the business is, or is not, dependent solely upon the professional skill or other personal characteristics of the owner….

This *Revenue Ruling* was modified by *Revenue Ruling 70-45*, regarding partial sales, however, this guidance remains the valid and enforceable position of the Internal Revenue Service.

In *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998), the issue was over the split-off of a subsidiary, Strassberg Ice Cream Distributors, Inc. ("SIC"). Strassberg developed personal relationships with customers over the previous 25 years, and was instrumental in the design of new ice cream packaging and marketing techniques. He was responsible for the introduction of Haagen-Dazs products into high volume retail stores in New Jersey.

There was an oral agreement with Haagen-Dazs for Strassberg to distribute products in New Jersey. Strassberg sold the assets of SIC to Haagen-Dazs in 1988. The Tax Court ruled that the oral contract and personal relationships were never assets of Martin Ice Cream, but owned solely by Strassberg. Upon sale of those assets to Haagen-Dazs Strassberg received capital gains treatment.

There is a substantial body of statutory authority, judicial precedent and administrative rulings regarding the valuation and amortization of non-compete agreements. The Internal Revenue Service has a four-part test for recognition of a non-compete agreement (see *Forward Communications v. US*, 78-2 USTC Para. 9542, also see the sample report at the end of this paper for a detailed analysis), which asks the following questions:

1. Is compensation paid for the covenant severable from the price for goodwill?
2. Was the party to the covenant attempting to repudiate an amount fixed by both the buyer and the seller for the covenant?
3. Did both parties actually intend, when they signed the sale agreement, that some portion of the price be allocated to the covenant?
4. Is the covenant economically real and meaningful?

Revenue Ruling 77-403 addressed the issue of whether a cash payment for a covenant not to compete was a separate asset or part of the real property sold. The facts are as follows:

- P bought real property from S for $12x
- P also paid S $3x for covenant not to compete
- S was obligated for a defined period of time not to participate directly or indirectly in the construction, purchase or management of competing properties within a specified distance from property sold to P
- S had constructed and sold many buildings but did not have personnel capable of managing rental property, had never managed real property, and irrespective of the existence of non-compete, did not intend to construct, purchase or manage rental property

The test is that in order for a payment for a covenant not to compete to be separate from the cost of property, the non-compete has to have a demonstrable value. The tests for determining a demonstrable value include:

- whether, in the absence of the covenant, the covenantor would desire to compete with covenantee;

- the ability of the covenantor to compete effectively with the covenantee in the activity in question; and,
- the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area in the covenant.

The Internal Revenue issued an ISP Coordinated Issue Paper for All Industries on May 7, 1992. This Paper addressed the issue that consideration paid for a bona fide covenant not to compete represents ordinary income to the seller and an amortizable deduction to the buyer for the duration of the covenant. If the amount paid under a covenant is intended to compensate for lost earnings, it constitutes ordinary income to the seller and is amortizable to the buyer. Facts surrounding the allocation to covenants must be scrutinized to ascertain if the covenant is separable from goodwill, and that value represents economic reality. The most important fact is whether the covenant is the product of bona fide bargaining arrangement rather than a sham. Economic reality theory is primarily concerned with business realities which would cause reasonable persons, genuinely concerned with the economic future, to bargain for the covenant not to compete.

This ISP was revised by the Internal Revenue Service in 1996 due to a change in the tax law (Omnibus Budget Reconciliation Act of 1993, specifically IRC §197). The concern was that the new tax law might result in the under-valuation of covenants not to compete. Factors to be considered in the recognition and valuation of the covenant include:

- Did the seller have the ability to compete?
- Was the payment intended as compensation to the seller in lieu of his employment in a competing venture?
- Are there any other factors that reflect the economic reality of the covenant?

IRC §197 (d)(1) specifically includes covenants not to compete, but provides for a 15-year amortization period which is probably different from the duration of covenant.

There are several recognized methods to quantify the value of a covenant. These include:

- Total Business Approach - value of business with and without the covenant
- Lost Sales Approach - value of the lost earnings from sales lost
- Lost Margins Approach - value of lost earnings from costs absorbed

Each of these methods is a form of the Income Approach. The calculation is intended to derive the present value of the lost earnings attributable to the lack of a covenant.

Factors to be considered to establish the value of non-competition for the covenantor generally include:

- Age, health and educational background
- Financial ability to compete against buyer after deal
- Technical expertise and know-how to engage in competition
- Need for specialized equipment, tools or other devices
- Business contacts and control of the client/customer base
- Intention to actually compete after the deal
- Legal capacity to compete after the deal

- Business reputation in the community

Identification of the specific impact that each covenantor would have on the business if no covenant were in place is an important consideration. It usually varies with each person.

The issue of a covenant not to compete is not just applicable to service oriented businesses (e.g. accounting, medicine, investment, advertising, etc.). The central issue regarding the earnings source (i.e. client/customer) is who owns that source? Is it owned by the business or controlled by the covenantor? The less institutionalized the environment, the greater the value of the covenant. The business may not be marketable in the absence of a covenant. The test, however, is not always an "All or Nothing" proposition.

Conclusion

There is no easy way to separate personal goodwill from that if the enterprise. Court decisions, such as *Thompson* and *Held*, while intending to be fair regarding the division of marital property, place the non-business owner spouse at a significant disadvantage. While we agree with the notion that the business owner should not pay for what cannot be transferred to a willing buyer, we also believe that fairness must make the court re-evaluate its previous attitude about covenants not to compete and non-solicitation agreements.

Beginning on the next page, we have included two different scenarios regarding how personal goodwill can be addressed in the valuation under current case law. Neither is foolproof, as a skilled attorney can always attack the expert. The only hope is that the court can see the reasonableness of the calculations.

Scenario 1 - The Dental Practice

An approach that we recently used in a dental practice valuation appears below. This used covenant not to compete data from a transaction database to allocate the goodwill.

A covenant not-to-compete (non-compete agreement) is an intangible asset based on a contractual agreement. Typically, the seller of a business, the covenantor, agrees not-to-compete with the buyer of the business, the covenantee, in a defined industry or market for a specific period of time, in a geographically defined area. A non-compete agreement has value to the buyer to the degree that it protects the assets (tangible and intangible) from loss of value by restricting competitive actions of the seller. From an economic perspective, the value of a non-compete agreement is dependent on several factors, including the ability of the seller to compete, the derivation of the non-compete agreement, and the losses the company would suffer if the seller competed.

In the instance where the seller has the ability to compete, the relevant question becomes, what impact would competition from the seller have on the business? The answer to this question depends on a myriad of factors. Chief among them are: 1) the seller being in possession of relationships that could redirect business from the company to a new company established or invested into by the seller, and 2) the seller having either sufficient knowledge or technology to allow him or her to bring competitive services to market.

The value of non-compete agreements in the purchase and sale of a company has been the subject of numerous court cases involving the Internal Revenue Service ("IRS") and taxpayers. According to Neil C. Kelly, ASA, CFA, the IRS maintains a theory called the "mass asset" rule. Prior to tax reform, this theory held that certain intangible assets were "non-depreciable as a matter of law, because such intangible properties are part of a single mass asset, which, in the aggregate, has no determinable useful life and is either inextricably linked to goodwill or self regenerating." According to Mr. Kelly, for a non-compete agreement to not fall under the mass asset rule, it must have the following components:

1. *A recital to the effect that it is the intent of the parties that the Covenant not-to-compete is separate and distinct from any goodwill the seller may be selling.*

2. *That the subject covenant is not merely for the purpose of protecting the purchase goodwill.*

3. *That the Covenant has an independent basis-value.*

4. *That the Covenant was expressly bargained for – separate and distinct from the goodwill of the seller.*

5. *That a specific monetary sum is being paid for the Covenant.*

6. *That the Covenant is for a specified period of time - which goes to the permissible amortized period.*

7. *That the Covenant to compete restrains a key individual from competing with the purchaser, and if same is not accomplished, that the purchaser will suffer an economic detriment because of the key person's ability and competitive activities.*

8. *That even in the event of the death of the grantor of the Covenant, such will not entitle the purchaser to depreciate or recover the cost of such Covenant over a period shorter than the term of such a Covenant.*

9. *The amount the purchaser is paying for the Covenant not-to-compete is depreciable over the life of the Covenant regardless of whether the purchaser makes payments for such Covenant over a period shorter than the life of the Covenant.*

10. *A recital to the effect that the value allocated to the Covenant has economic reality or substance.*

In addition, guidance can be found in the four tests that the courts have historically applied to non-compete agreements in determining whether it could be amortized for federal income taxes. The four tests were summarized in Forward Communications Corp. v. U.S., 78-2 USTC Para. 9542, as follows:

1. *Whether the compensation paid for the covenant is severable from the price paid for the acquired goodwill.*

2. *Whether either party to the contract is attempting to repudiate an amount knowingly fixed by both the buyer and seller as allocable to the covenant.*

3. *Whether there is proof that both parties actually intended, when they signed the sale agreement, that some portion of the price be assigned to the covenant.*

4. *Whether the covenant is economically real and meaningful.*

The first test was effectively established in Marsh & McLennan, Inc. v. Commissioner, 51 T.C. 56 (1968) aff'd on other grounds, 420 F.2d 667 (3d Cir. 1969). In this case, the court looked at whether the compensation paid for the covenant is separable from the price for goodwill. Where goodwill and the covenant not-to-compete are closely related, the benefits of the elimination of competition may be permanent or of indefinite duration and, hence, the value of the covenant is not exhaustible or a wasting asset to be amortized over a limited period.

In Commissioner v. Danielson, 378 F. 2d 771 (3d. Cir.) cert. Denied 389 US 358 (1967), the courts looked at whether either party was attempting to repudiate an amount knowingly fixed by both as allocable to the covenant, the calculable tax benefit of which may fairly be assumed to have been a factor in determining the final price.

In Annabelle Candy Co. v. Commissioner, the courts looked at whether the covenant played a real part in the negotiations.

Of particular importance, is whether the covenant was at issue in the negotiation process. This relates to the economic reality of the covenant and its economic significance. According to Kelly, the following are factors which are important in determining the economic reality of a non-compete agreement.

1. *The presence of a grantor of the covenant not-to-compete having business expertise evidencing a formidable capability to compete;*

2. *Grantor's ownership of technology and machinery necessary to compete;*

3. *Grantor's possession of sufficient economic resources to compete;*

4. *Legal enforceability of the covenant for the term of the particular covenant under state law;*

5. *Grantor's legal capacity to compete;*

6. *Covenant having sufficient scope to assure non-competition without overreaching;*

7. Not too advanced age of grantor;

8. Good health of grantor;

9. Payments for covenant that are not pro-rata to the grantor's stock ownership in the seller;

10. Purchaser's policing of the covenant not-to-compete;

11. Structuring payments under the covenant to occur over time and to cease upon breach of such covenant;

12. Vigorous negotiations over the covenant and negotiations over its value should be recited in the agreement;

13. A detailed, specific, and carefully drafted covenant not-to-compete;

14. Independent appraisal of the value of the covenant not-to-compete;

15. Some degree of reasonableness in the percentage of the considerations allocated to the covenant and other items.

The importance of the covenant not-to-compete having economic substance was further delineated by a Bureau of National Affairs' paper on the subject published in 1992. The paper stated:

> *The most important factor is whether the covenant is economically real, that is, whether the covenant is the product of bona fide bargaining rather than a sham. The economic reality theory is primarily concerned with business realities which would cause reasonable persons, genuinely concerned with their economic future, to bargain for the covenant not-to-compete.*

Among the facts to be considered are whether the seller could actually compete with the purchaser. Where the seller is, objectively, likely to be a competitor, the paper states that courts have also looked at the actual contract negotiations to determine if the parties' intentions were for the covenant not-to-compete to have value.

> *In addition, the amount allocated to the covenant not-to-compete may not reflect economic reality. The taxpayer has the burden of proving that he is entitled to the deduction. Welch v. Helvering, 290 U.S. 111 (1933). Courts have frequently found that covenants have no value or, at least, substantially less value than the purchaser attributes to them. The same factors as above have been considered for this purpose. Further, courts have looked at the actual contract negotiations to determine if the parties intended the covenant to have any value. For example, if the parties agreed to pay a certain amount for the assets of the seller and the purchase price is not altered when a covenant not-to-compete is later added, the covenant has no or minimal value.*

Other guidance on determining the value of a covenant not-to-compete is given in Revenue Ruling 77-403. The ruling states that the relevant factors for determining the value of a non-compete agreement include:

> *1) Whether in the absence of the covenant the covenantor would desire to compete with the covenantee; 2) the ability of the covenantor to compete effectively with the covenantee in the activity in question; and 3) the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant.*

Based on the issues presented by Kelly in regard to the mass asset rule, the covenant is a distinguishable asset that can be valued separately from goodwill.

In essence, a covenant not to compete is used to protect the goodwill that is associated with the practitioner that would allow that individual to compete with the purchaser of the practice. In the valuation performed in this matter, the indicated value of $702,000 can be broken down between tangible and intangible value as follows:

Tangible Value	*$208,000*
Intangible Value	*494,000*
Total Value	*$702,000*

The normalized balance sheet was used to derive the value of the net tangible assets. Therefore, by subtraction, any remaining value would be attributable to intangible assets. This would be the maximum amount that a willing buyer would be looking to protect in an acquisition of Johnson Dental Care. In order to estimate the amount of personal goodwill associated with Johnson Dental Care, the appraiser looked for two separate factors which would provide market evidence as to the value of a non-compete agreement.

CONTRACT FOR SALE BETWEEN DR. SCOTT SMITH AND DR. MARK JONES (JULY 1989)

As indicated earlier in this report, the asset purchase agreement that involved Dr. Smith included a restrictive covenant. In fact, according to the allocation on page three of this agreement, the $366,000 purchase price was allocated between tangible and intangible assets as follows:

Tangible Assets	*$153,720*
Intangible Assets	*212,280*
Total	*$366,000*

The intangible assets were broken down between patient records and restrictive covenant as follows:

Patient Records	*$131,760*
Restrictive Covenant	*80,520*
Total	*$212,280*

This indicates that approximately 22 percent of the purchase price was allocated to a restrictive covenant ($80,520 ÷ $366,000).

MARKET EVIDENCE FROM THE PRATT'S STATS DATABASE

Included in the detail of the Pratt's Stats database is information relating to whether or not a covenant not compete was granted, and if so, how much of the sale price was allocable to this covenant. An analysis was performed of the transactions resulting in the information provided in Table 19.

TABLE 19
PRATT'S STATS TRANSACTIONS
WITH NON COMPETE INFORMATION

Business Description	Sale Date	Sell Price	Liabilities Assumed	Employ Agree Value	Price-Liabilities & Employment Agreement	Noncompete Value	NonCompete to Selling Price
Dental Practice	1/22/1999	443,500	0	0	443,500	175,933	39.67%
Dental Practice	11/2/1999	20,000	0	0	20,000	5,000	25.00%
Dental Practice - General Family	9/7/1999	314,262	0	0	314,262	10,000	3.18%
Dental Practice - General Family	10/5/1999	222,500	0	0	222,500	10,000	4.49%
Dentist	10/24/1997	287,000	0	0	287,000	1,000	0.35%
Dentist, General	5/1/1997	482,000	0	0	482,000	33,000	6.85%
Dentist, General	4/1/1998	150,000	0	0	150,000	15,000	10.00%
Dentist, General	4/1/1998	120,000	0	0	120,000	20,000	16.67%
Dentist, General	1/1/1998	210,000	0	0	210,000	20,000	9.52%
Dentist, General	2/1/1998	210,000	0	0	210,000	40,000	19.05%
Dentist, General	4/1/1997	173,000	0	0	173,000	20,000	11.56%
Dentist, General	1/1/1998	137,000	0	0	137,000	10,000	7.30%
Dentist, General	10/1/1997	147,000	0	0	147,000	12,000	8.16%
Dentist, General	2/1/1998	60,000	0	0	60,000	20,000	33.33%
Dentist, General	10/1/1997	28,000	0	0	28,000	3,000	10.71%
Dentist: Orthodontist	10/15/1998	119,000	0	0	119,000	10,000	8.40%
Dentist: Orthodontist	6/15/1999	342,000	0	0	342,000	11,000	3.22%
Family Dentistry	5/28/1998	176,677	0	0	176,677	5,000	2.83%
Family Dentistry	9/15/1998	105,500	0	0	105,500	10,000	9.48%
Family Dentistry & Implantology	5/1/1998	752,000	0	0	752,000	50,000	6.65%
General Dentist	8/15/1998	132,000	0	0	132,000	11,000	8.33%
General Dentist	6/15/1999	350,000	0	0	350,000	30,000	8.57%
General Dentist	6/15/1999	130,000	0	0	130,000	10,000	7.69%
General Dentist	5/15/1999	79,000	0	0	79,000	4,000	5.06%
General Dentist	2/15/1999	301,000	0	0	301,000	11,000	3.65%
General Dentist	7/15/1999	68,000	0	0	68,000	6,000	8.82%
General Dentist	3/15/1999	277,000	0	0	277,000	25,000	9.03%
General Dentist	1/15/1999	202,000	0	0	202,000	20,000	9.90%
General Dentistry	12/1/1998	115,001	0	0	115,001	10,000	8.70%
General Dentistry	6/15/1999	300,000	0	0	300,000	35,000	11.67%
General Dentistry	6/1/1997	277,000	0	0	277,000	50,000	18.05%
General Dentistry	12/1/1998	90,000	0	0	90,000	10,000	11.11%
General Dentistry	10/13/1997	399,369	0	0	399,369	60,000	15.02%
General Dentistry	4/1/1998	135,000	0	0	135,000	20,000	14.81%
General Dentistry	4/1/1999	115,000	0	0	115,000	10,000	8.70%
General Dentistry	4/15/1999	250,000	0	0	250,000	20,000	8.00%
General Dentistry	5/15/1999	100,000	0	0	100,000	10,000	10.00%
General Dentistry	6/15/1999	550,000	0	0	550,000	35,000	6.36%
General Dentistry	5/15/1999	325,000	0	200,000	125,000	30,000	24.00%
General Dentistry	4/1/1999	250,000	0	0	250,000	20,000	8.00%
General Dentistry- Family Prac.	11/24/1998	229,357	0	0	229,357	154,000	67.14%
General Family Dentistry	6/14/1999	344,782	0	0	344,782	15,000	4.35%
General Family Dentistry	7/26/1999	196,366	0	0	196,366	10,000	5.09%
General Family Dentistry	9/8/1999	286,000	0	0	286,000	10,000	3.50%
General Family Dentistry	4/12/1999	240,000	0	0	240,000	5,000	2.08%
General Family Dentistry	3/18/1999	125,000	0	0	125,000	75,000	60.00%
General Family Dentistry	7/9/1999	157,180	0	0	157,180	93,000	59.17%
General Family Dentistry	1/26/1999	426,031	0	0	426,031	220,000	51.64%
General Family Dentistry	10/22/1999	152,800	0	0	152,800	16,800	10.99%
General Dentistry	7/18/1997	376,150	0	0	376,150	50,000	13.29%
Oral and Maxillofacial Surgery	12/1/1997	400,000	0	0	400,000	20,000	5.00%
Oral and Maxillofacial Surgery	3/1/1998	800,000	145,000	0	655,000	50,000	7.63%
Oral and Maxillofacial Surgery	2/1/1998	500,000	0	0	500,000	25,000	5.00%
Oral and Maxillofacial Surgery	5/15/1999	1,000,000	0	0	1,000,000	50,000	5.00%
Oral and Maxillofacial Surgery	5/15/1999	425,000	0	200,000	225,000	40,000	17.78%
Oral and Maxillofacial Surgery	5/15/1999	550,000	103,000	0	447,000	40,000	8.95%

