

HUNTING GOODWILL

(with apologies to Matt Damen and Ben Affleck)

by David H. Levy¹

Introduction

The valuation of the professional business practice reveals unique issues that are not faced by appraisal of conventional businesses. Generally, the most valuable asset of a professional business practice is its goodwill. While it is easy for the valuator to present a price tag for a fleet of the high-tech dentists' chairs at Dr. Novocain's House of Pain, or determine the resale value for the rustic suburban cottage that serves as office and operating space for the Lassie & Yeller Veterinary Clinic, the steady hand, bright mind and reputation of the practitioner may have value as well. It is this value that is more difficult to quantify. In a dissolution of marriage proceeding, the court must often determine if this quantifiable value – or, goodwill – exists at all and, if it does, what it's worth, and how to divide it.

Personal vs. Enterprise Goodwill

The goodwill of a professional practice can be intrinsic in the practice itself (“enterprise” goodwill) or unique to the professional (“personal” goodwill), or both. To further complicate matters; the goodwill component of seemingly similar practices can be vastly different and have vastly different values. An individual pediatrician's office on Fifth Avenue may inoculate the children of Broadway stars, while a group pediatricians' office in Madison, Wisconsin, may care for the kids of state employees and alfalfa farmers. The New York office is not necessarily the practice with the more valuable enterprise or divisible goodwill. Say the Manhattan practice is anchored by an M.D. who hob-nobs with other Manhattan socialites who send their children to

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that doctor because of the personal relationship, while the Madison practice is staffed by several pediatricians, locally raised and educated. The practices' shingle has been there for decades, but scores of doctors have worked in the office throughout the years. The Fifth Avenue office may earn substantially more profit than the Madison office, yet the enterprise goodwill of the Madison office would garner a larger premium than the practice in New York. The reason for this is the difference between the types of goodwill each practice has.

Enterprise goodwill relates to the practice's ability to consistently generate profits based on the practice's reputation—the long-familiar shingle in Madison. There, no single doctor attracts new clientele or retains families. Rather, the goodwill is developed by the long-cultivated reputation for quality service, the local flavor of the practice, the location of the office, or the familiar space the doctors inhabit. Even items such as an always-familiar catchy telephone number or recognizable ad campaign contribute to enterprise goodwill. As such, personal goodwill does not attach to any single practitioner. In connection with a valuation of the practice in a dissolution proceeding, it is generally viewed as a divisible asset: it is a property right, that can be sold, and it therefore has value to a non-practitioner spouse.

Personal goodwill comes from an *individual* practitioner's reputation, accolades, and unique successes in his or her field; the clients of such a professional care not about the shingle, but rely on the individual because of his particular aptitude or reputation. Many courts view personal goodwill as a component of future earnings, rather than as a separate asset. It is not a property right, it cannot be sold, and it therefore has no apportionable value to a non-practitioner spouse in a dissolution case. Basically, it is the intangible that allows a person to earn at a significantly higher rate and thereby be able to pay a higher amount of support.

A potential purchaser of the Madison, Wisconsin office would likely pay a higher premium for the goodwill attached to that practice – the phone number, the surroundings, and the engendered trust collectively have a discernable value, which would be retained even without the services of any individual doctor. In contrast, the Midtown practice’s goodwill, if any exists, comes directly from the pediatrician’s presence, his contacts and reputation. The Court in *Rathmell v. Morrison*, 732 S.W.2d 6 (Tx Ct App 1987), wrote that goodwill related to a solo practitioner “would be extinguished in the event of the professional's death, retirement, or disablement.” Once Dr. Manhattan is happily confined to the Hamptons, his practice’s goodwill value would be rendered insignificant. That’s not the case if a doctor in the Madison practice retires to Lake Geneva. The shingle stays and the goodwill accorded the practice remains. Enterprise goodwill is transferable, personal goodwill is not -- hence a likely premium in Madison, not Manhattan, (without regard to other factors, of course) from a hypothetical pool of buyers.

Goodwill as a Property Right

The distinction between personal and enterprise goodwill is particularly important given the national trend to treat personal goodwill not as an asset of the professional practice, but as an aspect of the professional spouse’s future earning capacity to be used in determining the nonprofessional spouse’s maintenance award or in deciding the division of marital property. (See, “Problems in Valuing Professional Goodwill in Divorce Proceedings,” by Michael W. Kalcheim, *Illinois Bar Journal*, Vol. 78 #2, February, 1990). Nationally, there are three divergent lines of cases regarding to the recognition of personal goodwill as property. Very generally, some courts are willing to recognize goodwill as a property right, some courts are not

willing to do so, and some courts examine the facts before them and decide on a case by case basis.

