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DIVORCE, BUSINESSES, AND THE MYSTERY OF VALUING GOODWILL

Michael J. Berger

Jennifer Cantrell

Kalcheim, Schatz & Berger
Chicago, Illinois

With assistance from Travis Chamberlain, Clifton Gunderson, LLC, Indianapolis, Indiana

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I. INTRODUCTION

In any divorce, division of marital assets is frequently one of the most, if not the most, hotly contested issues. Before assets can be divided, however, they must be identified and valued. When one of the parties to a divorce owns a business, the marital or non-marital character of that business interest and its value must be determined. Goodwill, in one form or another, is one component of the value of nearly every business. The challenge in a divorce case is determining how much of the goodwill in a marital business can be included in the marital estate. The most complex courtroom battles of experts usually deal with this elusive concept of goodwill.

II. DEFINING GOODWILL

A. In General

Accountants define "goodwill" as the value of the business in excess of its identifiable tangible and intangible assets and net of liabilities. Relevant IRS regulations state that "goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor." Reg. 1.197-2(b)(1). In dissolution of marriage cases, courts have identified two species of goodwill: enterprise (or entity) goodwill, and personal (or professional) goodwill.

B. Enterprise Goodwill

Generally speaking, enterprise goodwill is that portion of the business's goodwill which is associated with the business itself. For example, to the extent that IBM enjoys a reputation for manufacturing quality computer products, the goodwill associated with that reputation is enterprise goodwill. No identifiable individual specifically contributes to that goodwill value.

C. Personal Goodwill

Personal goodwill, on the other hand, is the value of the services of a particular, identifiable individual to the business. Personal goodwill is most often encountered in a professional services setting. For example, a physician's private medical practice contains a significant element of personal goodwill. That physician's reputation as an individual practitioner, and his or her personal ability to generate business through referrals and personal contacts, constitutes most of the value of the business. It is service oriented and relatively lacking in hard assets. It requires a license or certification that is personal to the individual practitioner. The success of the business is keyed to the individual physician's continued involvement.

III. SEPARATING ENTERPRISE AND PERSONAL GOODWILL

A. The Divorce Courts' Approach

In a divorce situation, the key question with respect to goodwill in a business setting is, how much of the goodwill is personal to the individual and how much is the goodwill of the business enterprise? This is not a simple question to answer. In some situations, such as a professional practice (doctors and lawyers, for example), it is clear that much of the goodwill value is personal to the individual because the value of the practice is dependent upon that individual's skills. A leading California case, *In re Marriage of Lopez*, 38 Cal.App.3d 93, 113 Cal.Rptr. 58 (1974), sets forth certain criteria which the Court of Appeals for the Third District determined were significant in valuing the goodwill of a professional practice. Those criteria include: the age and health of the individual; the individual's demonstrated earning power; the individual's reputation in the community for judgment, skill, and knowledge; the individual's comparative professional success; and the nature and duration of the professional's practice either as a sole proprietor or as a contributing member of a partnership or professional corporation.

The *Lopez* Court talked in general about how the goodwill value of a professional practice might be determined, but did not answer the question of whether that goodwill should be included in the marital estate, or to what degree. Instead, the Court simply stated that "professional goodwill may be separate or community property or varying degrees of both depending on the particular circumstances." Thus, the *Lopez* Court defined the issue but failed to provide a solution.

Other courts have attempted to refine the *Lopez* ruling just a little. The Illinois Supreme Court, in *In re Marriage of Zells*, 143 Ill.2d 251, 572 N.E.2d 944 (1991), held that "professional goodwill as an aspect of economic potential is reflected in maintenance and support

awards in dissolution proceedings but is not divisible marital asset." The professional practice at issue in Zells was the husband's law practice, a classic example of a situation where personal goodwill exists. The Court stated that "consideration of goodwill as a divisible marital asset results in gross inequity." This was based on the Court's analysis of the relevant factors of the Illinois equitable distribution statute: the relevant economic circumstance of each spouse when the division of property is to become effective; the occupation, amount and sources of income, vocation skills, and employability of … of each of the parties; and the reasonable opportunity of each spouse for future acquisition of capital assets and income. In Illinois practice, this is known as the "double dip" argument: it is not fair to consider a spouse's ability to earn future income as an asset subject to a present distribution in a dissolution of marriage case because the same dollars are being considered as both an asset and as a stream of income.