TABLE 19
PRATT'S STATS TRANSACTIONS
WITH NON COMPETE INFORMATION

Business Description	*Sale Date*	*Sell Price*	*Liabilities Assumed*	*Employ Agree Value*	*Price-Liabilities & Employment Agreement*	*Noncompete Value*	*NonCompete to Selling Price*
Oral and Maxillofacial Surgery	*1/15/1999*	*400,000*	*0*	*200,000*	*200,000*	*40,000*	*20.00%*
Oral and Maxillofacial Surgery	*1/15/1999*	*675,000*	*0*	*525,000*	*150,000*	*40,000*	*26.67%*
Oral and Maxillofacial Surgery	*12/31/1998*	*400,000*	*0*	*180,000*	*220,000*	*30,000*	*13.64%*
Oral and Maxillofacial Surgery	*1/15/1999*	*300,000*	*0*	*150,000*	*150,000*	*35,000*	*23.33%*
Oral and Maxillofacial Surgery	*2/15/1999*	*175,000*	*0*	*0*	*175,000*	*25,000*	*14.29%*
Oral and Maxillofacial Surgery	*4/15/1999*	*275,000*	*0*	*200,000*	*75,000*	*35,000*	*46.67%*
Oral and Maxillofacial Surgery	*6/15/1999*	*550,000*	*0*	*0*	*550,000*	*40,000*	*7.27%*
Oral and Maxillofacial Surgery	*4/1/1998*	*500,000*	*0*	*0*	*500,000*	*45,000*	*9.00%*
Oral and Maxillofacial Surgery	*3/15/1999*	*2,000,000*	*0*	*0*	*2,000,000*	*50,000*	*2.50%*
Oral and Maxillofacial Surgery	*4/1/1998*	*325,000*	*0*	*0*	*325,000*	*40,000*	*12.31%*
Oral and Maxillofacial Surgery	*6/15/1999*	*300,000*	*0*	*0*	*300,000*	*30,000*	*10.00%*
Oral and Maxillofacial Surgery	*12/1/1998*	*330,000*	*0*	*0*	*330,000*	*30,000*	*9.09%*
Oral and Maxillofacial Surgery	*1/15/1999*	*650,000*	*17,000*	*450,000*	*183,000*	*42,000*	*22.95%*
Oral Surgery	*11/15/1997*	*175,000*	*0*	*0*	*175,000*	*50,000*	*28.57%*
Orthodontia	*7/15/1999*	*200,000*	*0*	*0*	*200,000*	*20,000*	*10.00%*
Orthodontist	*4/1/1998*	*400,000*	*0*	*0*	*400,000*	*25,000*	*6.25%*
Orthodontist	*2/1/1998*	*175,000*	*0*	*0*	*175,000*	*20,000*	*11.43%*
Pediatric Dentistry	*3/1/1998*	*375,000*	*0*	*0*	*375,000*	*40,000*	*10.67%*
Periodontal Practice	*1/5/1998*	*265,000*	*0*	*0*	*265,000*	*50,000*	*18.87%*
					Average		***14.29%***

Table 19 reflects the selling price of The Practice minus any liabilities assumed and employment agreement values that were specifically allocated as part of the selling price in order to determine the price of the practice, net of the liabilities and of the employment agreement. We then compared this amount to the result that was allocated to the value of the non-compete agreement. The average non-compete agreement value to the net selling price amounted to 14.29 percent. We further analyzed this data and removed all specialty practices to see what impact, if any, these had on the average. The average went up to 14.74 percent. Therefore, the market evidence indicates that of these transactions, between 14 and 15 percent is indicative of the non-compete values.

CONCLUSION

Clearly, the best indication of the value of a non-compete agreement would be using market data involving Dr. Smith himself. Although the transaction was from 1989, clearly, it is within the range of reasonableness (22 percent versus 14.74 percent) based on the other market evidence. Therefore, it appears that approximately 20 percent of the purchase price, or $140,400 ($702,000 x 20 percent) would be a reasonable indication of the value of the non-compete. Therefore, in our opinion the value of Johnson Dental Care that should be subject to equitable distribution as of March 23, 2000 would be $561,600.

Scenario 2 - The Durable Medical Equipment Business

This is a unique situation. The husband and wife agree to the value of the business ($5 million) and amicably resolved equitable distribution without a trial. Two weeks after the divorce was put through, the wife received a FedEx package addressed to the husband that had closing documents that he sold his company to a publicly traded entity for almost $17 million. By the time this matter got back into the court based on fraud, the argument was over how much of the value was attributable to personal goodwill? Parts of the report have been omitted due to space constraints.

DESCRIPTION OF THE ASSIGNMENT: *Trugman Valuation Associates Inc. was retained by Mary Smith to determine the equitable distribution value of Smith Respiratory Services, Inc. ("SRS" or the "Company") as of March 9, 1995, as well as to determine the value of the covenant not-to-compete that was part of an actual transaction involving certain assets of the Company. We have also been requested to opine on whether the value ascribed to the covenant not-to-compete is corporate, personal, or a combination of both.*

In order to accomplish the assignment at hand, the following steps were taken by the appraiser:

1. *Determine the fair market value of SRS;*
2. *Determine the fair market value of the tangible assets of SRS;*
3. *Determine the fair market value of the identifiable intangible assets of SRS;*
4. *Subtract the fair market value of the tangible and identifiable intangible assets of SRS from the fair market value of the total enterprise.*

The result of this process will be to determine the residual, or unidentifiable intangible value that makes up the balance of the fair market value of the enterprise.

DEFINITION OF EQUITABLE DISTRIBUTION VALUE: *For this matter, equitable distribution value of the equity of SRS has been determined as a result of an actual transaction involving certain assets of the Company. Other assets were kept by the sole shareholder.*

The equitable distribution value has been determined and is referenced in the "Order on Motion to Vacate Final Judgment of Dissolution of Marriage" signed by the Honorable Robert Jones on July 24, 1996. The value established in paragraph (8) of this order is $16,900,000.

DEFINITION OF FAIR MARKET VALUE: *The most commonly used definition of fair market value is located in Internal Revenue Service Revenue Ruling 59-60. This revenue ruling defines fair market value 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.*

VALUATION METHODOLOGIES: *There are two fundamental bases on which a company may be valued:*

1. *As a going concern, and*
2. *As if in liquidation.*

The value of a company is deemed to be the higher of the two values determined under a going concern or a liquidation valuation. This approach is consistent with the appraisal concept of highest and best use, which requires an appraiser to consider the optimal use of the assets being appraised under current market conditions. If a business will command a higher price as a going concern then it should be valued as such. Conversely, if a business will command a higher price if it is liquidated, then it should be valued as if in orderly liquidation.

In this instance, SRS will be valued on a going concern basis since the company has significantly greater value as a going concern. This has been evidenced by a transaction that took place where certain assets of SRS were purchased. This transaction is discussed in greater detail later in this report.

VALUATION APPROACHES: *The three basic approaches that must be considered by the appraiser are:*

1. *The Market Approach,*
2. *The Asset Based Approach, and*
3. *The Income Approach.*

Within each of these approaches there are many acceptable valuation methods available for use by the appraiser. Appraisal standards suggest that an appraiser test as many methods as may be applicable to the facts and circumstances of the property being appraised. It is then up to the appraiser's informed judgment as to how these various values may be reconciled in ultimately deriving a final estimate of value.

THE MARKET APPROACH: *The market approach is fundamental to valuation. Fair market value is determined by the market. Under this approach, the appraiser attempts to find guideline companies traded on a public stock exchange, in a same or similar industry as the appraisal subject, that allows a comparison to be made between the pricing multiples that the public company trades at and the multiple that is deemed appropriate for the appraisal subject.*

Another common variation of this approach is to locate entire companies that have been bought and sold in the marketplace, publicly traded or closely-held, that allows the appraisers to determine the multiples that resulted as part of the transaction. These multiples can then be used, with or without adjustment, depending on the circumstances, for the appraisal subject.

THE ASSET BASED APPROACH: *The asset based approach, sometimes referred to as the cost approach, is an asset oriented approach rather than a market oriented approach. Each component of a business is valued separately, and summed up to derive the total value of the enterprise.*

The appraiser estimates value, using this approach, by estimating the cost of duplicating or replacing the individual elements of the business property being appraised, item by item, asset by asset. The tangible assets of the business are valued using this approach, although it cannot be used alone as many businesses have intangible value as well, which this approach cannot easily be applied to.

THE INCOME APPROACH: *The income approach, sometimes referred to as the investment value approach, is an income oriented approach rather than an asset or market oriented approach. This approach assumes that an investor could invest in a property with similar investment characteristics, although not necessarily the same business.*

The computations, using the income approach generally determine that the value of the business is equal to the present value of the future benefit stream to the owners. This is generally accomplished by either capitalizing a single period income stream or by discounting a series of income streams based on a multi-period forecast.

Since estimating the future income of a business is at times considered speculative, historical data is generally used as a starting point in several of the acceptable methods under the premise that history will repeat itself. The future cannot be ignored, however, since valuation is a prophecy of the future.

REVENUE RULING 59-60 - VALUATION OF CLOSELY-HELD STOCKS: *Among other factors, this appraiser considered all elements listed in Internal Revenue Service Ruling 59-60 which provides guidelines for the valuation of closely-held stocks. Revenue Ruling 59-60 states that all relevant factors should be taken into consideration, including the following:*

1. *The nature of the business and the history of the enterprise from its inception.*
2. *The economic outlook in general and the condition and outlook of the specific industry in particular.*
3. *The book value of the stock and financial condition of the business.*
4. *The earning capacity of the company.*

5. The dividend paying capacity of the company.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market either on an exchange or over the counter.

Since determining the fair market value of a business and allocating its purchase price are the questions at issue, one must understand the circumstances of each individual case. There is no set formula to the approach to be used that will be applicable to the different valuation issues that arise. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular business or business interest. In resolving such differences, one should recognize that valuation is not an exact science. Revenue Ruling 59-60 states that "a sound valuation will be based on all 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."

The fair market value of specific shares of stock in an unlisted corporation will vary as general economic conditions change. Uncertainty as to the stability or continuity of the future income from the business decreases its value by increasing the risk of loss in the future. The valuation of shares of stock of a company with uncertain future prospects is a highly speculative procedure. The judgment must be related to all of the factors affecting the value.

There is no single formula acceptable for determining the fair market value of a closely-held business, and therefore, the appraiser must look to all relevant factors in order to establish the business' true fair market value as of a given date. The Internal Revenue Service has also issued a training manual, which is in excess of one hundred pages, in order to aid representatives in accurately valuing a closely-held business.

NATURE AND HISTORY OF THE COMPANY

Smith Respiratory Services, Inc. was incorporated on June 10, 1981. The Company began operations in Plant City, Florida, providing durable medical equipment and respiratory therapy products to patients referred to the Company by their doctors. Products were sold primarily to elderly patients through Medicare, Medicaid or private insurance. SRS was formed after the dissolution of a partnership between Mr. and Ms. Smith, and William Johnson, a pharmacist in the Orlando area. Mr. Johnson was involved in the oxygen concentrator business. The partnership was formed in late 1980. Ms. Smith had left her job at Saron Pharmacal, Inc. where she had been a marketing representative. The partnership was formed with the understanding that Ms. Smith would bring her existing patient referral base to the partnership. Mr. Johnson furnished the Smiths with a vehicle, equipment, and billing services. The Smiths worked Ms. Smiths' existing patient referral base and developed new referrals.

Late in 1980, Ms. Smith went to work for Dr. Edgar Randolph four days per week due to the Smiths' poor financial situation. Ms. Smith was employed by Dr. Randolph prior to her employment at Saron Pharmacal, Inc. Dr. Randolph had a large geriatric patient base, many of whom required oxygen. Dr. Randolph referred these patients to the Smiths, initially in their partnership with Mr. Johnson and later to SRS.

When the Smiths left their partnership with Mr. Johnson, they needed money to finance SRS. Ms. Smith took out a second mortgage on her home in the amount of $20,000 to provide the Company with financing. After operating out of the marital home for the next three years, SRS had become successful enough to require more space for its operations. In 1984, Ms. Smith went to Dr. Randolph, and using her personal relationship with him, asked him for a loan of $200,000. This money was used to build a facility in Plant City for SRS' operations.

Afterwards, SRS opened three additional locations, in Lakeland, Zephyrhills, and Sebring, Florida. Each of these locations was opened after Mr. Smith and his marketing team determined that the location was viable, *based on its demographics. Each of the SRS facilities was owned by Mr. Smith personally, and leased to the Company.*

At the valuation date, SRS was operating in Hardee, Hernando, Highlands, Hillsborough, Pasco, and Polk counties, selling items such as beds, wheelchairs, walkers, and respiratory therapy products. Sixty percent of SRS' sales came from respiratory therapy products, 30 percent from durable medical equipment, and 10 percent from miscellaneous products. Management estimated that 70 percent of its revenues resulted from rentals, and 30 percent from sales.

Table 1 presents SRS' equipment and medication mix as of October 31, 1994.

TABLE 1
EQUIPMENT AND MEDICATION USAGE

Equipment/Therapy	***Number of Patients***
Nebulizers	***340***
Medications	***680***
Portable Oxygen	***966***
Concentrators	***957***

Payment for products and medications came from four sources: Medicare, Medicaid, private insurance, and retail. These sources represented 70 percent, 18 percent, 10 percent, and 2 percent of payments, respectively. SRS developed a reputation for delivering high quality service to its patients. Services included guaranteed one hour delivery, 24 hours a day service, and educating patients in the use of their equipment. This was very important in differentiating SRS from the rest of the market. Other companies in the durable medical equipment market competed with SRS. In Plant City and Hillsborough County, competitors included Respitch, Inc. and Lincare. In Lakeland, SRS' competition included MediHealth, Inc., Lincare, Americare, Inc., and State Oxygen, Inc. Competition in Zephyrhills consisted of Coast, Inc., and Lincare. In Sebring, Lincare, Sunshine, Inc., Medicaid, Inc., and Homedco, Inc. competed with SRS. As will be discussed later in this report, although these companies participated in the same markets as SRS, Mr. Smith did not believe that any of these companies offered a significant, competitive threat to SRS.

As of the valuation date, the Company had approximately 50 employees. Responsibility for overall management was shared between Mr. Smith and Ms. Lori Daniels. Their duties included day-to-day operations, training, marketing, and ensuring that whatever needed to be done was accomplished. They also shared the responsibilities for managing the Plant City facility, which was both a retail and billing operation. Each of the other three stores had a manager responsible for the store's operations. The Company had four marketing representatives whose primary responsibilities were to maintain existing referral sources and establish new ones. SRS also had a delivery manager, who was responsible for coordinating drivers and the delivery of products to patients. Additional employees included customer service representatives, drivers, accounts receivable clerks, office staff, warehouse staff, and a dispatcher.

As part of our analysis, we inspected the former SRS retail locations, now operated by Lincare. All of the SRS locations are located on main roadways near major local and regional medical centers and numerous doctors' offices. This served as a constant reminder to doctors that SRS was close by. In addition, this enabled SRS to deliver services such as setting up oxygen in a doctor's office or a hospital, in order to send a patient home. Geographic local made it easier for SRS to respond rapidly to these needs. In addition, the demographics of the area surrounding the SRS locations were favorable to the oxygen therapy business. This allowed for expansion of markets and market share based on an established presence in these areas. The following paragraphs discuss the four retail locations operated by SRS.

The Zephyrhills store was located at 6500 Gall Boulevard. This is one of the major roadways running through Zephyrhills along with Route 54, which Gall Boulevard intersects approximately a mile and a half from 6500 Gall Boulevard. The storefront is approximately one quarter of a mile from East Pasco Medical Center, which is located at 7050 Gall Boulevard. Associated with the medical center are some office buildings that contain approximately 20 different medical practices and laboratories. The medical center has a surgery center, emergency room, therapies department, and out patient imaging department. There are additional doctors' offices on Dougherty Road, which is just past the medical center, approximately one-half mile from the Lincare facility. Approximately three quarters of a mile down Route 301 is Townview Medical Arts Center, which appears to contain approximately eight medical practices. Across US Route 301 from the medial center is Spanish Trails senior living trailer home, a trailer park. We observed additional medical office buildings and trailer parks on Route 301, within one to two miles of the SRS location.

Plant City is approximately 17 miles southeast of Zephyrhills on Route 39. The Plant City facility is located in the Village at Watson Lake mini-mall on South Alexander Street. Alexander Street intersects Route 92 in Plant City. Alexander Street is a four lane roadway running north and south. South Florida Baptist Hospital is on North Alexander Street . The Village at Walden Lake contains a restaurant, hair and tanning salon, a realtor, photography business, and a Lincare facility under the name of Smith. The Watson Clinic is located within one-half mile of the facility. Florida Baptist Hospital is approximately two miles north of the SRS location.

In Lakeland, the former SRS store is located at 1100 Lakeland Hills Boulevard. Lakeland Hills Boulevard contains Lakeland Regional Medical Center. The street is lined predominantly with medical office buildings, centers, clinics, and health care aid facilities from the 1100 through 1700 blocks, where the medical center is. The Watson Clinic is located on the 1500 block of Lakeland Hills Boulevard. The Lakeland facilities are still operating under the name Smith Respiratory Services and the trucks also carry the Smith name. The area is significantly more commercialized than either Zephyrhills or Plant City.

The Sebring location is approximately one-half mile from the Highland Regional Medical Center. It is located on Route 27 South. There is a professional medical building diagonally across the street that appears to have two or three medical practices in it. This is a somewhat less densely populated area than the areas the other stores are located in.