There are a number of courts which view personal goodwill as an asset with an ascertainable value. As early as 1983, in *Dugan v. Dugan*, 92 N.J. 423, 433, 457 A.2d 1, 6, the New Jersey Supreme Court wrote that “[goodwill] reflects not simply a possibility of future earnings, but a probability based on existing circumstances” and “[w]hen that occurs, the resulting goodwill is property subject to equitable distribution.” The Kentucky Court of Appeals held that goodwill in a business is “a factor to be considered in arriving at the value of the practice” (*Heller v. Heller*, 672 S.W.2d 945, 947 (1984)). The court in *In re Marriage of Nichols* (43 Colo.App. 383, 385, 606 P.2d 1314, 1315 (1980)) held that goodwill is a divisible property right because “it can, in conjunction with the assets of the practice, be sold.” The Court in *In re Marriage of Martin* (707 P.2d 1035 (1985)) quoted the *Nichols* Court to reiterate that although “goodwill may be difficult to value, is elusive in nature, and is not easily marketable,” such notions are “not a proper reason to disregard it in the valuation of the marital estate” (*Id.*, at 1037, citing *Nichols*).

Other courts have held that to assign personal goodwill independent value is to “double charge” the professional spouse, because “[t]he goodwill of a sole practitioner is related only to his future earnings” (*Holbrook v. Holbrook*, 103 Wis.2d 327, 346, 309 N.W.2d 343, 352 (1981)). Another Wisconsin Court quoted *Holbrook* in stating that “it would be inequitable to compel ‘a professional practitioner to pay a spouse a share of intangible assets at a judicially determined value that could not be realized by a sale or another method of liquidating value’” (*Peerenboom v. Peerenboom*, 147 Wis.2d 547, 552, 433 N.W.2d 282, 284 (1988), quoting *Holbrook*, 309 N.W.2d at 355). But the *Peerenboom* Court held that the evidence must show “marketable”

goodwill with a specific value “over and above the value of the practice’s assets and the professional’s skills and services” to be a divisible marital asset (*Peerenboom*, at 284). In *Casey v. Casey*, 362 S.E.2d 6 (1987), the South Carolina Supreme Court held that personal goodwill should *not* be considered because it is “too speculative” and too closely connected with future earnings, with such earnings already considered in a maintenance award. The Kansas Supreme Court in *Powell v. Powell*, 231 Kan App 2d 456, 648 P.2d 218 (1982), likewise held that because goodwill is so tied to the future earnings of the professional, it has no independent value.

Finally, some courts consider personal goodwill a property right only to the extent that it can be separated from the individual practitioner from whose reputation the goodwill is derived. Enterprise goodwill is an asset which has value for purposes of a valuation of a practice, but personal goodwill is not. Courts that follow this middle-ground, case-specific approach assert that the value of a professional practice is reliant upon the circumstances of each practice, and upon the facts in a given case. These courts say that goodwill, as a “marketable business asset distinct from the personal reputation of a particular individual. . . has an immediately discernable value as an asset of the business and may be identified...” (*Prahinski v. Prahinski*, 75 Md.App. 113, 133, 540 A.2d 833, 843 (1988), citing *Wilson v. Wilson*, 294 Ark. 194, 741 S.W.2d 640 (1987), and *Taylor v. Taylor*, 222 Neb. 721, 386 N.W.2d 851 (1986)). If the goodwill, however, “depends on the continued presence of a particular individual, such good will, by definition, is not a marketable asset distinct from the individual” (*Id.*). The Court in *Rathmell v. Morrison*, cited previously, 732 S.W.2d 6, 17 (Tx Ct App 1987), wrote that personal goodwill, as distinguished from enterprise goodwill, “does not possess value or constitute an asset separate and apart from the professional's person, or from his individual ability to practice his profession.” On the other hand, “[g]ood will that exists separate and apart from a professional's

personal skills, ability, and reputation is divisible upon divorce” (*Id.*). The Supreme Court of Nebraska agreed, although it stated that “we neither state nor imply that goodwill, as a salable or marketable business asset, may *never* exist in a professional practice,” and that evidence of “salability or marketability of goodwill” could make it a divisible asset (emphasis added) (*Taylor v. Taylor*, 222 Neb 721, 731, 386 N.W.2d 851, 859 (1986)).