Illinois followed the *Zells* decision with *In re Marriage of Talty*, 166 Ill.2d 232, 652 N.E.2d 330 (1995). In *Talty*, the business at issue was a car dealership. The husband argued that much of the value of his dealership was personal to him. *Talty* is a departure from the "professional practice" paradigm. One might say that car salesmen are not ordinarily held in the same professional esteem as lawyers or doctors. More importantly, a car dealership has hard assets, notably inventory, which can be valued and sold. Although a car dealership may have an element of goodwill in its value, that goodwill may not be solely attributable to the efforts of the individual owners of the business. However, the *Talty* Court ruled that a distinction between personal and enterprise goodwill may be appropriate in certain situations. The Court further went on to state that "to the extent that goodwill inheres in the business, existing independently of [husband's] personal efforts, and will outlast his involvement in the enterprise, it should be considered an asset of the business and hence of the marriage. In contrast, to the extent that goodwill of the business is personal to [husband], depends on his efforts, and will cease when his involvement with the dealership ends, it should not be considered property."

There's the rub, of course. *Talty* acknowledged that a business may have both elements of personal and enterprise goodwill. The Court, however, offered no guidance as to how that distinction should be made. In fact, although other courts have adopted the logic of *Talty*, *see, e.g., Yoon v.* Yoon, 711 N.E.2d 1265 (Ind. 1999), there appear to be no reported dissolution of marriage cases that actually distinguish between the personal goodwill value and the enterprise goodwill value of a business. Litigants file appeals, claiming that trial courts erred by including personal goodwill in the value of an asset subject to distribution. Appellate courts agree that and remand with instructions to the trial courts to determine the personal vs. enterprise goodwill values. But there appear to be no reported dissolution of marriage cases containing specific instructions on how that distinction should be made. It seems that the family law courts have asked the question, but have not answered it.

Obviously, the courts are struggling with a difficult issue in an attempt to achieve fair results. With respect to this goodwill issue, it seems that two basic concepts of divorce law are in conflict. On one hand, courts try to ensure that non-business owner spouses are compensated for their contributions during the marriage. On the other hand, the business owner's post-decree income and earnings should not be included in an award of marital property.

B. Other Courts' Approaches

Maybe divorce courts are simply avoiding the issue. It seems likely that these kinds of cases settle on remand because the valuation questions are tough. However, the issue has not been completely ignored by all courts. There are tax court cases dealing with corporate liquidations that address the question, and those cases seem to hinge on whether the goodwill in question is "vendible." *See. E.g., Watson*, 35 TC 203 (1960). The *Watson* Court stated that goodwill, "from a transferee's standpoint, is an opportunity to succeed to the advantageous position of his predecessor. Generally, attitudes of customers or others may be transferred from one proprietor to another (1) by furnishing the transferee with all the symbols and other transferable attractions which invoke a favorable response in the customers, and 2) by removing the transferor as an alternative attraction."

The *Watson* approach seems to invite a valuation of personal goodwill based on the existence of a non-compete agreement. In another recent tax court case, *Norwalk*, TCM 1998-279, the Court ruled that a lack of non-

compete agreements between an accounting firm (which was being liquidated) and the accountants who worked at the firm rendered all of the goodwill value in the practice to be personal to the individual accountants. The firm itself had no goodwill. In a similar tax case, *Martin Ice Cream*, 110 TC 189 (1998), the Court ruled that, because the ice cream business had not executed any employment agreement or non-compete agreement with a former shareholder who sold his distribution rights to another ice cream company, the business did not own those intangible assets. Thus, the goodwill associated with those assets was personal to the individual former shareholder.

IV. METHODS FOR VALUING PERSONAL GOODWILL

A. The Non-Compete Agreement

Based on *Watson, Norwalk,* and *Martin Ice Cream*, then, it seems that one way to assign a value to personal goodwill would be by valuing a non-compete agreement. However, further analysis indicates that this may not be practical, or even possible, in a dissolution of marriage situation.