ECONOMY/INDUSTRY INFORMATION

(This section has been omitted)

FINANCIAL ANALYSIS

(Part of this section has been omitted)

EXCESS ASSETS: *From our analysis of SRS' financial statements, it appears that SRS has excess assets. Excess assets, sometimes referred to as non-operating assets, are assets that a business owns, that are not necessary for the operations of the business.*

SRS had two categories of assets that are considered to be excess, current assets, and fixed assets. At the valuation date, SRS' balance sheet indicates that the Company had $1,136,933 of current assets and $9,977 of current liabilities. This does not include the $550,000 of accounts receivable sold to Lincare. The reason for this is that SRS' financial statements are prepared on a cash basis, which does not include accounts receivable. Taking this into consideration, SRS had current assets of $1,686,933. Subtracting SRS' current liabilities from this figure results in the calculation of SRS' working capital of $1,676,956 ($1,686,933 - $9,977 = $1,676,956).

To check the reasonableness of this position, we reviewed Robert Morris Associates' Annual Statement Studies for working capital industry norms for durable medical equipment providers. For 1995, RMA reported that median working capital, as a percentage of sales, was 7 percent. Applying this to SRS' revenues for the 12 months ended February 28, 1995 results in the following calculation of working capital:

Revenues	*$ 5,930,480*
RMA Working Capital as a Percent of Revenues	*7%*
Required Working Capital	*$ 415,134*

This indicates that SRS had excess current assets of $1,261,822.

Lincare and SRS allocated $550,000 of the purchase price to accounts receivable. Lincare assumed no other current assets, and $35,000 of accrued current liabilities were not recorded as of February 28, 1995. This results in working capital of $515,000. This represents 8.68 percent of SRS' revenues in the latest 12 months. Although slightly above the median, this figure is still within industry norms. As a result, we have determined that SRS has excess current assets of $1,136,933. This figure represents all of SRS' current assets other than the accounts receivable.

SRS owned certain vehicles that we believe were non-operating assets. These vehicles were as follows:

1992 Mercedes	*$ 125,603*
1992 Mercedes	*61,158*
1989 Jaguar	*58,332*
1993 Jeep	*17,176*
	$ 262,269

In our opinion, these vehicles were not necessary for the operation of SRS. They are luxury automobiles that represented perquisites to Mr. Smith. In addition, Mr. Smith retained these vehicles after the asset sale to Lincare. As a result, we have determined these vehicles are non-operating assets. Their value has been estimated to be approximately $200,000.

VALUATION OF SMITH RESPIRATORY SERVICES, INC.

As indicated previously, the valuation of a closely-held company can be accomplished using the three approaches to value. One might ask why the transaction that transpired could not be used as the best indication of fair market value? Our analysis indicates that the price that was paid by Lincare, Inc. represents a value that was greater than the fair market value of SRS.

In the actual transaction that took place, Lincare purchased certain net assets of SRS at a price of $15,035,000. According to the allocation included in the Asset Purchase Agreement dated March 9, 1995, the following was purchased:

Accounts receivable	*$ 550,000*
Inventory	*40,000*
Fixed assets	*712,000*
Covenants	*100,000*
Goodwill/customer list	*13,633,000*
Total	***$ 15,035,000***

The price paid is greater than the fair market value of the assets purchased. Since the definition of fair market value is based on "the most probable price," a review of other factors brought to our attention in this matter, make us believe that the most probable price is lower than this amount. In addition, we believe that Lincare had special motivations in consummating this deal, that would cause the definition of fair market value to be violated.

In the deposition transcript of Steve Nagel, a principal of Steven Richard Associates, the business broker engaged by Mr. Smith to assist in the sale of SRS, several statements are made that assist us in substantiating our position. Mr. Nagel's responses are relevant in that they reflect the knowledge and expectations of the seller. In the course of Mr. Nagel's deposition, he asserts that Lincare overpaid for SRS, supporting his opinion with several pieces of information. Other than Lincare, Mr. Nagel indicated there were four offers made to purchase SRS. The companies and their offers are as follows:

Home Medical	*$ 11 million*
Abey Home Healthcare	*12 million*
Homedco	*11 million*
Continuem Care	*Undisclosed*

Mr. Nagel was then asked about the first Lincare offer of $13.5 million for SRS. This was an all cash offer and Mr. Nagel thought after presenting the offer to Mr. Smith "...our deal was done." Mr. Nagel's opinion is explained in the ensuing dialogue.

"I felt that no one would turn that down and we just felt it was – at the time we believed it to be the highest price Lincare had ever paid for a company. In fact, we could almost assure that it was the highest price they ever paid for a company." Mr. Nagel was then asked, "the highest price in dollar amount or the highest price compared to profits?" To this, Mr. Nagel responded,

> *It's the highest price compared to gross revenues. Lincare's never – they pay between 1.75 and 1.2 times gross revenue and that's just – we thought that was outstanding.*

That offer we took to Mr. Smith, to Ben, and it never hit his desk before he threw it back at us and I'm telling you the truth. This thing never hit his desk. He wouldn't even look at it. He wouldn't talk to us.

Q. Did he say why he was turning it down?
A. Yes.

Q. Why?
A. Two provisions that we told him about, that most of his employees would be fired and he had no tenant for two of his properties. So after that point we let Lincare sit out on a fence and I took that offer to all the other players and they all said let Lincare buy it. That went on for about a month and we never had – we probably had some contact, but most of the contact with Lincare was coming in the front door. They were calling us, what's going on?

Finally, the last player who hadn't given up was Continuem Care. Continuem Care kept fooling around, fooling around. Lincare was getting nervous. They thought they were going to lose the deal. And we went back to them and said, make – give it one best shot. Go ahead. You're still way off the mark. We never told them what the other offers were. We just said, you're way off the mark. With the suggestion that they keep all the employees in the billing center and take all the leases on the property and it did. I mean, I had really nothing to – well, I guess it had a lot to do with me. I pushed it.

Q. You persuaded Lincare?
A. I held their hand to the fire because they thought they were going to lose this deal in their own backyard and it would look very, very bad for a public company to do that.

It is clear Mr. Smith's advisors thought this was a tremendous deal, and it exceeded their expectations. The offer was not rejected by Mr. Smith because of the price. According to Mr. Nagel, the offer was rejected by Mr. Smith because most of SRS' employees would be fired, and he would not have a tenant for two of his properties. It was Mr. Nagel who obtained the higher offer from Lincare, along with the accommodation of Mr. Smith's concerns. He did this by letting Lincare "sit out on a fence" and by telling Lincare that they were "way off the mark," even though it was by far the best offer he had received for SRS. What allowed Mr. Nagel to do this was a non-financial concern on the part of Lincare, namely that the deal was in Lincare's "own backyard" and losing it would be embarrassing to Lincare. From Mr. Nagel's statements, it appears that Mr. Smith would have accepted the $13.5 million dollar offer if his two conditions regarding his employees and tenancy had been met.

In fact, the dialogue comes back to this issue:

Q. All right. Did Mr. Smith ever tell you what changed his mind regarding deciding to sell his business? He kept turning you down and later he-

> *A. The key issue was that as soon as we locked the employees in place and no one was to be terminated is when he said that's worth all the money in the world to me and that's exactly what he said, it's worth all the money in the world, these people having a job.*

Again, according to Mr. Nagel, Mr. Smith's issues were not related to price, but other non-price factors.

Mr. Nagel further explains the actions of Lincare by stating:

> *A. They're buying earnings. Earnings drive the price of their stock. Ben had a lot of earnings for the size of business that he had. And whether they paid 15 million dollars or 12 million dollars or 13 million dollars, at that time it didn't matter. They got rid of a competitor and they got the best – and they got people there that they don't – that are better than any people that they have, so they took everything into – I'd like to say we had a lot to do with getting 15 million dollars for this company.*

This further highlights his beliefs that Lincare's motivation was beyond financial, and that Mr. Smith's reasons for rejecting the first Lincare offer were unrelated to the purchase price.

Mr. Nagel's comments raise the issue of whether Lincare paid fair market value for SRS, or paid above fair market value for synergistic and public image reasons. As discussed earlier in this report, fair market value is established between a willing buyer and willing seller, neither party being under compulsion and both having reasonable knowledge of the relevant facts. It appears from the comments of Mr. Nagel that he believed that Lincare was under compulsion, and that he could exploit that compulsion to the advantage of Ben Smith.

This brings about the possibility of a buyer's premium. A buyer's premium is concerned with elements of investment value. According to Pratt, investment value is defined

> *..... as value to a particular investor based on individual investment requirements, as distinguished from the concept of market value, which is impersonal and detached.*

As Pratt states, investment value is different for different buyers. There are many factors that can influence investment value such as estimates of earning capacity, perceptions of risk, tax statutes, and synergies.

Stated differently, the investment value of a closely-held company is the value to a particular buyer, as compared to the population of willing buyers, as is the case in fair market value. This value definition would be applicable, when an investor might have specific investment criteria that must be fulfilled in an acquisition.

An appraiser will frequently use this standard of value when he or she represents a buyer who wants to know, "How much is the business worth to me?" The fact that the buyer is specific about the business value to him or her changes the standard of value to investment value, as opposed to fair market value, which may be the value to everyone else.

Under such a definition of investment value, certain elements can be quantified numerically in an income stream, and differences between fair market value and investment value can be calculated. Others, like Lincare's desire not to let other major competitors into its "backyard" cannot be calculated from an income stream. Typical market data does not allow us to calculate such a premium.

However, one study has provided us with an insight into this type of a premium by comparing the multiples of earnings before interest and tax ("EBIT") paid by financial buyers and strategic buyers. The study consisted of a poll of 35 professional investment bankers, lenders, and the managing partners of buyout firms, and covered the manufacturing, retail, communications, services, and healthcare industries, in particular.
As discussed above, hard data is difficult to obtain for such a survey. Accordingly, the study is based on the respondents "feel for the industry based on their experiences in both proprietary deals and auction settings. At times, their answers were categorized as a broad interpretation of the diversity within a sector." Table 12 presents the multiples obtained by the survey for 1989, 1993, and 1995, and calculates the premium that strategic buyers are paying over financial buyers.

TABLE 12
TRENDS IN ACQUISITION MULTIPLES

	1989	1993	1995
Strategic Buyers	7.76	6.11	7.24
Financial Buyers	7.41	5.40	6.50
Premium	4.72%	13.15%	11.38%

Source: Jennifer Lea Reed, Buyouts, February 20, 1995, p.1

As can be seen in the data in Table 12, the premium for 1995 was 11.38 percent. To apply a buyer's premium to the sale of SRS, the premium is applied to Lincare's initial offer of $13.5 million. The justification for this is two-fold. First, Lincare's offer appears to already have included some elements of investment value, as it was significantly greater than the other offers for SRS. Second, Mr. Smith's reasons for not accepting the offer were unrelated to the purchase price, but rather were related to the non-financial terms of the agreement.

We have applied this premium to Lincare's $13.5 million offer to test to our hypothesis. The results are presented in Table 13.

TABLE 13
APPLICATION OF A BUYER'S PREMIUM

Initial Offer From Lincare	$ 13,500,000
Times One Plus Strategic Premium	x 1.1138
Price with Buyers Premium	$ 15,036,300

Final Purchase Price	*$ 15,035,000*
Difference	*$ 1,300*

This strongly supports the assertion that Lincare was a strategic buyer in its acquisition of SRS, and the assertions made by Mr. Nagel in his deposition. To verify this against other known data, we relied on the deposition of Mr. Deutsch, Lincare's national acquisition program manager. Mr. Deutsch indicated that Lincare's acquisitions typically occur at 3.5 to 4.0 times free cash flow for the trailing 12 months. Based on Lincare's estimate of free cash flow for the trailing 12 months of $3.5 million, the price to free cash flow multiple paid for SRS using a value of $13,500,000 was 3.86 ($13,500,000 ÷ $ 3,500,000 = 3.8571 or 3.86 rounded). Based on this data and the information presented in Mr. Nagel's deposition, we conclude that the fair market value of the operating business of Smith Respiratory Services was $13,500,000 at March 9, 1995, based on the actual market transaction that was consummated.

In order to test the conclusion reached in the market approach, we then applied an income approach methodology in our analysis. To implement the income approach, we have selected the discounted future benefits method.

The discounted future benefits method is one of the most theoretically correct methods of appraisal. It is premised on the concept that value is based on the present value of all future benefits that flow to an owner of a property. These future benefits can consist of current income distributions, appreciation in the property, or a combination of both. The formula for the discounted future benefits method is as follows:

$$\sum_{n=1}^{n=t} \frac{E_n}{(1+i)^n} + \frac{TV_t}{(1+i)^t}$$

Where

E	=	*Forecasted benefit stream.*
n	=	*Year in which the benefit stream is achieved.*
i	=	*Required rate of return.*
TV	=	*Terminal value, which is the estimated value of the benefit stream after the forecast period.*
t	=	*Year of stabilization.*

The formula appears much more complicated than it is. In essence, this valuation method requires a forecast to be made of future benefits, going out far enough into the future until an assumed stabilization occurs for the property being appraised. In this instance, the benefit stream being discounted is cash flow.

In order to apply this methodology, we began the analysis with a forecast of expected future operating cash flows for SRS. Table 14 presents the forecasted income statement for SRS for the years ended March 9, 1996 through 2000.

TABLE 14
FORECASTED INCOME STATEMENT AND CASH FLOW
FOR THE YEARS ENDED MARCH 9,

	1996	1997	1998	1999	2000
Net Sales[1]	*$ 6,500,000*	*$ 7,345,000*	*$ 8,299,850*	*$ 9,378,830*	*$ 10,504,290*
Less: Cost of Sales[2]	*916,500*	*1,035,645*	*1,170,279*	*1,322,415*	*1,481,105*
Equals: Gross Profit	*$ 5,583,500*	*$ 6,309,355*	*$ 7,129,571*	*$ 8,056,415*	*$ 9,023,185*
Less: Operating Expenses[3]	*2,723,500*	*3,077,555*	*3,477,637*	*3,929,730*	*4,401,297*
Equals: Net Operating Income	*$ 2,860,000*	*$ 3,231,800*	*$ 3,651,934*	*$ 4,126,685*	*$ 4,621,888*
Less: Taxes[4]	*1,144,000*	*1,292,720*	*1,460,774*	*1,650,674*	*1,848,755*
NET INCOME	***$ 1,716,000***	***$ 1,939,080***	***$ 2,191,160***	***$ 2,476,011***	***$ 2,773,133***

1. *Revenues for the trailing 12 months in 1995 are based on the Lincare pro forma included in this report as Exhibit 2. Revenues are grown thereafter to generate a compound annual growth rate for the entire forecast period of 12.7 percent. This is the approximate rate of growth projected for the industry, as previously discussed.*

2. *Cost of sales is forecasted as 14.1 percent of sales for each year in the forecast period. This is based on the historical average for the period analyzed.*

3. *The historic average operating expenses for the period ended May 30, 1991 through May 30, 1994 and the latest twelve months ended December 31, 1994 was 45.1 percent of sales. For fiscal 1994, operating expenses were 41.9 percent of sales, which we used in each year of the forecast period. The most recent fiscal year's figure was selected over the average, based on the downward trend in operating expenses as a percentage of sales during the historic period analyzed.*

4. *We have assumed a combined federal and state tax rate of 40 percent.*

Using the forecasted income statements presented in Table 14, combined with an analysis of the balance sheet of SRS, we have prepared a forecast of the net cash flow for the years ended March 9, 1996 through 2000. This appears in Table 15.

TABLE 15
FORECASTED NET CASH FLOW
FOR THE YEARS ENDED MARCH 9,

	1996	1997	1998	1999	2000
Net Income (Table 14)	*$ 1,716,000*	*$ 1,939,080*	*$ 2,191,160*	*$ 2,476,011*	*$ 2,773,133*
Add: Depreciation[1]	*548,422*	*743,589*	*964,128*	*1,213,337*	*1,492,451*
Gross Cash Flow	*$2,264,422*	*$2,682,669*	*$3,155,288*	*$3,689,348*	*$4,265,584*
Less: Capital Expenditures[2]	*1,209,000*	*1,366,170*	*1,543,772*	*1,744,462*	*1,953,798*
Less: Increase in Net Working Capital	*43,506*	*59,150*	*66,839*	*75,529*	*78,782*
NET CASH FLOW	***$ 1,011,916***	***$ 1,257,349***	***$ 1,544,677***	***$ 1,869,357***	***$ 2,233,004***

1. *Depreciation is based on two factors: First, depreciating the existing fixed assets as of February 28, 1995 of $1,878,538 over a remaining useful life of five years, and second, depreciating future fixed asset additions over a useful life of seven years.*

2. *Capital expenditures are calculated as 18.6 percent of sales. This is based on capital expenditures as a percentage of sales in fiscal 1994. The calculation is as follows:*

Net Fixed Assets at May 31, 1995	*$ 1,771,669*
Less: Net Fixed Assets at May 31, 1994	*(1,214,949)*
Plus: 1994 Depreciation Expense	*375,715*
1994 Fixed Asset Additions	*$ 932,435*
Divided by 1994 Sales	*$ 5,018,896*
1994 Fixed Assets as a Percent of Sales	*18.6%*

Our review of prior years' capital expenditures revealed 15.9 percent and 19.3 percent, for 1992 and 1993, respectively. We felt that the 1994 capital expenditures was reasonable under the circumstances.

3. *The increase in working capital is based on the median for medical equipment rental and leasing companies with three to five million dollars in sales, which was 7 percent.*

   Therefore, we have used this figure times the increase in sales to estimate increases in working capital for each year in the projection period.

Once the cash flow has been forecast, the selection of a proper discount rate becomes necessary. Since the benefit stream being estimated will not occur until some time in the future, the future benefits must be discounted to their present value. In this instance, a discount rate of 19.2 percent has been deemed applicable (see section of this report entitled "Discount and Capitalization Rates"). This results in the value estimate of SRS being calculated as follows:

Year	***Forecasted Cash Flow***	***x***	***19.2% Present Value Factors***	***=***	***Present Value Future Cash Flow***
1996	*$ 1,011,916*		*0.8389*		*$ 848,896*
1997	*1,257,349*		*0.7038*		*884,922*
1998	*1,544,677*		*0.5904*		*911,977*
1999	*1,869,357*		*0.4953*		*925,893*
2000	*2,233,004*		*0.4155*		*927,813*
TV	*21,636,450*		*0.4155*		*8,989,945*
TOTAL					***$ 13,489,446***

The terminal value (TV) is calculated as follows:

Terminal Cash Flow	=	*$ 2,856,011*
Discount Rate - Growth (.192 - .06)	=	*.132*
Capitalizing $ 2,856,011 @ 13.2%	=	*$ 21,636,450*

In this instance, the terminal value is determined by growing the last year's forecasted net income by a stabilized growth rate. Net income is then converted to cash flow as follows:

Terminal Value Net Income	*$ 2,939,521*
Plus: Depreciation[1]	*2,000,000*
Less: Capital Expenditures[1]	*2,000,000*
Less: Increase in Working Capital[2]	*83,509*
TERMINAL VALUE CASH FLOW	***$ 2,856,011***

1. *Depreciation and capital expenditures are set equal in the terminal year.*
2. *The increase in working capital is calculated as the increase in 2000, times one plus the long-term growth rate of 6 percent.*

The benefit stream used in the calculation of the terminal value is the stabilized benefit stream expected to be achieved by SRS after the forecast period. The stabilized stream is then capitalized, and discounted to its present value at the appraisal date. (Discount rates, capitalization rates and a discussion of growth rates can be found in the report section entitled "Discount and Capitalization Rates").