An Oklahoma Appeals Court in *Mocnik v. Mocnik* held that because the professional spouse “cannot recoup this goodwill value in any other manner than continued professional services” with his professional corporation, and “has no right to sell, separate and apart from the stock, his share of goodwill”, the goodwill is not an asset (*Mocnik v. Mocnik*, 838 P.2d 500 (1992), citing *Holbrook*, 309 N.W.2d 343, and *McCabe v. McCabe*, 525 Pa. 25, 575 A.2d 87 (1990)). Another Pennsylvania case called *DeMasi v. DeMasi* (366 Pa Super 19, 44, 530 A.2d 871, 883 (Pa Super Ct 1987), allocatur denied, 539 A.2d 811 (1987)), found that the goodwill of a professional practice with more than one doctor was not an asset because the doctor whose stake was at issue in his divorce case specialized in a form of medicine different from his partner. Therefore, “if husband left the professional corporation, at least his rheumatology patients would follow. It was husband, not the professional corporation, who attracted the rheumatology patients. Therefore, upon his death, retirement or resignation, there would be no other physician at the corporation who could retain husband's patients.” Courts like this are at times skeptical of applying enterprise goodwill: even the sharing of a shingle is not necessarily evidence of an allocable asset.

Proving the Existence of Goodwill

For goodwill to be allocable, it must be an asset. For goodwill to be an asset, it must be capable of being sold. To show a court that goodwill can be sold, a valuator must have evidence

of similar sales, analogous transactions, or actual offers. The leading case on proving the existence of goodwill is *Hanson v. Hanson*, 738 S.W.2d 429, 435 (Mo 1987), in which the Missouri Supreme Court held that for personal goodwill to be divisible, evidence that it exists and is *capable of being sold* must be established. The Court noted that mere testimony as to value does not prove that goodwill exists, as a valuator can assume existence, plug in a formula, and come up with a value. Rather, “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” (Id.).

Methods Used to Assign Value to Goodwill

The jurisdictions that consider goodwill an allocable asset differ as to how to determine the value of the asset, though it is agreed that such value is a question of fact. The *capitalized excess earnings* approach, once favored, is now viewed by many jurisdictions as too speculative. Many courts require proof of *offers to purchase* to prove first the existence, and thereafter the value, of goodwill. A still-growing number of states accept the *comparable sales* and related market comparison approaches. The Florida Supreme Court first determined the fair market value of the practice, and then subtracted the value of the assets to calculate the value of goodwill. (*Thompson v. Thompson*, 576 So.2d 267 (1991)). Other methods include straight capitalization, capitalization of economic income, discounted economic income, and multiple of revenues. Depending upon the jurisdiction involved, as well as the purpose of the valuation, (both of which can readily influence a valuation), commentators often suggest that valutors use more than one approach. (See, generally, *In re Marriage of Fleege*, 91 Wash.2d 324, 588 P.2d

1136 (1979)). Also, do not overlook buy/sell agreements between the partners of the practice or the amount paid by an incoming partner to become an owner of the practice. Neither of these two values should be considered as determinative of the true value of the goodwill of the practice as they undoubtedly include the value of the fixed assets and receivables as well as the goodwill, but they can provide a starting point regarding value. Obviously, if a valuator fails to incorporate this information into his opinion, he opens himself up to criticism when cross-examined.

A thorough investigation should also determine if there are any covenants not to compete if a professional leaves the practice. This is especially significant if there are different amounts paid depending on which partner is departing. It can be reasonably assumed that a larger amount paid to one partner over another is for the value of that partner and the concern the partnership has that he/she would take business with him/her.

Assigning Value to the Professional Practice – Putting It All Together

First, the valuator must establish whether or not goodwill exists. Then, the valuator must determine if the goodwill is the effect of “Dr. Manhattan,” or the consequence of “the shingle”—is it part of a practitioner, or resulting from an enterprise. Next, if goodwill is of the latter variety, the valuator selects a standard of value (generally fair market value), before determining an actual value, using an approach favored in his jurisdiction, and considering the purpose of the valuation.

After preparation and examination of financial statements, the valuator must figure the business’ profitability. Typically, when assessing professional practices in this manner, valutors focus on compensation, as most firms zero-out their income each year, paying all profits out as income, and also consider benefits and perquisites. Profit analysis involves

comparing these numbers to industry norms, often provided by law or medical associations, or “headhunting” firms.

Goodwill, then, is the attributable reason for a professional earning more than other practitioners whose field of expertise, and practice and target client demographics, are similar. Sometimes, of course, an inimitable work ethic, novel facilities, a vanguard on new technology, or another plausible demographic factor can explain the difference in numbers. Other times, of course, there is no such explanation: goodwill, the most intangible of assets, is apparent.

Conclusion

The valuation of goodwill of a professional practice continues to be one of the most challenging parts of a matrimonial case. To ignore it exposes the lawyer to criticism at best and a malpractice claim at worst. It is essential that the divorce practitioner familiarizes himself with the different kinds of goodwill, the methods of valuing it and his/her state’s view of divisibility.