In *Norwalk* and *Watson*, the tax court used the absence of a non-compete clause to infer a negative: no non-compete equals no enterprise goodwill in the businesses. The converse, however, is not necessarily true. If a business owner executes a non-compete, does he transfer all of his personal goodwill to the company? The answer to that question is probably "no." The value of a non-compete is normally measured by the potential damage the business avoids from the assurance that the individual will not directly compete for a given period of time. That is not to say that the individual has given up all of his goodwill. For instance, a doctor selling a medical practice may execute a non-compete in which she agrees not to practice medicine within five miles of the practice she has sold for a period of five years. This protects the business, and its new owner, from direct competition with the selling physician. It does not prevent the physician from practicing medicine anywhere, and it does not deprive the physician of her license, her training, and her expertise.

It is unlikely that any purchasing physician would buy this hypothetical practice without having the seller sign a non-compete. However, it may be more practical to think of a non-compete, in the sale of a business, as similar to title insurance. Although the transaction would not occur without it, the value of the title insurance is not equal to the purchase price of the property. The same is probably true of a non-compete agreement. It probably does not reflect the true value of the individual's personal goodwill.

B. Buy-Sell Agreements

The existence of a buy-sell agreement, such as may exist in a law partnership or other professional practice, is sometimes used to value an individual's personal goodwill. This approach has some strengths. A history of transactions according to the buy-sell agreement may provide useful valuation guidance. Also, the buy-sell agreement may be the required method of valuation in certain circumstances. However, this method has limited usefulness in a divorce context. For one thing, some courts have rejected it. In *In re Marriage of Gunn*, 233 Ill.App.3d 165, 598 N.E.2d 1013 (5th Dist. 1992), the Court specifically refused to consider the buy-sell agreement in placing a value on the husband's shares in a law firm. The Court noted that the document was "a friendly negotiated document between friendly parties who have as a sole purpose the continuation of legal practice." Thus, a buy-sell agreement may not reflect economic reality. It also may stipulate some form of book value, which does not give consideration to intangible assets or tangible assets with a fair market value in excess of their book value. Thus, a buy-sell agreement may not be a useful measure of the value of personal goodwill.

C. Net Asset Method

The net asset valuation is easily understood, which makes it initially a very attractive means of valuing a business interest. Simply put, net asset value is the fair market value of tangible and intangible assets minus liabilities. When this method is used, tangible assets are adjusted to fair market value and intangible assets are valued separately using appropriate methodologies. Of course, describing how this valuation method is used points out its weaknesses. Valuing intangible assets using "appropriate methodologies" can become very complicated, which makes this valuation less easy to understand. Net asset valuation does not ultimately render a very good indicator of goodwill.

D. Comparable Transaction Method

This method uses transactions in the subject company's stock or other similar companies to provide an indication of value for the interest being valued. The fact that the business's goodwill was transferable in another transaction may provide an indication that the goodwill is entity goodwill rather than personal (useful if you are representing the non-owner spouse). Similar transactions, or transactions in the same business are considered very helpful indications of value, and the saleable nature of companies in certain industries may indicate that personal goodwill is not very prevalent in those industries.

However, this approach does have some weaknesses. There may be few, if any, reported transactions in some industries. There may be a lack of detailed information for the transactions that do exist, such the presence or absence of non-compete agreements, historical operations, and other similar details that can vary tremendously from business to business. Although this is a useful methodology, it is still important to give great consideration to the specific facts of the case. The subject business and characteristics of the owner may be quite different from other seemingly similar businesses that were sold, and failure to account for those details can weaken an otherwise strong opinion of value.