Adding the terminal value to the present value of the anticipated interim benefit stream results in the present value of the future benefits of SRS to be $13,496,690, or $13,500,000 rounded.

Another reasonableness check was performed based on the deposition transcript of Howard Deutsch, Executive Vice President and General Counsel of Lincare. As he states in his deposition, Mr. Deutsch managed "the acquisition function for the company nationwide." The following excerpt from his deposition gives an overview of how Lincare analyzes potential acquisitions, including SRS.

> *Q. Okay. Could you tell me what criteria was used by Lincare for the purpose of establishing this $13,500,000 value?*
>
> *A. When we value businesses, we typically look at a number of elements, some financial related, others not specifically financial related. We look at the sales revenue. We look at the earnings on a historical basis of the business. We look at the earnings of what we believe to be a pro forma basis after acquisition. We look at the geographic area that the business serves. We look at the product mix that business has in terms of its respiratory and nonrespiratory components. We look at the scope of their business in terms of geography and referral sources. Those would be the principal criteria that we look at.*
>
> *Q. Well, is there a rule of thumb that you apply to earnings for the purpose of getting some preliminary feeling as to what a company would be worth to Lincare in connection with an acquisition?*
>
> *A. It's flexible. And those criteria determine whether or not our interest level is higher or lower and our valuation level is higher or lower with respect to a particular business. If it's got a better geographic situation for us, if there are more synergies, if it's a higher respiratory mix, those would be conditions which would put the value at the higher end of the spectrum. If those situations either singularly or in combination are less desirable compared to what we're looking for, then the business – then a particular business is at the lower end of the spectrum.*

Mr. Deutsch further describes the process and the interest Lincare had in SRS:

A. Well, as I said earlier, we look at the financial performance both historically and what it would be on a go-forward basis. And we then look at other elements to determine, you know, whether or not our interest level is at the higher end of the spectrum or the lower end of the spectrum. In this particular case, because of the locations because of the respiratory content, because of the reputation that the company had in the community it was at the higher end of the spectrum.

The key element of this statement is the reasons for Lincare's interest in SRS: good locations, high respiratory therapy content, and good company reputation.

Mr. Deutsch indicates that Mr. Byrnes put together a pro forma income statement based on what he believed Lincare would expect to occur at the SRS locations in the 12 months after acquisition by Lincare. Mr. Deutsch then used this pro forma to derive a value for SRS. Mr. Deutsch describes the valuation:

A. The only thing I can tell is that if you look across the broad range of acquisitions we've done, that based on a pro forma basis, the cash flow and reconciling that with historical performance, and looking at it at our operating center level, not at the corporate level on a consolidated basis, but at that center level, businesses typically tend to fall at about the three and a half to four times cash flow basis depending upon various and intangible factors, some higher and some lower.

Q. And some of them you've described here earlier today. And you've also indicated that because of the mix of product, the particular area where respiratory – Smith Respiratory was operating, the reputation of the company, using the higher end of the spectrum to the extent that the rule of thumb has applicability at all would have been what was – would have been Lincare's approach in this situation.

A. I don't have specific recall as to what the pro forma, if any, was done for this reflected. So I don't know what the multiple is in this particular case. But based on the quality of the business and its size and its location, I think it's a fair statement to say that this is at the very high end of the spectrum.

Although Mr. Deutsch did not recall the exact pro forma in his deposition, we have been provided a copy of it and it is presented as Exhibit 2 to this report. The pro forma indicated that Lincare expected $6.5 million in revenues, earnings before interest, tax depreciation and amortization ("EBITDA") of $3.75 million, and free cash flow of $3.5 million. Free cash flow is defined as EBITDA less capital expenditures. Dividing the purchase price of $15,035,000 by $3,500,000 results in a multiple of price to free cash flow of 4.30. Following Mr Deutsch's testimony, if we divide $13,500,000 by free cash flow of $3,500,000, the result is a multiple of 3.86. This is very much in line with the range of 3.5 to 4.0 times cash flow testified to by Mr. Deutsch.

This confirms the reasonableness of establishing the fair market value of the operating assets of SRS at $13.5 million.

VALUATION OF THE TANGIBLE ASSETS

The next step in our analysis is to value the tangible assets of SRS to be used in the allocation of the purchase price. As previously discussed, Lincare and SRS negotiated a transaction that included an allocation of the price to different classes of assets. In this instance, we are accepting the allocation of the tangible assets as being reasonable. This results in the tangible assets being valued as follows:

Accounts receivable	*$ 550,000*
Inventory	*40,000*

Fixed assets	*712,000*
Total	***$ 1,302,000***

VALUATION OF THE IDENTIFIABLE INTANGIBLE ASSETS

Before undertaking the valuation of the identifiable intangible assets, a short discussion about intangible assets is in order.

INTANGIBLE ASSETS: *Assets can take one of two basic forms, tangible and intangible. Tangible assets are easily identified because they can be seen and touched. They can take the form of money, or assets denominated in monetary terms, such as accounts receivable. Tangible assets can also be fixed assets, such as land, buildings, vehicles, or computers. Many times tangible assets are needed to obtain the value of an intangible asset. For example, a delivery business that has intangible value from its name or trademark needs vehicles to make deliveries.*

Accounting theory defines intangible assets as "assets that do not have physical substance, that grant rights and privileges to a business owner, and that are inseparable from the business enterprise." Theory defines intangible assets as having future benefits whose determination and timing are difficult to determine. One notable treatise on the subject defines intangible assets as "all the elements of a business enterprise that exist in addition to monetary and tangible assets." In essence, an intangible asset is an asset that cannot be seen or touched, gives the business owner rights and privileges, cannot be separated from the business enterprise, and exists in addition to the tangible and monetary assets of a business.

According to Pratt, for an intangible asset to exist in an economic sense, it needs to have certain characteristics:

1. *It must be subject to specific identification and recognizable description.*
2. *It must be subject to legal existence and protection.*
3. *It must be subject to the right of private ownership, and this private ownership must be legally transferable.*
4. *There must be some tangible evidence or manifestation of the intangible asset (e.g. a contract or a license or a registration document).*
5. *It must have been created or have come into existence at an identifiable time or as a result of an identifiable event.*
6. *It must be subject to being destroyed or to a termination of existence at an identifiable time or as the result of an identifiable event.*

In addition, Pratt lists three criteria that an intangible asset must have in order to have value:

1. *It must generate some measurable amount of economic benefit to the owner; this economic benefit could be in the form of an income increment or cost decrement.*
2. *This economic benefit may be measured in any of several ways, including net income or net cash flow, etc.*
3. *It must enhance the value of other assets with which it is associated, the other assets may include tangible personal property and tangible real estate.*

The distinction to be drawn from these two sets of criteria is between the legal existence and the economic value of an intangible asset. This is to say that an asset may have a legal existence and may be of no value to its owners. An example would be a copyrighted trademark that is never used. Although the trademark legally exists, it does not have economic value.

Intangible assets can take on many different forms and can have unique properties. As Pratt points out, intangible assets have been categorized into several discrete categories to allow for easy identification. He presents the following categorization of intangible assets:

1. *Technology-related (e.g., engineering drawings).*
2. *Customer-related (e.g., customer lists).*
3. *Contract-related (e.g., favorable supplies contracts).*
4. *Data processing related (e.g., computer software).*
5. *Human capital-related (e.g., trained and assembled workforce).*
6. *Marketing-related (e.g., leasehold interests).*
7. *Location-related (e.g., leasehold improvements).*
8. *Goodwill-related (e.g., going concern value).*

Intellectual property is another classification of intangible assets. Intellectual properties are intangible assets "created by human intellectual and/or inspirational activity". These assets are set apart from other intangible assets by their special legal recognition and protection.

Pratt classifies intellectual properties as either creative or innovative. Creative intellectual property can be protected by copyrighting the property, while innovative property can be protected through patents. The special rights given to intellectual properties are given through the protection of copyright and patent laws. The valuation of intellectual properties is carried out under similar methods as those used in valuing other types of intangible assets.

INTANGIBLE ASSET VALUATION APPROACHES: *The approaches to the valuation of intangible assets are similar to the approaches used to value a business enterprise: market, asset based, and income. Each of these approaches is discussed briefly below.*

THE MARKET APPROACH: *The market approach, also referred to as the sales comparison approach, entails researching and identifying similar intangible assets to the subject intangible that have been transacted in the marketplace. These transactions are then used as guidelines in developing the value of the subject intangible asset.*

THE ASSET BASED APPROACH: *The asset based or cost approach attempts to ascertain the value of the asset by determining its cost. Cost typically can have several definitions. The most common definitions of cost are, reproduction cost, the cost to reproduce an exact copy of the asset; replacement cost, the cost to purchase an identical asset, or the cost to replace the functionality or utility of the asset; creation cost, the original cost to create the asset; and recreation cost, what it would cost to recreate, or duplicate an existing asset. In many circumstances, the definition of cost also includes the concept of obsolescence, or deterioration in value. Obsolescence can result from physical deterioration of the asset, functional obsolescence, technical obsolescence or economic obsolescence. Although not all intangible assets suffer from obsolescence, the identification of obsolescence is important to the cost approach.*

THE INCOME APPROACH: *As in the case of the valuation of the business enterprise, the income approach for intangible asset valuation determines the present value of the future benefits that will accrue to the owner of the asset. This is generally accomplished by either capitalizing a single period income stream or discounting a series of income streams, based on a multi-period forecast.*

IDENTIFIABLE INTANGIBLE ASSETS: *In this appraisal, several intangible assets could be separately identified and valued. These assets include the following:*

- *Trademark*
- *Patient records*
- *Covenant not-to-compete*

Although other intangible assets could be identified as existing in SRS, namely trained employee workforce, procedure manuals, etc., they could not be separately valued. Therefore, these assets are valued under the residual method in the next section of this report.

THE INCOME APPROACH: *To value the identifiable intangible assets and the goodwill of SRS, we have used the income approach. To implement the income approach, we have used the residual cash flow methodology. The residual method allocates the cash flows of the business to its component assets. This includes both tangible and identifiable intangible assets. This is accomplished for assets whose values are known by calculating returns to those assets and subtracting the returns from the forecasted cash flows of the business. The cash flow of a business is the product of combining all of the assets of the business in their productive capacities to generate returns to the shareholders. The cash flow that remains after returns to all of the identified assets are subtracted is the cash flow attributable to the unidentified intangible assets.*

We started by analyzing the returns being generated by the tangible assets of the business. Since we have previously determined that excess assets existed in SRS at the valuation date, returns to these assets have not been computed, as this analysis focuses on the operating assets of the business. At the valuation date, the tangible operating assets have been valued in addendum 3.4 to the asset purchase and sale agreement between Lincare and SRS. The addendum has been attached as Exhibit 3 to this report. As per Exhibit 3, the value of the tangible assets at the valuation date was as follows:

Accounts Receivable	*$ 550,000*
Inventory	*40,000*
Fixed Assets	*712,000*
Total	***$ 1,302,000***

To compute returns from these assets, we have developed rates of returns for each, and applied them to the asset values. The starting point to estimate returns on these assets is the prime rate that banks charged at the valuation date. According to the Federal Reserve Board, the average prime rate for all U.S. commercial banks was 9 percent on March 9, 1995. The prime rate represents the rate of interest banks charge their best customers on the most secure types of loans.

For this analysis, we have added a premium to the prime rate for each of the different classes of assets to arrive at the following rates of return:

Asset Class	***Return***	***After-Tax Return***
Accounts Receivable	*11%*	*6.6%*
Inventory	*12%*	*7.2%*
Fixed Assets	*14%*	*8.4%*

Accounts receivable are the most liquid of the three asset classes, making them less risky than the inventory or fixed assets. Yet banks would still charge SRS a premium to lend against the receivables because it still presents risk to the bank. The inventory is less liquid than the accounts receivable and thus presents more risk to the bank. Therefore, we have added an additional one percent premium to the inventory rate. The fixed assets of the business are even less liquid than the inventory, and present a greater risk to a bank that *is considering lending against the fixed assets of a business. As such, we have added an additional 2 percent over and above the return to inventory.*

All of the returns calculated are pre-tax returns. Since our objective is to allocate after-tax cash flow to these assets, we need to tax effect the returns to put them on an after-tax basis. To accomplish this, we have assumed the tax rate to be 40 percent and multiplied the pre-tax returns by one minus the tax rate, or 60 percent (1 - 40% = 60%). It should be noted that the returns calculated here are minimum returns. The premise used here is that companies would require a rate of return equal to the cost to finance the asset. In fact, companies want to make profits on their assets and would want to earn an incremental return over and above their financing cost.

To calculate the cash flow that is allocable to each asset, the value of the asset is multiplied by the after-tax return. The calculations are presented in Table 16.

TABLE 16
CALCULATION OF RETURNS TO TANGIBLE ASSETS

Asset	Value	After-Tax Rate of Return	Return
Accounts Receivable	$ 550,000	6.6%	$ 36,600
Inventory	40,000	7.2%	2,880
Fixed Assets	712,000	8.4%	59,808

Once the returns from the tangible assets have been determined, we can subtract these returns from the cash flow of the business to obtain the cash flow allocable to all of the intangible assets. This is shown in Table 17.

TABLE 17
CASH FLOWS FROM INTANGIBLE ASSETS

	1996	1997	1998	1999	2000
Cash Flow (Table 15)	$ 1,011,916	$ 1,257,349	$ 1,544,677	$ 1,869,357	$ 2,233,004
Less Returns On:					
Accounts Receivable(Table 16)	36,300	36,300	36,300	36,300	36,300
Inventory (Table 16)	2,880	2,880	2,880	2,880	2,880
Fixed Assets (Table 16)	59,808	59,808	59,808	59,808	59,808
Cash Flows From Intangible Assets	**$ 912,928**	**$ 1,158,361**	**$ 1,445,689**	**$ 1,770,369**	**$ 2,134,016**

TRADEMARK

A trademark, or trade name as it is sometimes referred to, is one of the most common types of intangible assets. The trademark is the name that the company is recognized by in the market place. This is the reason trademarks have value, because they are recognized by customers and referral sources. Typically in an acquisition, the use of the trademark by the seller is prohibited to protect the value of the assets purchased by the buyer.

The valuation of a trademark is based on the present value of a stream of royalties that would be paid for the use of the trademark. Royalty rates for such purposes are typically defined as a percentage of sales. To obtain the actual rates, one must observe similar transactions in the marketplace.

A few companies keep databases of royalty rate data. For the purposes of this assignment, we used the database of ASU Consulting and Trademark Licensing Associates. These databases were searched for companies in the medical equipment and respiratory therapy industries and related fields. The searches did not identify any transaction that would be appropriate to the valuation of SRS' trademark.

Our research and discussions with individuals at ASU Consulting and Trademark Licensing Associates leads us to believe that royalty rates typically range between one percent and 10 percent across markets and industries. Considering the low level of technology involved in SRS, as well as the company's strength and reputation, we have selected a royalty rate of 4 percent.

Estimating that the trademark has a relatively long term holding period, we have calculated the cash flow for a 25 year life. The strength of the SRS name becomes more and more apparent when the historic sales growth is examined. Table 18 reflects our calculation.

TABLE 18
CASH FLOW ALLOCABLE TO TRADEMARK

Year	Sales	Rate	Cash Flow
1996	$ 6,500,000	4.0%	$ 260,000
1997	7,345,000	4.0%	293,800
1998	8,299,850	4.0%	331,994
1999	9,378,831	4.0%	375,153
2000	10,504,290	4.0%	420,172
2001	11,134,548	4.0%	445,382
2002	11,802,620	4.0%	472,105
2003	12,510,778	4.0%	500,431
2004	13,261,424	4.0%	530,457
2005	14,057,110	4.0%	562,284
2006	14,900,536	4.0%	596,021
2007	15,794,569	4.0%	631,783
2008	16,742,243	4.0%	669,690
2009	17,746,777	4.0%	709,871
2010	18,811,584	4.0%	752,463
2011	19,940,279	4.0%	797,611
2012	21,136,696	4.0%	845,468

TABLE 18
CASH FLOW ALLOCABLE TO TRADEMARK

Year	*Sales*	*Rate*	*Cash Flow*
2013	*22,404,897*	*4.0%*	*896,196*
2014	*23,749,191*	*4.0%*	*949,968*
2015	*25,174,143*	*4.0%*	*1,006,966*
2016	*26,684,591*	*4.0%*	*1,067,384*
2017	*28,285,667*	*4.0%*	*1,131,427*
2018	*29,982,807*	*4.0%*	*1,199,312*
2019	*31,781,775*	*4.0%*	*1,271,271*
2020	*33,688,682*	*4.0%*	*1,347,547*

Once the cash flow has been forecast, the selection of a proper discount rate becomes necessary. Since the cash flow stream being estimated will not occur until some time in the future, the future cash flow must be discounted to its present value.

The SRS trademark is well established in its local markets. The Company had an excellent reputation for service and integrity. As Mr. Smith has said, he did not spend money on advertising, but let SRS' reputation build by word of mouth, from satisfied patient to doctor, and from doctor to doctor. These events have gone a long way in strengthening the trademark of SRS in its marketplaces. SRS had the predominant market position in each of its markets and continually maintained and upgraded its position with diligent marketing efforts. These positive qualities provide value to a trademark and reduce the risk associated with it. As a result, we have selected a 20 percent discount rate.

