GOODWILL VALUATION
IN
MARITAL DISSOLUTION

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GOODWILL VALUATION IN MARITAL DISSOLUTION
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I. GOODWILL DEFINED

A. What Is Goodwill?

Some common definitions for goodwill from various valuation resources include:


2. “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), IRS Regulations.

3. “Goodwill has been described as the value of a business or practice that exceeds the combined value of the net assets used in the business. Goodwill in a professional practice may be attributable to the business enterprise itself by virtue of its existing arrangements with suppliers, customers and others, and its anticipated future customer base due to factors attributable to the business. It may also be attributable to the individual owner's personal skill, training or reputation. This distinction is sometimes reflected in the use of the term ‘enterprise goodwill,’ as opposed to ‘personal goodwill.’” -- Yoon vs. Yoon, 711 N.E.2d 1265, 1268 (Ind. 1999).

B. Types of Goodwill Relevant in Marital Dissolution Cases

Goodwill has been divided into two different types:

1. Enterprise or practice goodwill, associated primarily with the business, and

2. Professional or personal goodwill, associated primarily with the individual.


C. Jurisdictional Differences to Consider

1. “Business Valuation Resources – Goodwill Hunting in Divorce” provides a state by state summary of leading cases. This
resource, updated annually, is available online through www.BVResources.com (under Free Resources & Podcasts).

2. As of the most recent update in 2011, a breakdown of the treatment is as follows:
   a. States with no position: No decisions related to goodwill – one (Alabama).
   b. States with the position: Enterprise goodwill is marital, personal goodwill is not – twenty-nine states (including Kentucky).
   c. States that do not recognize a distinction and consider all goodwill as marital – twelve.
   d. States that do not consider personal or enterprise goodwill as marital – three.
   e. States which recognize some distinction but are more case specific – six.

3. The treatment of goodwill in a divorce case will depend on the jurisdiction, and there are a lot of factors that need to be considered. Listed below are several of the factors that various jurisdictions have treated differently in case law.

4. Jurisdictional differences include:
   a. Liquidation or sale may or may not be considered unless imminent and foreseeable.
   b. Income streams may or may not be extended past valuation date.
   c. Discounts may or may not be allowed.
   d. Deferred taxes may or may not be allowed.
   e. Role of covenant not to compete varies among jurisdictions.
   f. “Value” is not clearly defined in most jurisdictions.
   g. Value of professional license may not be considered marital.
   h. Division of entity goodwill into personal vs. enterprise may or may not make a difference in determining marital or non-marital assets.
i. Impact of buy-sell agreement.

j. Which standard of value is relevant.
   i. Fair market value -- any willing buyer.
   ii. Investment (intrinsic) value – specific buyer.
   iii. Fair value.
   iv. Strategic value.

5. Words such as “value” and “reasonable,” if not well defined, lend themselves to subjective opinions and a wide range of interpretations. Professional licenses are tied to an individual so it would seem logical that goodwill in professional practices would be considered personal and non-marital but that is not the case in all jurisdictions.

D. Entity Goodwill

That which belongs strictly to the entity itself. Examples include:

1. Name.
2. Telephone/website.
3. Location.
4. Special attributes (e.g. special menu items or recipes at a restaurant).
5. Work force in place (but is that goodwill?).
6. Going concern value (but is that goodwill and is assembled workforce part of a going concern value?).

E. Personal Goodwill

1. One major problem with consistent treatment of goodwill is the lack of a standard definition for personal goodwill.

2. Personal goodwill, also referred to as professional goodwill, is associated with the individual practitioner. This type of goodwill is based on revenues being generated because of the practitioner’s skills, knowledge, and reputation. -- Yoon v. Yoon, 711 N.E.2d 1265 (Ind. 1999).

a. Sample definitions come from:
   i. Text books.
   ii. Articles.
   iii. Court opinions.

b. Definitions cited in this survey range from very simple to much more detailed and there is no single acceptable definition of goodwill.
   i. Generally, personal goodwill is goodwill associated with the individual and is based upon the income generated because of the individual's skills, knowledge and reputation.
   ii. Personal goodwill depends on the continued presence of a particular individual.
   iii. For example, in many professional practices there is obviously a great deal of personal goodwill.
   iv. In other cases, it may not be quite so simple, such as in a commercial business.