E. Income Approach

This approach predicts a future stream of income and then discounts that stream of income to a present value using a risk adjusted discount or capitalization rate. This method is generally considered to provide a good indication of all of a company's value, including goodwill and other intangible assets. It provides the valuator with flexibility to tailor the appraisal because he can give consideration to the personal goodwill of the business in several ways: decrease the future cash flows of the business; increase the risk when calculating the discount rate; quantify and deduct a key person discount for the individual; or allocate the resulting total goodwill to entity and personal goodwill. This method also allows the valuator to comply with the requirements of SFAS 141, a statement recently issued by the Financial Accounting Standards Board, which eliminated the pooling of interest accounting for mergers and acquisition and now requires accountants to use the purchase method of accounting. Under this standard, purchase price allocation is much more rigorous than it was previously, especially to identifiable intangible assets, such as customer lists, patents, etc. This makes the calculation of "goodwill" more scientific, because the goodwill is then determined to be the residual after the value of other intangible assets is identified. Interestingly, the amount of "goodwill" recognized under SFAS 141 could be reduced, as amounts that previously would have been deemed goodwill are allocated to other intangible assets. From a divorce valuation standpoint, this could decrease the amount that could potentially be deemed personal goodwill, which would be beneficial to the non-owner spouse.

The major weakness of using the income approach to value goodwill is that it is highly subjective. A valuator utilizing this method must give careful consideration to all of the factors that affect personal goodwill in order to present a credible opinion of value that will hold up under cross examination.

F. Other Methods

Valuation in a litigation context can be something of a free for all. Imaginative valuators sometimes use "methods" that are not necessarily routine or recognized in order to suggest a value that, for one reason or another, makes sense to the valuator. Some of these approaches may include the following:

- Point scoring – The factors to be considered for personal v. entity goodwill are subjectively "scored" to obtain relative values.
- Analysis of actual competition – The valuator prepares a spreadsheet showing how much business the individual could "take" in the years after departure and determines the impact on net income, and thus value.
- Average income – Assumes the personal goodwill is equal to a multiple (usually 0.75 to 1.5 times) of average income for similar professionals. Assumes that "any" competent professional could earn the average.
- Workforce in place – Assumes the value of the workforce in place is entity goodwill.

V. DIVORCE LAW REALITY

One of the problems with presenting any business valuation in a divorce context is that it is necessarily artificial. Business appraisers nearly always try to make their opinions of value comply with the "fair market value" of

definition of Revenue Ruling 59-60 – 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.

As any experienced divorce lawyer knows, this makes no sense in a divorce case. In the vast majority of cases, the business owner spouse has no intention of selling his business, and more often than not, the fact that he is required to share its value with the non-owner spouse is perceived as akin to a "compulsion to sell." Moreover, frequently the non-owner spouse (and that spouse's experts) may not have "reasonable knowledge of relevant facts." Pretrial discovery is an imperfect process, after all. And yet, in divorce cases, time and again the square peg of business valuation techniques is forced into the round hole of marital asset identification. The lawyers are not always so knowledgeable about sophisticated business theories, the litigants have numerous other concerns (support, custody, visitation, who gets the silverware and the house), and the judges often know very little about economic theory. Although there is a desire to do the "fair" thing, it is often nearly impossible to figure out just exactly what is "fair." Tax court cases about dissolving accounting firms and ice cream vendors shed very little light on the reality of divorce. The most sensible "reality" to remember is this: after the divorce, the business owner needs to be able to continue in business, and the non-owner spouse needs to be compensated appropriately. Attempts to value personal goodwill must be done with an eye toward that reality.

VI. CONCLUSION

Lopez, Talty, and all the cases that have come since do nothing to clarify the issue of what constitutes personal goodwill and how to separate it from enterprise goodwill. At best, they remind the matrimonial bar that this issue exists and is not going away. Lawyers need to take a realistic approach to goodwill questions. If the case is large enough, the thing to do is to get the best valuation expert available and make sure that that expert can explain his position – whatever it may be – clearly and simply. The caselaw indicates that these matters are beauty contests. The best expert wins. If the client can afford the best expert, then this issue is worth the fight. If the stakes are not so large, however, then this issue may not be worth pursuing. It may not benefit the client to spend all of his or her money fighting over the goodwill inherent in a dog grooming business run by a really good dog groomer. The best lawyers can see the difference between a case worth the fight and a case that is not. This is not to suggest that the client does not deserve the best representation possible. Far from it. The suggestion is that, sometimes, the best representation is to resolve an issue without the fight. Economic reality demands that the dollars involved be worth the dollars spent.