This results in the value estimate of the trademark being calculated as follows:

Year	*Forecasted Cash Flow*	*x*	*20% Present Value Factors*	*=*	*Present Value Future Cash Flow*
1996	*$ 260,000*		*0.8333*		*$ 216,658*
1997	*293,800*		*0.6944*		*204,015*
1998	*331,994*		*0.5787*		*192,125*
1999	*375,153*		*0.4823*		*180,936*
2000	*420,172*		*0.4019*		*168,867*
2001	*445,382*		*0.3349*		*149,158*
2002	*472,105*		*0.2791*		*131,764*
2003	*500,431*		*0.2326*		*116,400*
2004	*530,457*		*0.1938*		*102,803*

Year	Forecasted Cash Flow	x	20% Present Value Factors	=	Present Value Future Cash Flow
2005	562,284		0.1615		90,809
2006	596,021		0.1346		80,224
2007	631,783		0.1122		70,886
2008	669,690		0.0935		62,616
2009	709,871		0.0779		55,299
2010	752,463		0.0649		48,835
2011	797,611		0.0541		43,151
2012	845,468		0.0451		38,131
2013	896,196		0.0376		33,697
2014	949,968		0.0313		29,734
2015	1,006,966		0.0261		26,282
2016	1,067,384		0.0217		23,162
2017	1,131,427		0.0181		20,479
2018	1,199,312		0.0151		18,110
2019	1,271,271		0.0126		16,018
2020	1,347,547		0.0105		14,149
TOTAL					**$ 2,134,308**

The indicated fair market value of SRS' trademark is $2,134,308, or $2,134,000 rounded.

PATIENT RECORDS

One of the important intangible assets of a business like SRS, are the patient records or customer list. These records are important to a potential purchaser because it is this very patient base that generates immediate cash flow to the company.

This type of asset is generally valued by reviewing the expected life of the patient relationship, and applying some factor to the sales in order to estimate the cash flow that would be expected to be generated from this relationship. Before applying factors to the cash flow of the company, we must first determine the cash flow available from the patient records and the remaining assets. This is calculated in Table 19.

TABLE 19
CASH FLOWS AVAILABLE TO PATIENT RECORDS

	1996	1997	1998	1999	2000	2001	2002
Cash Flow (Table 15)	*$ 1,011,916*	*$ 1,257,349*	*$ 1,544,677*	*$ 1,869,357*	*$ 2,233,003*	*$ 2,366,983* [1]	*$ 2,509,002* [2]
Less Returns On:							
Accounts Receivable (Table 16)	*36,300*	*36,300*	*36,300*	*36,300*	*36,300*	*36,300*	*36,300*
Inventory (Table 16)	*2,880*	*2,880*	*2,880*	*2,880*	*2,880*	*2,880*	*2,880*
Fixed Assets (Table 16)	*59,808*	*59,808*	*59,808*	*59,808*	*59,808*	*59,808*	*59,808*
Trademark (Table 18)	*260,000*	*293,800*	*331,994*	*375,153*	*420,172*	*445,382*	*472,105*
Cash Flow to All Intangible Assets Other Than Trademarks	***$ 652,928***	***$ 864,561***	***$ 1,113,695***	***$ 1,395,216***	***$ 1,713,843***	***$ 1,822,613***	***$ 1,937,909***

Using the same survivorship factors as the Valuation Group, the survivorship rates for the life of the patient relationships are as follows:

Year	*Survivorship %*
1	*83.88*
2	*62.43*
3	*47.22*
4	*34.57*
5	*23.13*
6	*12.32*
7	*1.87*

Therefore, projected cash flows from the existing patient base are estimated in Table 20.

Year	Cash Flow to the Residual	Survivorship Rate	Cash Flow to Patient Records
1996	$ 652,928	.8388	$ 547,676
1997	864,561	.6243	539,745
1998	1,113,695	.4722	525,887
1999	1,395,216	.3457	482,326
2000	1,713,843	.2313	396,412
2001	1,822,613	.1232	224,546
2002	1,937,909	.0187	36,236

After calculating the cash flow attributable to the patient records, the next step is to discount these amounts to their present values to determine an estimate of the value of the patient records. In our opinion, the least risky of the identified intangible assets are the patient records, as they are actual physical documents. Possessing these documents allows a buyer to continue servicing the existing patients. The remaining life of these records can and has been estimated. In addition, buyers such as Lincare and other large companies in the industry have their own experiences with how long a patient will remain with the company. As these patients are currently availing themselves of SRS's services, they are generating cash flows and will generate a material and predictable portion of SRS' cash flows over the following months and years. This makes the risk of receiving these cash flows low. Therefore, we have applied a 14 percent discount rate to the patient records. This results in an estimate of value as calculated in Table 21.

TABLE 21
CASH FLOWS ALLOCABLE TO PATIENT RECORDS

Year	Cash Flow to Patient Records	Present Value Factors	Present Value
1996	$ 547,676	0.8782	$ 480,421
1997	539,745	0.7695	415,334
1998	525,887	0.6750	354,973
1999	482,326	0.5921	285,585
2000	396,412	0.5194	205,896
2001	224,546	0.4556	102,303
2002	36,239	0.3996	14,481
Total Present Value			**$ 1,858,995**

Therefore, based on our analysis, the value of the patient records is estimated to be $1,858,995, or $1,859,000 rounded.

COVENANT NOT-TO-COMPETE

A covenant not-to-compete (non-compete agreement) is an intangible asset based on a contractual agreement. Typically, the seller of a business, the covenantor, agrees not-to-compete with the buyer of the business, the covenantee, in a defined industry or market for a specific period of time, in a geographically defined area. A non-compete agreement has value to the buyer to the degree that it protects the assets (tangible and intangible) from loss of value by restricting competitive actions of the seller. From an economic perspective, the value of a non-compete agreement is dependent on several factors, including the ability of the seller to compete, the derivation of the non-compete agreement, and the losses the company would suffer if the seller competed.

In the instance where the seller has the ability to compete, the relevant question becomes, what impact would competition from the seller have on the business? The answer to this question depends on a myriad of factors. Chief among them are: 1) the seller being in possession of relationships that could redirect business from the company to a new company established or invested into by the seller, and 2) the seller having either sufficient knowledge or technology to allow him or her to bring competitive services to market.

The single most important source document in determining the value of a covenant not-to-compete is the agreement in which the covenant is made. For this reason, we have performed a detailed review of the asset purchase agreement between Lincare, SRS, and Ben W. Smith, dated March 9, 1995 (the "agreement"). The following discussion highlights items in the agreement that impact the value of the covenant not-to-compete.

Article 1.1(b) defines business as it applies to the agreement:

> *"<u>Business</u>" shall mean the entire business of Company [SRS], including, but not limited to, the business of marketing, advertising, selling, leasing, renting, distributing or otherwise providing oxygen, oxygen equipment, aerosol inhalation therapy equipment and respiratory medications, nasal continuous positive airway pressure devices, infant monitoring equipment and services, home sleep studies and related therapy equipment, and other respiratory therapy and durable medical equipment, products, supplies and services to customers in their homes or other alternative site care facilities.*

Article 1.1(f) defines territory as:

> *[T]he State of Florida and a radius of one hundred fifty (150) miles from any of Company's current operating centers, regardless of which states such radius may include.*

Section 3.4 of the agreement pertains to the allocation of the purchase price and states:

> *The parties agree to allocate the Purchase Price among the Assets as set forth in Addendum 3.4. The values assigned to the Assets as set forth Addendum 3.4 were separately established by the parties in good faith and each party agrees to report the transaction contemplated by this Agreement to the Internal Revenue Service as required by Section 1060 of the Internal Revenue Code in accordance with Addendum 3.4, subject to the approval of Lincare's and Company's independent auditors.*

An important statement in this section is the discussion of the values being "separately established by the parties in good faith." This indicates that the parties discussed each of the values and negotiated them separately, including the covenant not-to-compete. Addendum 3.4 has been attached to this report as Exhibit 3.

Article 8.2 contains a no solicitation clause which states:

a) *From and after the Closing, neither Company nor the Shareholder [Ben W. Smith] shall:*

i) *directly or indirectly, hire, offer to hire, or entice away, or in any other manner persuade or attempt to persuade, any officer, employee or agent of Lincare (including, but not limited to, any former officer, employee or agent of Company), or in any manner persuade or attempt to persuade, any officer, employee or agent of Lincare (including , but not limited to, any former officer, employee or agent of Company) to discontinue his or her relationship with Lincare. It is understood and agreed that the prohibitions contained in this Section 8.2 (i) shall apply to all current and future officers, employees and agents of Lincare (including, but not limited to, any former officer, employee or agent of Company), whether or not any such person is then currently an officer, employee or agent of Lincare or whether any such prohibited activity is in connection with employment, an offer of employment or other action within or outside the Territory; or*

ii) *directly or indirectly solicit, divert or take away, or attempt to solicit, divert or take away any business Company had enjoyed or solicited prior to the date hereof or which Lincare may enjoy or solicit in the Territory after the date hereof.*

b) *It is expressly understood and agreed by the parties hereto that it shall be a breach hereof for Company or the Shareholder to assist in any way any member of his or her family, any business associate, or any other person, firm, corporation, partnership, joint venture, association, trust or other entity, to engage in any activity which is prohibited by this Section 8.2.*

Notice that this article deals with the existing customers and employees being acquired at the time of the agreement. This article acts as protection for Lincare with respect to the customers and human capital it is acquiring.

Article 9 is the covenant not-to-compete and is presented in its entirety.

9.1 *<u>Covenant</u>.*

a) *In consideration of the purchase by Lincare of the Assets and the Business pursuant to the terms and conditions of this Agreement, and for other good and valuable consideration, the Company and Shareholder, (each hereinafter referred to individually as a "Covenantor" and collectively as the "Covenantors") hereby represent, warrant, covenant and agree, jointly and severally, that commencing on the date hereof and continuing for a period of five (5) years thereafter, none of the Covenantors will, directly or indirectly, engage in the business of marketing, advertising, selling, leasing, renting, distributing, or otherwise providing oxygen, oxygen equipment, aerosol inhalation therapy equipment and respiratory medications, nasal continuous positive airway pressure devices, infant monitoring equipment and services, home sleep studies and related therapy equipment, or any other respiratory therapy or durable medical equipment, products, supplies and services to customers in their homes or other alternative site care facilities within the Territory.*

b) *Without limiting the generality of the provisions of Section 9.1 (a) hereof, this Covenant Not-to-compete shall be construed so that Covenantors shall also* *be in breach hereof if any of them is an employee, officer, director, shareholder, investor, trustee, agent, principal or partner of, or a consultant or advisor to or for, or a subcontractor or manager for, a person, firm, corporation, partnership, joint venture, association, trust or other entity which is engaged in such business in the Territory, or if any of them receives any compensation or remuneration from or owns, directly or indirectly, any outstanding stock or shares or has a beneficial or other financial interest in the stock or assets of any such person, firm, corporation, partnership, joint venture, association, trust or other entity engaged in such business in the Territory. Notwithstanding anything to the contrary contained in this Section 9.1 (b), no Covenantor shall be deemed to be in breach of this Covenant Not-to-compete solely by reason of owning an interest of less than one percent (1%) of the shares of any company traded on a national securities exchange or in the over the counter market.*

c) It is expressly understood and agreed by Covenantors that it shall be a breach of this Covenant Not-to-compete for any Covenantor to assist in any way any family member, any business associate, or any other person, firm, corporation, partnership, joint venture, association, trust or other entity, to engage in any activity which a Covenantor is prohibited from engaging in by this Covenant Not-to-compete.

9.2 Remedies.

Covenantors agree that the remedy at law for any breach of obligation under this Covenant Not-to-compete will be inadequate and that in addition to any other rights and remedies to which it may be entitled hereunder, at law or in equity, Lincare shall be entitled to injunctive relief, and reimbursement for all reasonable attorneys' fees and other expenses incurred in connection with the enforcement hereof. It is the intention of Covenantors and Lincare that this Covenant Not-to-compete be fully enforceable in accordance with its terms and that the provisions hereof be interpreted so as to be enforceable to the maximum extent permitted by applicable law. To the extent that any obligation to refrain from competing within an area for a period of time as provided in this Covenant Not-to-compete is held invalid or unenforceable, it shall, to the extent that it is invalid or unenforceable, be deemed void ab initio. The remaining obligations imposed by the provisions of this Covenant Not-to-compete shall be fully enforceable as if such invalid or unenforceable provisions had not been included herein and shall be construed to the extent possible, such that the purpose of this Covenant Not-to-compete, as intended by Covenantors and Lincare, can be achieved in a lawful manner.

The key elements of the covenant not-to-compete are as follows:

- *The covenant is for a term of five years.*
- *The covenant covers what the agreement defines as "business".*
- *The covenant relates to the geographic region defined in the agreement as the "territory".*
- *Prohibits partaking in the "business" in the "territory" for the five year period.*
- *The covenant defines remedies for Lincare if the covenant is violated.*

The valuation of the covenant not-to-compete is highly dependent on the impact of the seller's ability to compete in the marketplace with the buyer. Therefore, in order to estimate the potential impact of SRS competing with Lincare, after the sale, we have performed a lost sales analysis.

A lost sales analysis entails estimating the potential losses to the covenantee from competition from the covenantor. The analysis is used as part of a residual method valuation of a non-compete. As part of a residual method of valuation, the lost sales analysis determines the cash flow that is allocable to the covenant not-to-compete. The cash flow is then valued directly in the residual valuation analysis.

Lost sales analysis can be used to value the subject business' cash flow for the period of the covenant, first assuming the covenant is in place and then a second time without the covenant. The difference in the values in these two scenarios is the value of the non-compete agreement.

Regardless of how it is to be used, there are several steps involved in preparing a lost sales analysis. The first step is to prepare a forecast of the company's income statement and cash flow assuming the covenant is in place, and the covenantor is not in violation of the agreement. This has previously been done to value the entire operating enterprise.

The next step is to ascertain what level of sales would be lost if the covenant was not in place. The impact of the lost sales on the company's income statement and cash flow must then be analyzed and forecasted. Determining the likely level of lost sales is a highly intricate process that typically involves in-depth discussions with management of the acquiring company. The closest information we have to interviews in this case are the depositions of the Lincare officials and of Mr. Smith. Based on our review of the various deposition transcripts provided to us, we determined that the possible range of lost sales would be between 1 and 25 percent. Our analyses follows in Tables 22 through 27.

A general rule that is applied to these scenarios is that we have not reduced sales in any one year by more than 10 percent. This has been done to reflect that transferring revenues to a new entity would take Mr. Smith time to accomplish.

Each of these tables has the same assumptions regarding to cost of sales, operating expenses and income taxes. They are:

1. *Cost of sales is forecasted at 14.1 percent of sales based on the historic cost of sales.*

2. *Operating expenses are forecasted as 41.9 percent of sales.*

3. *We have assumed a combined federal and state tax rate of 40 percent.*

Table 22 presents the forecasted income statements of SRS for the years ended March 9, 1996 through 2000 assuming a one percent loss of revenues due to competition from Mr. Smith.

TABLE 22
SRS' FORECASTED INCOME STATEMENTS
ASSUMING A 1 PERCENT LOSS IN REVENUES

	1996	1997	1998	1999	2000
Net Sales[1]	$ 6,435,000	$ 7,271,550	$ 8,216,852	$ 9,285,042	$ 10,399,247
Less: Cost of Sales	907,335	1,025,289	1,158,576	1,309,191	1,466,294
Equals: Gross Profit	$ 5,527,665	$ 6,246,261	$ 7,058,275	$ 7,975,851	$ 8,932,953
Less: Operating Expenses	2,696,265	3,046,779	3,442,861	3,890,433	4,357,285
Equals: Net Operating Income	$ 2,831,400	$ 3,199,482	$ 3,615,415	$ 4,085,419	$ 4,575,669
Less: Taxes	1,132,560	1,279,793	1,446,166	1,634,167	1,830,268
NET INCOME	**$ 1,698,840**	**$ 1,919,689**	**$ 2,169,249**	**$ 2,451,251**	**$ 2,745,401**

Note: Figures may be off due to rounding.

1. *Sales in 1996 have been multiplied by 99 percent of the $6,500,000 figure used in the non-competition forecast analysis ($6,500,000 x .99 = $ 6,435,000). Thereafter sales have been grown at the rates used in the non-competition forecast analysis.*

The next analysis assumes a 5 percent loss of sales from seller-based competition and is presented in Table 23.

TABLE 23
SRS' FORECASTED INCOME STATEMENTS
ASSUMING A 5 PERCENT LOSS OF REVENUES

	1996	1997	1998	1999	2000
Net Sales[1]	$ 6,175,000	$ 6,977,750	$ 7,884,858	$ 8,909,889	$ 9,979,076
Less: Cost of Sales	870,675	983,863	1,111,765	1,256,294	1,407,050
Equals: Gross Profit	$ 5,304,325	$ 5,993,887	$ 6,773,093	$ 7,653,595	$ 8,572,026
Less: Operating Expenses	2,587,325	2,923,677	3,303,755	3,733,243	4,181,233
Equals: Net Operating Income	$ 2,717,000	$ 3,070,210	$ 3,469,337	$ 3,920,351	$ 4,390,793
Less: Taxes	1,086,800	1,228,084	1,387,735	1,568,140	1,756,317
NET INCOME	**$ 1,630,200**	**$ 1,842,126**	**$ 2,081,602**	**$ 2,352,211**	**$ 2,634,476**

Note: Figures may be off due to rounding.

1. *Sales in 1996 have been estimated by multiplying the estimated 1996 sales in the non-competition scenario by 95 percent ($6,500,000 x 95% = $6,175,000). Sales thereafter are grown at the same rates used in the non-competition scenario.*

The next analysis assumes that 10 percent of sales were lost due to seller competition. This analysis is presented in Table 24.

TABLE 24
SRS' FORECASTED INCOME STATEMENTS
ASSUMING A 10 PERCENT LOSS OF REVENUES

	1996	1997	1998	1999	2000
Net Sales[1]	$ 5,850,000	$ 6,610,500	$ 7,469,865	$ 8,440,947	$ 9,453,861
Less: Cost of Sales	824,850	932,081	1,053,251	1,190,174	1,332,994
Equals: Gross Profit	$ 5,025,150	$ 5,678,420	$ 6,416,614	$ 7,250,774	$ 8,120,867
Less: Operating Expenses	2,451,150	2,769,800	3,129,873	3,536,757	3,961,168
Equals: Net Operating Income	$ 2,574,000	$ 2,908,620	$ 3,286,741	$ 3,714,017	$ 4,159,699
Less: Taxes	1,029,600	1,163,448	1,314,696	1,485,607	1,663,880
NET INCOME	**$ 1,544,400**	**$ 1,745,172**	**$ 1,972,044**	**$ 2,228,410**	**$ 2,495,819**

Note: Figures may be off due to rounding.

1. *Sales in 1996 have been estimated by multiplying the estimated 1996 sales in the non-competition scenario by 90 percent ($6,500,000 x 90% = $5,850,000). Sales thereafter are grown at the rates used in the non-competition scenario.*

The next analysis assumes that 15 percent of sales are lost due to seller competition. This analysis is presented in Table 25.