4. “Pure” personal goodwill.
   a. That goodwill which cannot be transferred to the entity or to anyone else under any circumstance.
   b. These are usually personal relationships.
      i. “We want Chris to testify in this case because we know what type of a witness he is. No one else will do.”
      ii. “Bunny has been our family business advisor for twenty-five years. Only she can give us the comfort level we need in an outside consultant.”

II. MEASURING GOODWILL

A. Once It Is Determined that Goodwill Exists, then We Have the “Measurement Dilemma”

   The challenge of measuring personal goodwill:
   1. There are many widely accepted methodologies that are used to determine the total goodwill of a business (discussed later).
2. Generally, the valuation of personal goodwill is very fact specific.

3. There is no one magic formula to value personal goodwill!

4. There are few, if any methodologies that are widely accepted for valuing and separating personal goodwill from enterprise goodwill.

5. Facts and circumstances are unique in each case.

6. **The Key Determinant:** *What would be the impact of the individual’s departure from the business?*

B. Factors to Consider from *In re Marriage of Lopez*, 113 Cal.Rptr. 58, 68 (Cal.App. 1974).

1. The individual’s demonstrated earning power.

2. The individual’s reputation in the community for judgment, skill and knowledge.

3. The age and health of the individual.

4. The individual’s comparative professional success.

5. 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.

C. Additional Factors to Consider

1. The individual’s role in the business -- the fewer the number of professionals the stronger the personal goodwill (small entrepreneurial businesses).

2. The depth of management.

3. The source of the business’ new customers.

4. The amount of work actually performed by the individual -- dependent on employee-owner personal skills and relationships.

5. The size of the workforce in place.

6. The competitive characteristics of the industry.

   a. Do companies compete based on price or reputation?

   b. How is the company positioned competitively?

   c. Is the service a commodity where price is the most important factor?
III. CONTRACTUAL ISSUES

A. Non-Compete Agreements

1. Does the existence of a non-compete or employment agreement indicate that the individual’s personal goodwill has been transferred to the business and is now part of the enterprise goodwill?

2. If the individual has transferred his/her goodwill to the business through a non-compete or employment agreement, is this personal goodwill included in the marital estate?

3. Is the value of a non-compete agreement the same as the value of the personal goodwill of the individual?

4. 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.

5. The value of personal goodwill may include elements of the non-compete and also the value to the business of the individual’s continued involvement in the business.

6. Some argue that if the business could not be sold without the owner signing a non-compete agreement, then all of the goodwill is personal.

7. However, there are very few transactions that occur without the former owner signing a non-compete agreement.

B. Buy-Sell Agreements

1. Considerations.
   a. Do mandatory valuation provisions exist?
   b. The document should be analyzed in light of the circumstances to ensure that it is binding and reflects economic reality.

2. Strengths.
   a. A history of transactions according to the buy-sell agreement may provide useful valuation guidance.
   b. The buy-sell agreement may be the required method of valuation in circumstances.

3. Weaknesses.
a. The agreement may not be binding for a divorce proceeding.

b. The formula may not reflect economic reality.

c. The agreements 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.

d. The agreement may be “divorce proof.”

C. Employment Agreements

1. Are there restrictions present that indicate the existence of personal goodwill?

2. Has the agreement been updated for changes in the business or economy?

3. Does the agreement reflect the local market/customary restrictions of the profession?

4. Is the agreement assignable by state law without the employee’s consent?

IV. PROFESSIONAL PRACTITIONERS

A. Due to Unique Characteristics of a Professional Practice, There Is a Greater Likelihood of Significant Personal Goodwill in a Professional Practice

1. Common professional practice characteristics.

   a. Usually service oriented.

   b. Normally less asset intensive. Intangible assets, such as goodwill, may comprise a large portion of the assets.

   c. The profession often requires a license or certification that is personal to the individual practitioner.

   d. Referrals are an important source of new customers in a professional practice.

   e. Do the referrals come from existing customers or patients or from other practitioners?

   f. The individual’s reputation is an important aspect of the practice.
2. These factors increase the risk to the continued success of the business if the professional were to leave.

B. Some Unique Factors to Consider in a Professional Practice Are as Follows

1. Does the practitioner offer a specialized service? The more specialized the service, the greater the likelihood of significant personal goodwill. For example, a heart surgeon could possess more personal goodwill than a family doctor.

2. How much experience does the practitioner have?

3. Technical and professional components of medical revenue.

4. Demographics.

5. Billing practices.

6. What is the practitioner's reputation in the community?

7. Malpractice history.

8. How was the practice acquired? Was it purchased from another practitioner?

V. COMMERCIAL BUSINESSES

A. It Is Also Possible for Personal Goodwill to Exist in a Commercial Business. There Are Unique Factors that Should Be Considered in These Instances.