TABLE 25
SRS' FORECASTED INCOME STATEMENTS
ASSUMING A 15 PERCENT LOSS OF REVENUES

	1996	1997	1998	1999	2000
Net Sales[1]	$ 5,850,000	$ 6,279,975	$ 7,096,372	$ 8,018,900	$ 8,981,168
Less: Cost of Sales	824,850	885,476	1,000,588	1,130,665	1,266,345
Equals: Gross Profit	$ 5,025,150	$ 5,394,499	$ 6,095,783	$ 6,888,235	$ 7,714,823
Less: Operating Expenses	2,451,150	2,631,310	2,973,380	3,359,919	3,763,109
Equals: Net Operating Income	$ 2,574,000	$ 2,763,189	$ 3,122,404	$ 3,528,316	$ 3,951,714
Less: Taxes	1,029,600	1,105,276	1,248,961	1,411,326	1,580,686
NET INCOME	**$ 1,544,400**	**$ 1,657,913**	**$ 1,873,442**	**$ 2,116,990**	**$ 2,371,028**

Note: Figures may be off due to rounding.

1. *Sales in 1996 have been estimated by multiplying the estimated 1996 sales in the non-competition scenarios by 90 percent ($6,500,000 x 90% = $5,850,000). 1997 Sales are then grown by 13 percent, the rate of growth from the non-competition scenario. The result is then multiplied by 95 percent, to reflect the further 5 percent decrease in sales ($5,850,000 x 1.13 = $6,610,500 x 95% = $6,279,975). Sales thereafter are grown at the rates of growth used in the non-competition scenario.*

The next analysis presented assumes 20 percent of the sales volume of the former SRS locations is lost due to seller competition. This analysis is presented in Table 26.

TABLE 26
SRS' FORECASTED INCOME STATEMENTS
ASSUMING A 20 PERCENT LOSS OF REVENUES

	1996	1997	1998	1999	2000
Net Sales[1]	$ 5,850,000	$ 5,949,450	$ 6,722,879	$ 7,596,853	$ 8,508,475
Less: Cost of Sales	824,850	838,872	947,926	1,071,156	1,199,695
Equals: Gross Profit	$ 5,025,150	$ 5,110,578	$ 5,774,953	$ 6,525,696	$ 7,308,780
Less: Operating Expenses	2,451,150	2,492,820	2,816,886	3,183,081	3,565,051
Equals: Net Operating Income	$ 2,574,000	$ 2,617,758	$ 2,958,067	$ 3,342,615	$ 3,743,729
Less: Taxes	1,029,600	1,047,103	1,183,227	1,337,046	1,497,492
NET INCOME	**$ 1,544,400**	**$ 1,570,655**	**$ 1,774,840**	**$ 2,005,569**	**$ 2,246,237**

Note: Figures may be off due to rounding.

1. *Sales in 1996 have been estimated by multiplying the estimated 1996 sales in the non-competition scenarios by 90 percent ($6,500,000 x 90% = $5,850,000). 1997 sales are then grown by 13 percent, the rate of growth from the non-competition scenario. The result is then multiplied by 95 percent, to reflect a further 10 percent decrease in sales ($5,850,000 x 1.13 = $6,610,500 x 90% = $5,949,450). Sales thereafter are grown at the rates of growth used in the non-competition scenario.*

The last analysis we present in our lost sales sensitivity analysis assumes that 25 percent of revenues at the former SRS locations is lost due to seller competition. This analysis is presented below in Table 27.

TABLE 27
SRS' FORECASTED INCOME STATEMENTS
ASSUMING A 25 PERCENT LOSS OF REVENUES

	1996	1997	1998	1999	2000
Net Sales[1]	$ 5,850,000	$ 5,949,450	$ 6,386,735	$ 7,217,010	$ 8,083,051
Less: Cost of Sales	824,850	838,872	900,530	1,017,598	1,139,710
Equals: Gross Profit	$ 5,025,150	$ 5,110,578	$ 5,486,205	$ 6,199,412	$ 6,943,341
Less: Operating Expenses	2,451,150	2,492,820	2,676,042	3,023,927	3,386,798
Equals: Net Operating Income	$ 2,574,000	$ 2,617,758	$ 2,810,163	$ 3,175,484	$ 3,556,543
Less: Taxes	1,029,600	1,047,103	1,124,065	1,270,194	1,422,617
NET INCOME	**$ 1,544,400**	**$ 1,570,655**	**$ 1,686,098**	**$ 1,905,291**	**$ 2,133,926**

Note: Figures may be off due to rounding.

1. *Sales in 1996 have been estimated by multiplying the estimated 1996 sales in the non-competition scenarios by 90 percent ($6,500,000 x 90% = $5,850,000). 1997 sales are then grown by 13 percent, the rate of growth from the non-competition scenario. The result is then multiplied by 90 percent, to reflect a further 10 percent decrease in sales ($5,850,000 x 1.13 = $6,610,500 x 90% = $5,949,450). Sales in 1998 are grown by 13 percent, as in the non-competition scenario, and then multiplied by 95 percent to reflect a further 5 percent decrease in revenues ($5,949,450 x 1.13 = $6,722,875.50 x 95% = $6,386,734.58, $6,386,735 rounded).*

Having presented these analyses, the lost income calculated under each scenario is summarized in Table 28.

TABLE 28
SUMMARY OF LOST INCOME
FROM SELLER COMPETITION

Lost Revenue	1996	1997	1998	1999	2000
1 Percent	17,160	19,391	21,912	24,760	27,731
5 Percent	85,800	96,964	109,558	123,801	138,657
10 Percent	171,600	193,908	219,116	247,601	277,313
15 Percent	171,600	281,167	317,718	359,022	402,104
20 Percent	171,600	368,425	416,320	470,442	526,895
25 Percent	171,600	368,425	505,062	570,721	639,207

As can be seen in Table 28, the greater the loss of sales, the greater the loss of income, and as a result, loss of cash flow. The question that needs to be answered after an analysis like this is, what is the most likely loss of revenue that would result from the competition of the seller? In order to answer this question, we reviewed numerous documents relating to this matter. We have highlighted that which we consider to be most relevant to our analysis.

The deposition of John Byrnes provided us with a significant amount of relevant information. Mr. Byrnes is, and was at the time of the SRS acquisition, Chief Operating Officer of Lincare. From his deposition, it is clear that he is highly experienced in the respiratory therapy business as an industry insider.

On page 4 of his deposition, Mr. Byrnes explained his involvement in the acquisition of SRS by Lincare. Mr. Byrnes indicated that he reviewed a "book" from Mr. Smith's business brokers, and then attended a meeting with the brokers, Ben Smith and Lori Daniels. Mr. Byrnes indicated the reason he went to the meeting was "...to see if Lori was capable of running the business herself." This is significant because it demonstrates that Lincare believed Ms. Daniels to be a key individual in the operations of SRS.

When asked if he knew of SRS and Mr. Smith prior to their meeting in December 1994, he said "...we knew who they were and we knew that they're at four locations and were a good competitor."

Later Mr. Byrnes was asked "Why were you concerned about whether or not Ms. Daniels would be able to run the company after the acquisition?" His response was "Because the feeling I got was that Mr. Smith wasn't coming in the acquisition." Mr. Byrnes was asked "Did Lincare have an interest in having Mr. Smith continue on with the business in some capacity, if you recall." Mr. Byrnes' reply was "No", "we did not have an interest." This is a very clear statement that Lincare's interest was in Lori Daniels and not in Ben Smith.

Mr. Byrnes was asked what Ms. Daniels's role has been from the acquisition forward. His response was "Her title is an area manager. She runs the four Smith locations. We opened up an Arcadia office. She also runs up through Ocala and Gainesville for us now. She has several locations that report to her." Clearly Ms. Daniels has shown the capabilities, not only to effectively run what was SRS, but also the ability to take on these new locations, as well.

When asked about the source of referrals that generate revenues for his company, Mr. Byrnes indicated that half come from doctors and half come from hospitals. Mr. Byrnes was asked how these referral relationships were maintained. He replied, "In Smith's case, we continued to do exactly the same things that they were doing. They had four or five sales reps who called on hospitals, the doctors, the nursing agencies, who were willing to service their indigent patients who provided a high level of service." Mr. Byrnes was then asked, "Did you attempt to ascertain as part of the due diligence who had been responsible for generating the doctors, hospitals and nurse referrals that Smith Respiratory had?"

Mr. Byrnes responded that Lincare had ascertained that information and "that it was the sales people who brought in the business." Mr. Byrnes was then asked "Did you have any reason to believe that the relationships that existed with the doctors, nurses, and hospitals had been of long standing, namely initiated and started by Mr. Smith himself?" Mr. Byrnes responded "There's probably some in Plant City. But for the other locations outside of Plant City, I think it was the salespeople he hired." Mr. Byrnes was then asked a series of questions regarding the percentage of business SRS derived from each of its locations. His response indicated the following:

Plant City	*25%*
Sebring	*15%*
Lakeland	*40%*

Total	*80%*

In regard to the Lakeland store, Mr. Byrnes was asked "did you attempt to ascertain or did you ascertain the role that Mr. Smith individually had in initially establishing and having continuity in terms of the referral relationship?"

Mr. Byrnes answered "It was Judy Clark that got the business there." Mr. Byrnes was asked how he was aware of this and he responded "because when he opened in Lakeland, I was the center manager there [For Lincare]." Mr. Byrnes further commented that he "...knew who was out calling on the docs."

From all of these questions and answers, it is clear that Mr. Byrnes is well versed in the local markets where SRS operated, and how the Company was generating its referrals. Mr. Byrnes' concerns were about the abilities of Lori Daniels, as discussed above. Mr. Byrnes was later asked what his determination of Ms. Daniels's abilities to run the locations was. He responded "I thought she could." When asked why, Mr. Byrnes said, "She knew what was going on. She knew where the business was coming from. She knew what was going on in all four markets. And I just felt confident that she was on top of the business."

Another deposition that was helpful was that of Mr. Deutsch, who was specifically asked about the non-compete agreement and how the value was derived. He responded as follows:

> *A. As you know, we've been on a fairly active acquisition program for a number of years. From the beginning of 1991 through today, we've closed more than 70 acquisitions.*
>
> *Working with our independent auditors, we have determined that during 1995, we were basically allocating $50,000 per shareholder to the covenant. Because of the size of this transaction, which was – the business was larger than the normal business in the industry and larger than our normal acquisition, we felt it appropriate to increase that from 50,000 to 100,000 in terms of allocation of the purchase price to the covenant. So it was a standard calculation adjusted for the size of the business that we arrived at working with our outside auditors.*

Although one could construe this statement as indicating that Lincare applies a blind rule of thumb to the allocation of purchase price for a non-compete, we do not believe that is the case. As Mr. Deutsch indicated, his company is very experienced in acquiring other companies. Their method of allocating to a non-compete is based on this experience, and as he mentioned, from working with Lincare's independent auditors. At some point in this process, Lincare, with its outside accountants' assistance, determined this to be an appropriate measure. This should also be held up against Lincare's tax and accounting incentives. An allocation of purchase price to a non-compete agreement can be amortized over the life of the agreement. Goodwill on the other hand, is amortizable for financial statement purposes over 40 years. In prior years, goodwill was not at all deductible for income tax purposes. Now, it can be amortized over 15 years.

In addition, Lincare is required by law, to submit its financial statements to the Securities and Exchange Commission because of its status as a publicly traded company. These financial statements must fairly represent the financial condition of the company and have been audited by the company's outside accountant, KPMG Peat Marwick. In recording the allocation of purchase price, the company has a duty to fairly report it to its shareholders, and the independent accountant has opined to its fairness. Given these facts and circumstances, we do not believe that Lincare's methodology is without merit.

The third Lincare deponent was Robert G. Abood, whose deposition pointed out two issues relevant to our analysis. The first issue is the importance of Lori Daniels to Lincare in the transaction.

Q. Now, in that regard, is that instrument or Ms. Daniels's Employment Agreement with Lincare pursuant to the terms of the agreement? Because I don't know why, but I was of the impression that Ms. Daniels did not have a written Employment Agreement with Smith Respiratory.

A. No. This is an Employment Agreement between Ms. Daniels and Lincare as a condition precedent to closing the acquisition.

The key is that her employment agreement with Lincare was a precondition to the acquisition. Lincare was concerned with locking her into the deal from the very beginning.

The second issue is over the negotiation of the individual asset values.

Q. And did Mr. Gonzales or anyone on behalf of Mr. Smith make any suggestion as to what the allocation should be or was the allocation something that was the product of Lincare?

A. I do not believe anyone representing the seller or the seller himself made any suggestions as to what the allocation should be. I believe the process was we presented our good faith estimate of what the allocation should be and it was accepted by the seller after their review.

The importance of this response is that neither Mr. Smith nor his representatives commented on the allocation of the asset values. This issue will be taken up again later in this report.

The fourth and final Lincare official deposed in this matter was Phillip Phenis. Mr. Phenis is Lincare's controller. Mr. Phenis was deposed for the purposes of understanding more about Lincare's acquisition process, and how Lincare values individual assets, particularly covenants not-to-compete.

Mr. Phenis established that Lincare does have a written policy as to how it allocates purchase prices. In establishing this, he stated:

> *We have – using the term "protocol" or methodologies as to how we – how we come up with the end product of a purchase price allocation. That is, from the inception of the early – late 1990, '91 and '92 when we started acquiring businesses with our outside auditors, KPMG Peat Marwick, we developed that methodology.*
>
> *And it's been applied over that entire span of our acquisition program with very minor adjustments, very few in form and very few in substance. It's primarily the same methodologies from the time I started with the company in 1993.*

The important points in this statement are that the methodology has been developed with Lincare's outside auditor, KPMG Peat Marwick ,and that it has been applied over time with very little modification.

Mr. Phenis goes on further to discuss how covenants are valued, and what the trend has been over time.

A. And the covenant, which is the second item – ready to go to the next one? – if you're in an asset and stock purchase, in each of those transactions, there is normally – with an asset purchase, there is one or more persons that are the influential persons in that business.

In a stock purchase, certainly there are shareholders that are oftentimes participants in the business in our industry, and they are the significant influencing persons involved in the business.

> *We value covenant based on the same methodology, the number of persons that are involved times an amount. And the amount in the case of March 9th of 1995 was $100,000 for the significant person involved in the Smith Respiratory acquisition.*
>
> *The methodology of using a number of persons involved times a dollar amount has been in place for 1994 through today. The only variation is that the dollar amount that we have assigned to each of those significant persons in the business has changed. It's continued to slide on a downward scale.*
>
> *In 1994, we were valuing – when we were developing purchase price allocations, we were looking at businesses and saying – and we were buying from a different pool of sellers.*
>
> *In this case, I don't think Mr. Smith is a doctor. But in '94, we were buying many physician-owned practices. And you would often be buying for more than one person, and there's a – there's 12 shareholders. We were valuing those in that time frame from 50 to $100,000 per person.*
>
> *Through the middle of '95, then we started to change the valuation to more in the $25,000 per person; in 1996, more in the 10,000, where today and for the last 12 to 18 months, we've been valuing each covenant based on the number of persons at $5,000 per person.*
>
> *Q. Since that is truly the focus of our litigation, let me address that for a few moments.*
> *A. Sure.*
>
> *Q. The $100,000 number or $50,000 number, or whatever number may be used, where does that number come from?*
> *A. It is purely an estimate based on management's ability to estimate what this covenant is valued to us internally.*

There are two factors in this statement. First, that the dollar amount assigned to each shareholder has decreased through time. This indicates that Lincare has seen what it believes to be trends in the value of non-compete agreements, and has adjusted its valuations accordingly. This further supports the notion that Lincare's allocation is not arbitrary. Second, the value of the covenant is Lincare's perception. This indicates that as an active participant in this market Lincare does not believe that the owning individual is highly valuable to the success of the business.

A review of the deposition transcript of Ben Smith also provides us with important information regarding the covenant not-to-compete. From reviewing Mr. Smith's deposition transcript, we feel Mr. Smith was very knowledgeable about his business and his industry. It appears that Mr. Smith has good marketing skills and is a very effective teacher. These are both important skills in developing and growing a successful business in this industry. In addition, Mr. Smith describes the importance of his employees and the level of service provided to customers in the success of SRS. The deposition covers topics from opening new locations, competition, and key employees, to marketing and referral development.

Mr. Smith was asked about and discussed how SRS decided to open new locations. Key factors appeared to be a geographic area with an elderly population, and a sufficient potential referral base. In answering a question about how the actual decision process went, Mr. Smith said:

> *We'd take all my marketing people and I would think I'd see an area I thought would be good. I would visit it myself or I would have some kind of contact. And I would send all those marketing reps into the area, and they would talk with doctors about who they were using or*

how they were doing or how they could be, you know, handled better by a company. If we saw there was potential, then we would go there and open a facility.

Mr. Smith was asked why he opened the Sebring location. He responded:

A. Smith Respiratory continued to expand yearly looking for places that we thought we had potential business. And I had looked at purchasing a company down there one time and didn't. And then I thought it would be a good opportunity for Smith to expand.

So I expanded down there because I thought there would be some additional business, which, in that business, as always, you look for an older population of people that had some problems. That's why we moved there.

Mr. Smith later discussed how Zephyrhills differed in respect to why it was opened.

A. No sir. We did that a little bit different than that. We had some doctors in Plant City that also covered Zephyrhills. And so they were looking for some additional people. They wanted better coverage up there. So that helped make – There's more than just one reason you would decide to go there, but that was one of the major reasons to look at Zephyrhills.

And, again, it's an older population of people, which is what we were. We were government, Medicare – you needed older people – older sick people.

Training is a very important part of SRS' business. Employees who typically are not highly skilled when they began their employment at SRS must be trained to deliver a high level of service to SRS' patients. SRS' employees were trained in how to educate patients in using oxygen and other equipment. Mr. Smith discussed the training of these individuals in-depth.

A. It would be delivered to the patient's home, and they would educate the patient in how the doctor prescribed the oxygen for him, and how the equipment worked.

Q. Okay. Would this be someone that had been trained in your operation to do this?
A. Yes, sir.
Q. This wouldn't be someone out of the labor pool –
A. No.

Q. – in Tampa or Lakeland, would it?
A. No.

Q. This would be someone that you would recognize as having the degree of skill necessary to –
A. We had constant education programs at the company to educate everybody that came onboard. They all had to go through a training period or a training phase to do anything that was related to our company, whether it would be install a bedside commode or a walker. And we were governed by the joint commissions, which said that we were doing it in a proper safe manner for the patient.

Q. They were skilled people?
A. Well, you know, you don't hire them skilled. You hire them and then, you know, train them to do the job. So you weren't respiratory therapists or, you know, physical therapists or nurses, no, sir.

Q. Was there a difference between the truck driver and the person who actually took the tank to the patient?
A. No.

Q. Would that person that was trained by you – of course, he'd already know how to drive a truck, but, obviously, that person be trained by you, then, to take the tank inside and help the patient?
A. Yes, sir. Me or my staff trained them. Ninety percent of them I have trained myself.

Q. Was there some sort of formalized training you gave them? In other words, did you have some sort of brochure you followed or was it just based on your experience in the business?
A. Well, initially when we first did it, it was, you know, based around our experience the way – but when we became JCO certified or joint commissioned, then we had protocol that you had to follow, and it was a written procedure. We had a policy and procedure manual that we – Lori Daniels, matter of fact, wrote our policy and procedure manual that joint commissions came in and inspected us and said, yes, we're following proper procedure with all the safety precautions and everything that should be done to maintain the health and safety for the patients with the equipment.

The quality of the services provided by SRS differentiated the Company from its competition. In discussing the quality of the services provided compared to its competition, Mr. Smith felt that SRS was superior in all respects.

A. Not a chance.

Q. Is this because of the better training you provided your people?
A. I think it was better training and just simply the way we maintained, you know, our equipment. And there was just never a question just from the physicians and the patients themselves and the referrals from social services workers at hospitals, nurses at hospitals. Your patients and word-of-mouth back to the physicians is what built Smith Respiratory Services.

Q. And that's what I was going to ask you. Is it this quality of services that you – to which you attribute the obvious success of Smith Respiratory Services in these areas?
A. I think we gave the best out there, yes, sir. Lincare must think we gave pretty good, too, because they still carry our name in several of the locations. Even though they bought my company they still have my name on it.

Mr. Smith answers a series of questions relating to competition from other companies in the oxygen business. Through his responses, he indicated that he did not believe any of the independent companies in his industry offered any significant competition to SRS. Mr. Smith described SRS' competitive advantage as taking care of patients.

> *And so you got business based around what your ability – the physician, he wanted his patients taken care of. I mean, that's what he was looking for. So whoever gave the best care to his patients is, you know, who he's normally going to use. And so it was a combination of a lot of things, and it was years. We didn't do it overnight. It took us, you know, 13 years to build that business.*

In addition to providing high quality service to patients, Mr. Smith believed it was crucial to market these services to potential referral sources. When asked, Mr. Smith discussed the importance of marketing and the marketing staff to SRS.

A. *My marketing people met with me, not just – We had a meeting every week. There is no question about it. But it was daily that my marketing people would get on their radio or they had mobile phones in their car, that I talked to them constantly about, you know, this position, you need to do this. You need to do this. You need to do this hospital.*

So my marketing people were in constant contact with me every day. My marketing people is the backbone and center of this whole thing. So did I spend the majority of my time with my marketing people? There is no question about that.

I'm just simply talking about going outside and making sure everything got done. But my marketing people, that's the backbone of all this company. And if you'll check with Rotech and Bill Kennedy – and that's what I did when I went to work for Rotech. I trained the marketing people. That was my job with them, is to hire and train marketing people and then to expand my philosophy of how to do business throughout the Rotech system.

Q. *How many marketing people did you meet with when you would meet weekly?*
A. *Whatever number we had. So what was it? Five maybe.*

Q. *That's what I'm asking. I don't know.*
A. *Yes, sir.*

Q. *Would that include Lori Daniels or was she in addition to the marketing people that you're referring to?*
A. *Lori was a business director. That was her title. But it was not unusual for me to send Lori. If I had a big luncheon somewhere, if I had a special deal going on with a doctor, would I send Lori into one of the doctor's offices with the marketing person? Yes. That wasn't unusual for her to do that. It wasn't unusual for me to go to one myself.*

The key to referrals is developing relationships with doctors, nurses, social workers, and certain hospital personnel. Mr. Smith was asked about how significant referral sources were developed. His response to that question was:

A. *How you develop it was, it's a combination of a lot of things, but a lot of it depends on your reputation when you first did what you said you were going to do back in 1981, when Smith Respiratory first started. You had to do what you said you were going to do.*

And one of the things that helped us more than anything is, we went out and we said, "We will have equipment in a patient's home within the hour." And so it was a reputation that you built over years of doing exactly what you said you were going to do and taking care of patients better than anybody else could take care of it. And that reputation rested, honest to God, with Ben Smith, because it was Smith Respiratory.

Referral development was discussed further with Mr. Smith.

Q. *When you – your sales personnel would call on a physician or a hospital, did you regard them as engaging in referral development at that point?*
A. *That was their job. So anything that they did – They might do a talk for a nursing service. They might go to a nursing service and put on a demonstration. They*

> *would take a driver with them and they would do, you know, a demonstration of how oxygen equipment would work, or if a nursing service, you know, wasn't sure where the low air loss mattress how it worked, we would use our marketing people to go put on a demonstration for a nursing service.*

Mr. Smith clearly believed that marketing was the key to his business, as he said:

> *Everything that you do is a marketing. Anything that you do good is going to be considered a marketing tool. So everything that we did is geared around making sure that we get referrals.*

The discussion moved on to the subject of key personnel. One of the key individuals at SRS was Lori Daniels. When asked to describe her role at SRS, Mr. Smith responded:

> *A. Lori Daniels started to work for me in Lakeland for $5 an hour as a person to run the Lakeland store. And from there she developed and was trained and aggressive about, and she ended up being the director for the business. She ran the businesses just like I would have done from years and years of training.*
>
> *How good she is. She just was promoted this week to regional manager for Lincare. She has the highest job, other than the CEO, here in Florida. She covers all of the Florida operations for them, which is their largest, by far, dollar volume dollarwise in their company. So how good is she? That's how good she is.*
>
> *Q. What were her duties with SRS, Smith Respiratory Services?*
> *A. Yes, sir. Well, she started out, like I said, as a customer service person, and then, you know, from there, for different jobs, in charge of billing. And just finally, her title – I let her call herself whatever she wanted to – was director of business.*
>
> *Q. Was that her title as of December of 1994?*
> *A. Yes, sir.*
>
> *Q. Okay. And what were her duties as of December 31st, 1994?*
> *A. She had, you know, combination of everything, to make sure that – you know, same as I would do. The drivers did what they were supposed to, the marketing people did what they were supposed to, billing, that we collected our money.*
>
> *She met with – Every time we had a marketing meeting, she was part of that. If I had a meeting with drivers, she was part of that. If I had a meeting with drivers, she was part of that. Many a times I would send her to – if I couldn't go to run one of the operations that I had problems, I would send her to Sebring or send her to Lakeland or send her to Zephyrhills to handle a situation that, you know, I didn't have time to get to.*
>
> *So she did the same kind of things that I would have done if I couldn't get to them, or she was a part of what I wanted done. Like any CEO would do, that they would pass down to a president or someone under them to do things that, you know, needed to be done.*
>
> *So did she – One of the biggest things she ever did for Smith Respiratory, she wrote a manual – policies and procedures manual which was for joint commissions when we decided that we needed to be joint commissioned. Lori actually gathered the information and put this policy and procedure manual together that I would have had to spend $25,000 to get done. She did it for me in addition to her job. She did it on*

the weekends and at night and other times. So what did she do? She did everything.

Q. *Did she have any responsibilities concerning the referral development?*
A. *Absolutely.*

Q. *What were those?*
A. *Again, you know, if we had a marketing – If one of the marketing people needed her to help support them in some way, did Lori go from the office into physicians' offices and take care of whatever needed to be done? Yes.*

Q. *What was –*
A. *That wasn't her major – That was not her major job, no.*

Q. *What was her major job?*
A. *All of it. But the marketing part would have just been one of the 10 other things that she did. Her job was to make sure that everything there – that she was part of everything that went on. Somebody that you can count on if you're not there, that you know is going to do everything that you would do, and make sure that if you did go on vacation or you did go skiing or you did something, that you knew it was going to get done right.*

Mr. Smith felt that there were several key people at SRS in addition to Ms. Daniels, as indicated in the following discussion.

Q. *Who did you regard as the management personnel of Smith Respiratory Services in December of '94, other than yourself, obviously?*
A. *The key people?*

Q. *Yeah.*
A. *Key people at that point was Lori Daniels, all of my marketing people. Judy Clark was really important. No question. She had tremendous –*

Q. *She is one of those four or five marketing people?*
A. *Yes. And Janie Wey; tremendously important.*

Q. *Another one of the marketing people?*
A. *Caroline Hanken; tremendously important. My other marketing person, Kathy Elston, at that time was fairly new. Wasn't near as effective, because she didn't have the time under her belt. She had a really tough territory.*

God. Then, you know, my supervisor of my drivers was Johnie Goodson, my brother, a young lady by the name of Brenda Harrell, which ran my billing department for me, Cindy Jacobi.

From the deposition transcript, it is apparent that SRS' success is derived from the collaboration of several key individuals. As Mr. Smith stated, the marketing representatives are the "backbone" of the Company. It also appears that Ms. Daniels was very important to the business, as she worked in all facets of the business and was essentially interchangeable with Mr. Smith. It appears that Mr. Smith's skills lay in marketing and training. Mr. Smith said that he performed over 90 percent of the training of all employees. This developed the skills of the employees, making them proficient at their jobs.

In addition to the Lincare executives and Ben Smith depositions, we also searched for other authoritative sources to assist in the valuation of the covenant not-to-compete. The value of non-compete agreements in *the purchase and sale of a company has been the subject of numerous court cases involving the Internal Revenue Service ("IRS") and taxpayers. According to Neil C. Kelly, ASA, CFA, the IRS maintains a theory called the "mass asset" rule. Prior to tax reform, this theory held that certain intangible assets were "non-depreciable as a matter of law, because such intangible properties are part of a single mass asset, which, in the aggregate, has no determinable useful life and is either inextricably linked to goodwill or self regenerating." According to Mr. Kelly, for a non-compete agreement to not fall under the mass asset rule, it must have the following components:*

1. *A recital to the effect that it is the intent of the parties that the Covenant not-to-compete is separate and distinct from any goodwill the seller may be selling.*

2. *That the subject covenant is not merely for the purpose of protecting the purchase goodwill.*

3. *That the Covenant has an independent basis-value.*

4. *That the Covenant was expressly bargained for – separate and distinct from the goodwill of the seller.*

5. *That a specific monetary sum is being paid for the Covenant.*

6. *That the Covenant is for a specified period of time - which goes to the permissible amortized period.*

7. *That the Covenant to compete restrains a key individual from competing with the purchaser, and if same is not accomplished, that the purchaser will suffer an economic detriment because of the key person's ability and competitive activities.*

8. *That even in the event of the death of the grantor of the Covenant, such will not entitle the purchaser to depreciate or recover the cost of such Covenant over a period shorter than the term of such a Covenant.*

9. *The amount the purchaser is paying for the Covenant not-to-compete is depreciable over the life of the Covenant regardless of whether the purchaser makes payments for such Covenant over a period shorter than the life of the Covenant.*

10. *A recital to the effect that the value allocated to the Covenant has economic reality or substance.*

In addition, guidance can be found in the four tests that the courts have historically applied to non-compete agreements in determining whether it could be amortized for federal income taxes. The four tests were summarized in Forward Communications Corp. v. U.S., 78-2 USTC Para. 9542, as follows:

1. *Whether the compensation paid for the covenant is severable from the price paid for the acquired goodwill.*

2. *Whether either party to the contract is attempting to repudiate an amount knowingly fixed by both the buyer and seller as allocable to the covenant.*

3. *Whether there is proof that both parties actually intended, when they signed the sale agreement, that some portion of the price be assigned to the covenant.*

4. *Whether the covenant is economically real and meaningful.*

> *The first test was effectively established in Marsh & McLennan, Inc. v. Commissioner, 51 T.C. 56 (1968). aff'd on other grounds, 420 F.2d 667 (3d Cir. 1969). In this case, the court looked at whether the compensation paid for the covenant is separable from the price for goodwill. Where goodwill and the covenant not-to-compete are closely related, the benefits of the elimination of competition may be permanent or of indefinite duration and, hence, the value of the covenant is not exhaustible or a wasting asset to be amortized over a limited period.*
>
> *In Commissioner v. Danielson, 378 F. 2d 771 (3d. Cir.) cert. Denied 389 US 358 (1967), the courts looked at whether either party was attempting to repudiate an amount knowingly fixed by both as allocable to the covenant, the calculable tax benefit of which may fairly be assumed to have been a factor in determining the final price.*
>
> *In Annabelle Candy Co. v. Commissioner, the courts looked at whether the covenant played a real part in the negotiations.*

Although the valuation of a non-compete agreement is not concerned with whether or not the value is amortizable, these tests do provide meaningful guidance in the valuation process. In reviewing Mr. Kelly's points, we have determined the following:

1. *Based on the asset purchase agreement, the parties intended for the covenant not-to-compete to have value separate and distinct from the value of goodwill.*

2. *It appears that Mr. Smith was skilled in his business and would have the ability to compete with Lincare. This does not indicate what level of competition Mr. Smith might provide.*

3. *Based on our review, the covenant does have independent basis value as presented in Addendum 3.4 to the agreement.*

4. *The agreement clearly lays out the allocation of purchase price. A series of documents dated between March 1 and March 9, 1995, between Robert G. Abood, a member of Lincare's acquisition group and Associate Corporate Counsel, and Mr. Smith's attorney, Larry Gonzales, indicates that the asset purchase agreement and lease had been negotiated, as well as the value of the accounts receivable. In fact, Mr. Smith appears to have been personally involved in this negotiation. In a fax transmittal dated March 1, 1995, from Rick Glass of Steven Richards & Associates, Inc. to Mr. Abood, regarding the accounts receivable, Mr. Glass writes "Ben believes a fair resolution would be additional consideration of $332,516. The excess over $600,000 as of stopping billing on February 28, 1995."*

   Although there is no indication that Mr. Smith or his representatives expressly bargained for the value of the covenant not-to-compete, they did negotiate the terms of the deal, as well as particular asset values. From this, we must conclude that Mr. Smith and his advisors implicitly approved of the value of the covenant not-to-compete.

5. *The agreement clearly states that $100,000 is being paid for the covenant not-to-compete.*

6. *The covenant is for a period of five years after which it expires.*

7. *The covenant does constrain Mr. Smith from competing and the same stated in 2 above holds here, as well.*

8. *We are unaware of the impact the death of Mr. Smith would have on Lincare's ability to recover the cost over a shorter period of time.*

9. *The value of the covenant is depreciable over the life of the covenant even though payments for the covenant were made over a shorter period.*

10. No recital of the economic reality of the covenant was found.

In reviewing the four tests put forth in Forward Communications Corp. v. U.S., we found the following in regard to the agreement.

1. The compensation paid is separable from goodwill, as it was expressly laid out in the agreement.

2. We have found no evidence that Mr. Smith repudiated or attempted to repudiate the allocation to the covenant offered by Lincare.

3. Both parties clearly intended an allocation to be made to the covenant not-to-compete, as it is expressly laid out in the agreement.

4. Based on Mr. Smith's apparent skills and abilities, he appears to have an ability to compete. However, this is in no way an indication of the level of competition he could provide. Therefore, the covenant is economically real and meaningful.

Of particular importance, is whether the covenant was at issue in the negotiation process. This relates to the economic reality of the covenant and its economic significance. According to Kelly, the following are factors which are important in determining the economic reality of a non-compete agreement.

a. The presence of a grantor of the covenant not-to-compete having business expertise evidencing a formidable capability to compete;

b. grantor's ownership of technology and machinery necessary to compete;

c. grantor's possession of sufficient economic resources to compete;

d. legal enforceability of the covenant for the term of the particular covenant under state law;

e. grantor's legal capacity to compete;

f. covenant having sufficient scope to assure non-competition without overreaching;

g. not too advanced age of grantor;

h. good health of grantor;

i. payments for covenant that are not pro-rata to the grantor's stock ownership in the seller;

j. purchaser's policing of the covenant not-to-compete;

k. structuring payments under the covenant to occur over time and to cease upon breach of such covenant;

l. vigorous negotiations over the covenant and negotiations over its value should be recited in the agreement;

m. a detailed, specific, and carefully drafted covenant not-to-compete;

n. independent appraisal of the value of the covenant not-to-compete;

o. some degree of reasonableness in the percentage of the considerations allocated to the covenant and other items.

The importance of the covenant not-to-compete having economic substance was further delineated by a Bureau of National Affairs' paper on the subject published in 1992. The paper stated:

> *The most important factor is whether the covenant is economically real, that is, whether the covenant is the product of bona fide bargaining rather than a sham. The economic reality theory is primarily concerned with business realities which would cause reasonable persons, genuinely concerned with their economic future, to bargain for the covenant not-to-compete.*
>
> *Among the facts to be considered are whether the seller could actually compete with the purchaser. Where the seller is, objectively, likely to be a competitor.*

The paper states that courts have also looked at the actual contract negotiations to determine if the parties' intentions were for the covenant not-to-compete to have value.

> *In addition, the amount allocated to the covenant not-to-compete may not reflect economic reality. The taxpayer has the burden of proving that he is entitled to the deduction. Welch v. Helvering, 290 U.S. 111 (1933). Courts have frequently found that covenants have no value or, at least, substantially less value than the purchaser attributes to them. The same factors as above have been considered for this purpose. Further, courts have looked at the actual contract negotiations to determine if the parties intended the covenant to have any value. For example, if the parties agreed to pay a certain amount for the assets of the seller and the purchase price is not altered when a covenant not-to-compete is later added, the covenant has no or minimal value.*

Other guidance on determining the value of a covenant not-to-compete is given in Revenue Ruling 77-403. The ruling states that the relevant factors for determining the value of a non-compete agreement include:

> *1) Whether in the absence of the covenant the covenantor would desire to compete with the covenantee; 2) the ability of the covenantor to compete effectively with the covenantee in the activity in question; and 3) the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant.*

Based on the issues presented by Kelly in regard to the mass asset rule, the covenant is a distinguishable asset that can be valued separately from goodwill. Further, the covenant in the Lincare-SRS deal appears to pass the four tests from <u>Forward Communication Corporation v. U.S.</u> Tests two and three are of particular importance here. The importance of test two is that after Lincare proposed the allocation to the covenant, Mr. Smith and his advisor did not attempt to repudiate or negotiate it, although they did negotiate several other items in the agreement. As a result, we believe the covenant is economically real. Test three is significant because the allocation to the covenant is clearly made in the agreement.

From the deposition of various Lincare executives, we learned that Lincare has developed a methodology for allocating a portion of the acquisition price to covenants with the assistance of its outside accountant, KPMG Peat Marwick. In addition, we know that Lincare is a major player in the industry and has been undergoing a major acquisition program. Therefore, Lincare's actions appear to be reflective of market conditions.

As Mr. Deutsch states, "Lincare's interest in SRS was due to its good locations, respiratory therapy control and good reputation." According to Mr. Byrnes, he did not believe that Mr. Smith held many of the referral relationships personally. In fact, Mr. Byrnes knew first hand that in Lakeland, Judy Clarke was generating *the referrals. Mr. Byrnes believed that Mr. Smith may have originally held some of the relationships in Plant City. This puts Mr. Smith's control of the referral base at less than 25 percent.*

As we know from Mr. Smith, additional relationships were developed by the marketing representative in that territory. It was also the marketing person's responsibility to maintain existing relationships. In addition, from Mr. Smith's deposition, we understand that the marketing people are critical to the success of SRS.

We also learned from Mr. Smith that he was responsible for over 90 percent of the training of these individuals, as well as the other employees of the Company. Mr. Smith has imparted a great deal of his knowledge and expertise on these individuals. It appears this has occurred to a large extent with Ms. Daniels, who did everything Mr. Smith did for the Company.

Ms. Daniels's talents were recognized by Lincare, who ensured she was part of the acquisition, by making an employment agreement with her, a prerequisite to the acquisition closing. According to Mr. Byrnes, Lincare's interest was always in Ms. Daniels, and Lincare had no interest in retaining the services of Mr. Smith. We believe Mr. Byrnes to be credible on this issue because Lincare did not offer Mr. Smith an employment contract prior to the closing of the acquisition.

If Lincare felt that Mr. Smith was essential to the business because he held many personal relationships, then it would be a prudent business decision to bring Mr. Smith along with the acquisition, and lock him into an employment contract for a period of time that allows for a transfer of these relationships. In this type of a situation, a buyer needs to ensure the transferability of what it is purchasing. Relationships take time to develop. They cannot be transferred overnight.

An employment contract is typically used to retain the services of the seller as an employee of the acquirer for a specified period of time. Typical time periods range from six months to two years. During the term of the employment contract, the business seller assists the buyer in the transitioning of the business. Prudence dictates that such an agreement should be in place before closing, as was the agreement with Lori Daniels. Yet Lincare had no interest in such an arrangement with Mr. Smith. From this position, one can reasonably infer that Lincare did not believe that Mr. Smith was important to the successful transition of the customers and referral sources to Lincare.

Using all of this information, we have determined that Mr. Smith would be able to provide a minimal loss of business to the SRS locations acquired by Lincare. Mr. Smith created a company of highly skilled individuals and significantly reduced SRS' reliance on himself. In addition, Lori Daniels, the person who was most crucial to the deal taking place has been tied up in an employment contract by Lincare. As a result, we believe that only a small portion of the sales could be diverted if SRS continued to compete with Lincare. Therefore, we have selected 10 percent as the percentage of sales that SRS could divert from Lincare.

Based on a lost sales analysis of 10 percent, we have determined that the lost income attributable to the covenant not-to-compete is as follows:

1996	***1997***	***1998***	***1999***	***2000***
$ 171,600	*$ 193,908*	*$ 219,116*	*$ 247,601*	*$ 277,313*

The estimated cash flows attributable to the lost income, calculated in a manner similar to that which we calculated previously, is as follows:

1996	***1997***	***1998***	***1999***	***2000***

$ 22,471 $ 88,164 $ 116,897 $ 149,365 $ 185,730

The major difference between the lost net income and the cash flow is the level of capital expenditures, which far outpaces depreciation expense. These items were treated in a consistent manner when the valuation of SRS was previously performed. However, since management of the company can change the level of capital expenditures, we believe that it would be more prudent to discount the lost earnings, rather than cash flow, in valuing the covenant.

The value of the covenant not-to-compete is the present value of the lost income to the buyer. Using a discount rate of 24 percent, this equates to the value of the covenant being $578,766, or $579,000 rounded. The discount rate used is based on a discount rate applicable to cash flow of 18 percent, with a six percent premium due to the increased risk of earnings over cash flow.

The covenant not-to-compete is a less predictable asset and has several risk factors associated with it. In reviewing Kelly's factors pertaining to the economic reality of the covenant, we find the following:

1. *Mr. Smith has the expertise necessary to compete. Mr. Smith has proven to be quite knowledgeable about his business, and by all accounts has been very successful.*

2. *Mr. Smith has the financial resources necessary to compete. Given the low cost of doing business and Mr. Smith's financial assets, Mr. Smith reasonably has the economic capacity to compete.*

3. *Mr. Smith is not advanced in age nor is he of diminished health that would keep him from competing.*

4. *Very little of the purchase price was structured over time. Only $500,000 was not paid at closing and this was for accounts receivable. Several of Kelly's factors also serve to reduce the risk associated with the covenant.*

5. *The covenant has sufficient scope to insure non-competition. This reduces the risks associated with violation of the covenant.*

6. *There is no technology or machinery that Mr. Smith owns that would enable him to compete. In addition, SRS is a marketing-based business, and individuals other than Mr. Smith are in control of many of the relationships.*

As a result of these factors, we have selected an 18 percent discount rate for the covenant not-to-compete. It was increased by six percent to reflect the earnings premium. It should be noted that this rate does not reflect the level of competition that could be put forth by Mr. Smith, but only the risk associated with Mr. Smith competing.

As a test for reasonableness of the amount allocated to the covenant not-to-compete, we examined information available in the public domain. As a result of the respiratory therapy industry's current consolidation mode, we have reviewed the Securities and Exchange Commission's filings of publicly-traded companies in the respiratory product and medical equipment sales and rental industry, to gain some insight into their acquisition practices and how they allocate purchase price to intangible assets, and non-compete agreements, in particular.

We reviewed the 1995 10-K filings for Apria Healthcare Group, American Home Patient, Inc., Complete Management, Inc., Interwest Home Medical, Inc., Lincare, Pediatric Services of America, Inc., and Rotech Medical Corp. From these documents, we attempted to isolate information relating to how they allocated the purchase prices of their acquisitions. Although all of these companies discuss their acquisition in one form or another, only Lincare and Pediatric Services of America ("PSA") provided enough detail to be meaningful to our analysis. As a result, we analyzed Lincare's 10-Ks for 1993 through 1995, and PSA's 1995 filings.

In the notes to its consolidated financial statements, Lincare discloses the purchase price of its acquisitions for the year and the allocation of the total purchase. Lincare divides the allocation between current assets, fixed assets, identified intangibles, and goodwill. Table 29 presents this data for 1993 through 1995. Table 30 presents each item as a percentage of the year's total acquisition purchase price.

TABLE 29
BREAKDOWN OF LINCARE HOLDINGS, INC.'S
TOTAL ACQUISITIONS BY YEAR
1995 - 1993

	1995	1994	1993	Average
Current Assets	$ 8,097	$ 2,915	$ 1,704	$ 6,358
Property and Equipment	4,731	4,024	2,828	3,861
Intangible Assets	12,056	11,613	7,277	10,315
Goodwill	46,050	43,000	14,195	34,415
	$ 70,934	$ 61,552	$ 26,004	$ 54,949

TABLE 30
BREAKDOWN OF LINCARE HOLDINGS, INC.'S
TOTAL ACQUISITIONS BY YEAR
AS A PERCENTAGE OF TOTAL ACQUISITIONS
1995 - 1993

	1995	1994	1993	Average
Current Assets	11.4%	4.7%	6.6%	11.6%
Property and Equipment	6.7%	6.5%	10.9%	7.0%
Intangible Assets	17.0%	18.9%	28.0%	18.8%
Goodwill	64.9%	69.9%	54.6%	62.6%
	100.0%	100.0%	100.0%	100.0%

From Table 29, it is clearly seen that the largest component of the acquisition costs for each year was goodwill, followed by identified intangibles. Of particular importance to this analysis is the allocation to identifiable intangible assets. Lincare, as we will show later in this report, typically only identifies patient records and non-compete agreements. Therefore, we have made the assumption that the identified intangible assets line in Table 30 contains only these two types of assets. As can be seen in the data, these assets represented 17, 18.9, and 28 percent of the total purchase prices in 1995, 1994, and 1993, respectively.

As a major player in this industry, Lincare's economic decisions are reflective of market conditions. Total acquisition purchase price for 1995 was $70,934,000. This represented the accumulation of 20 separate and distinct transactions. Each of these was negotiated with an arm's-length (non-related) party. Most of these *businesses were much smaller than SRS, as total revenues for the acquired companies, excluding SRS, was $38.4 million, or an average of approximately $2 million. In 1993, Lincare acquired 15 companies with revenues of $18 million or $1.2 million each. In 1994, Lincare acquired 24 companies with $35 million in revenue, or $1.46 million each. As a result, the data taken from Lincare's 10-Ks provide us with a guide from the marketplace for the combined values of a non-compete agreement and a customer list. This guide indicates that on a combined basis, these assets should constitute 17.0 to 18.8 percent of the purchase price, based on Lincare's 1995 acquisitions and the three-year weighted average, respectively.*

On October 3, 1994, PSA bought Oxygen Specialties, Inc. ("OSI") for $4.9 million. OI was a medical equipment company located in New Orleans. According to PSA's Form 10-K, $200,000 of the purchase price was paid for the non-compete agreement. This represents approximately 4.1 percent of the purchase price. In our valuation, we determined the value of the covenant not-to-compete and the patient records (customer list) to be $2,450,000, and the covenant to be $579,000. Based on a total value of $13,500,000, the total of the covenant plus the patient records amounts to 18.06 percent of the total, and the covenant alone amounts to 4.3 percent of the total. This demonstrates the reasonableness of our calculations.

ALLOCATION OF THE COVENANT NOT-TO-COMPETE BETWEEN SRS AND BEN SMITH, INDIVIDUALLY

In addition to the issue of the economic reality of the covenant, the allocation of the covenant is significant in determining personal goodwill. A common practice in asset purchases is for the non-compete agreement to name the selling company, and its shareholders, as being subject to the non-compete. This is exactly the case in the sale of assets to Lincare. The agreement was between Lincare as the purchaser and SRS and Ben W. Smith as the sellers. The issue becomes one of allocating the non-compete between the company, which results in corporate goodwill, and Ben Smith, resulting in personal goodwill.

Smith Respiratory Services developed an excellent reputation for the services it provided to clients. This reputation is, in large part, the corporation's, and not Mr. Smith's. Mr. Smith has done an excellent job, over the years, in training personnel, teaching his marketing people, and transferring his importance to other members of the company. Earlier in the business' formation, there can be no doubt that Ben Smith was SRS. However, over the years there has been a clear transition to other members of the company. In fact, it was Lori Daniels, and not Ben Smith, who Lincare insisted sign an employment contract with the firm as a prerequisite to a deal.

Recognizing the fact that Mr. Smith is no longer required to provide a personal service to the patients, referral sources and others, we do not see there being any economic reason to allocate any of the covenant not-to-compete to Mr. Smith personally. We further believe that the deposition transcripts reviewed and cited throughout our report justify our position.

SUMMARY

The fair market value of Smith Respiratory Services as of March 9, 1995 was $13,500,000. The allocation of the purchase price of the Company as of the same date is as follows:

Accounts Receivable	*$ 550,000*
Inventory	*40,000*
Fixed Assets	*712,000*
Trademark	*2,134,000*
Patient Records	*1,859,000*
Covenant Not-to-compete - SRS	*579,000*
Covenant Not-to-compete - Ben W. Smith	*0*
Goodwill	*7,626,000*
Fair Market Value	***$ 13,500,000***
Buyers Premium	*1,535,000*
Price Paid by Lincare Holdings, Inc.	***$ 15,035,000***

The equitable distribution value of Smith Respiratory Services, Inc. as of March 9, 1995 was $16,900,000, consisting of the following:

Price Paid by Lincare Holdings, Inc.	*$ 15,035,000*
Retained Assets	*1,900,000*
Total	*$ 16,935,000*
Rounded	***$ 16,900,000***

DISCOUNT AND CAPITALIZATION RATES

Section 6 of Revenue Ruling 59-60 states:

> *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.*

In the text of Revenue Ruling 68-609, capitalization rates of 15 to 20 percent were mentioned as an example. Many appraisers are under the misconception that the capitalization rate must stay within this range. In reality, the capitalization rate must be consistent with the rate of return currently needed to attract capital to the type of investment in question.

There are various methods of determining discount and capitalization rates. Using the build up method of determining these rates results in the following:

Appraisal Date Long-Term Treasury Bond Yield		*6.99*[1]
Equity Risk Premium -- Stocks over Bonds	+	*7.00*[2]

Average Market Return	=	*13.99*
Benchmark Premium for Size	+	*4.00*[3]
Adjustments for Other Risk Factors	+	*1.20*[4]
Discount Rate for Net Cash Flow	=	*19.19*
Discount for Rate for Net Cash Flow (Rounded)	=	*19.20*

CAPITALIZATION RATE

Discount Rate for Cash Flow		*19.20*
Growth Rate	-	*6.00*
Capitalization Rate for Cash Flow	=	*13.20*

1. *Federal Reserve Board, http://www.bog.fbr.fed.us/releases1H15/data/b/temzoy.txt for a 20-year U.S. Treasury Bond for March 9, 1995.*

2. *Stocks, Bonds, Bills and Inflation 1995 Yearbook, Ibbotson Associates, difference between the total returns on common stocks and long-term government bonds from 1926 to 1994.*

3. *Stocks, Bonds, Bills and Inflation 1995 Yearbook, Ibbotson Associates, difference between the total returns on small company stocks and large company stocks.*

4. *Appraiser's judgment based on the analysis discussed throughout the report.*

A capitalization rate has been derived from a discount rate, which has been calculated above. The components of the discount rate include a safe rate which indicates the fact that any investor would receive, at a bare minimum, an equivalent rate for a safe investment. In this particular instance, United States Treasury Bonds are used as an indication of a safe rate.

An equity risk premium is added to the safe rate which represents the premium that common stockholders received in the public marketplace over investors in long-term government bonds. This indicates that since equity securities are considered to be more risky by the investor, a higher rate of return has been required over the period of time indicated in the calculation of this premium.

Additional premia have been added to reflect size differentials relating to SRS. An adjustment has also been made for other risk factors. In this instance, 1.2 percent has been added to reflect level of risk. As discussed throughout this report, SRS is in a competitive industry with many players. SRS is also smaller than the companies observed by Ibbotson Associates, Inc. in developing the marketing premium utilized above. The size differential is an additional risk element to SRS.

Summing all of these items results in the derivation of a discount rate. The mathematical formula to distinguish between a discount rate and a capitalization rate is the subtraction of the present value of long-term sustainable growth from the discount rate. The present value of the long-term sustainable growth has been included at a rate of 6 percent for SRS. This rate has been determined based on the trend in industry rates of growth and overall long-term economic growth.

In addition, support for this discount rate is gained from the actual transaction between SRS and Lincare. We earlier established the fair market value of SRS to be $13,500,000 as of March 9, 1995. (See the section of this report titled "Valuation of Smith Respiratory Services, Inc.). Using Lincare's estimate of pre-tax free cash flow of $3,500,000 presented in Exhibit 3 to this report, we can calculate the pre-tax capitalization rate implied in the transaction as follows:

Estimated Free Cash Flow		*$ 3,500,000*
Fair Market Value	÷	*13,500,000*
Pre-Tax Capitalization Rate (Rounded)		*26.0%*

To convert a capitalization rate to a discount rate, the long-term rate of growth needs to be added to the capitalization rate. In this instance, the calculation is:

Pre-Tax Capitalization Rate	*26.0%*
Long-Term Growth Rate	*6.0%*
Pre-Tax Discount Rate	*32.0%*

To convert a pre-tax discount rate to an after-tax rate, the pre-tax discount rate is multiplied by one minus the assumed tax rate. In this instance, we have assumed the combined federal and state tax rate to be 40 percent. The calculation of the after-tax discount rate is as follows:

Pre-Tax Discount Rate	*32.00%*
1 - Corporate Tax Rate @ 40%	*x .60*
After-Tax Discount Rate	*19.20%*

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Gary R. Trugman is a Certified Public Accountant licensed in the states of New Jersey, New York and Florida. He is Accredited in Business Valuation by the American Institute of CPAs and is a Master Certified Business Appraiser as designated by The Institute of Business Appraisers Inc. He is also an Accredited Senior Appraiser in Business Valuation by the American Society of Appraisers. Gary is regularly court appointed and has served as an expert witness in Federal court and state courts in several jurisdictions, testifying on business valuation, matrimonial matters, business and economic damages and other types of litigation matters.

Gary is currently on the American Institute of CPAs' ABV Examinations Committee and he is a former member of the AICPAs Subcommittee Working with the Judiciary, ABV Credentials Committee, Executive Committee of the Management Consulting Services Division, and the Business Valuation and Appraisal Subcommittee. He is currently Chairman of the Florida Institute of CPAs' Litigation, Forensic Accounting and Valuation Services Section and was formerly on the New Jersey Society of CPAs' Litigation Services Committee, Business Valuation Subcommittee (past-chairman) and Matrimonial Committee.

Gary is Chairman of the Ethics and Discipline Committee, and formerly served on the Qualifications Review Committee and is the former Regional Governor of the Mid-Atlantic Region of The Institute of Business Appraisers Inc. He has received a "Fellow" Award from The Institute of Business Appraisers Inc. for his many years of volunteer work in the profession. Gary has also received an AICPA "Hall of Fame" Award for his service to the accounting profession in assisting in the accreditation in business valuation process. Gary formerly served on the Business Valuation Education Subcommittee and the International Board of Examiners of the American Society of Appraisers. He is currently a faculty member of the National Judicial College.

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Gary was born in New York and received his undergraduate degree from The Bernard M. Baruch College of the City University of New York. He was the first business appraiser in the United States to earn a Masters in Valuation Sciences from Lindenwood College. His Masters Thesis topic was "Equitable Distribution Value of Closely Held Businesses and Professional Practices". Gary's appraisal education also includes various courses offered by The Institute of Business Appraisers, the American Society of Appraisers, the American Institute of CPAs and others. He has taught federal income taxation at Centenary College, financial statement analysis in the masters degree program at Lindenwood College, and several topics at the AICPA. National Tax School in Champaign, Illinois. He is a member of The Institute of Business Appraisers Inc., the American Society of Appraisers, the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants, the New Jersey Society of Certified Public Accountants and the New York State Society of Certified Public Accountants.

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Linda teaches business valuation courses throughout the country for The Institute of Business Appraisers, the AICPA, various state societies of CPAs, and the American Society of Appraisers. She also lectures nationwide. She has served as faculty for the National Judicial College. Linda is a co-author of the first, second and third editions of *Financial Valuation Applications and Models,* published by Wiley Finance, has authored several self-study courses and has served as a technical reviewers on all four editions of the AICPA's *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses* as well as *The Lawyer's Business Valuation Handbook* authored by Shannon Pratt and published by the American Bar Association. She is also the editor of *BVR's Guide to Business Valuation Issues in Estate and Gift Tax*, 2010 edition.

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