1. Depth of management -- a strong management team lessens the potential loss of value if the individual were to leave.

2. Source of new customers -- if a significant number of new customers are the result of the relationships developed and maintained by the individual, then the potential loss from the individual leaving may be greater.

3. The individual’s involvement with existing customers -- if the individual has significant involvement in maintaining relationships with existing customers, the loss of the individual may have a detrimental impact.

4. The individual’s reputation in the industry -- an individual may have significant personal goodwill due to a strong reputation in the industry.
B. Martin's Ice Cream

1. In *Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 (1998), the issue involved the split-off of a subsidiary, Strassberg Ice Cream Distributors, Inc. (“SIC”). Arnold Strassberg developed personal relationships with customers over the previous twenty-five years, and was instrumental in the design of new ice cream packaging and marketing techniques. Strassberg was responsible for the introduction of Haagen-Dazs products into high volume retail stores in New Jersey.

2. 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 the sale of those assets to Haagen-Dazs, Strassberg received capital gains treatment.

VI. VALUATION METHODOLOGY

A. Adjusted Net Asset Value

1. Value of the company = tangible and intangible assets – liabilities.

2. Tangible assets are adjusted to fair market value.

3. Intangible assets are valued separately. Appropriate methods will need to be employed to value the intangible assets.

4. Strengths: This method is usually easily understood.

5. Weaknesses.

1. This method seems simple at the outset, but can become very complex, especially when dealing with intangible assets.

2. Generally, this method does not provide a strong indication of goodwill.

3. Most often used for asset holding companies and real estate developers -- not applicable to intellectual property.

B. Comparable Transaction

1. Transactions in the subject company’s stock or other similar companies can be used to provide an indication of value for the interest being valued.

2. Transactions should be at arm’s-length.
3. The specific circumstances of the transaction should be considered to avoid double counting if personal goodwill has been severed (non-compete).

4. Strengths.
   a. Transactions can provide very helpful indications of value.
   b. The saleable nature of companies in certain industries may indicate that personal goodwill is not as prevalent.
   c. In *Yoon v. Yoon*, an Indiana divorce case, the Supreme Court seems to indicate that if the practice could be “sold or transferred” in a market transaction that might indicate a value that included only enterprise goodwill.

5. Weaknesses.
   a. There may be few, if any reported transactions in some industries.
   b. There may be a lack of detailed information for the transactions, such as non-compete agreements, historical operations, etc.
   c. Consideration may still need to be given to the specific facts of the case. The subject business and characteristics of the owner may be quite different from the businesses that were sold.

C. Discounted Cash Flow
   1. Future income of the business is discounted to present value using a risk adjusted discount or capitalization rate.
   2. Strengths: Generally, the discounted cash flow method provides a good indication of a company’s value, including goodwill and other intangible assets.
   3. The valuator can give consideration to the personal goodwill of the business through several ways.
      a. Measurement of the decrease the future cash flows of the business without personal goodwill;
      b. Increase the risk when calculating the discount rate;
      c. Quantify and deduct a key person discount for the individual; or
d. Allocate the resulting total goodwill to enterprise and personal goodwill. Mark Dietrich detailed a practical methodology of valuing a non-compete agreement in a professional practice. It is essentially a “with and without” DCF approach. The value of the CNTC does not relate directly to total personal goodwill -- only a portion of personal goodwill.

4. Weaknesses.
   a. Predicting the future.
   b. Significant assumptions are required.
   c. Use of projections may not be permitted in some jurisdictions.
   d. Difficult to follow the math.

D. Excess Earnings
   1. Most often used with professional practice valuation.
   2. Combines asset income and market approaches/methods.
   3. Often compares owner compensation (to determine excess) to industry benchmarks or surveys (MGMA).

4. Strengths.
   a. Based upon empirical comparative data for the industry.
   b. Combined approach to valuation.
   c. Measures all goodwill (personal and enterprise).

5. Weaknesses.
   a. Statistical accuracy of the comparative data or summary.
   b. Assumptions regarding discount rates and future.
   c. Assumes existence of goodwill (excess earnings).

E. Residual
   1. Goodwill could also be calculated using a residual method, similar to the requirements of the IRS and for GAAP (SFAS 141), whereby all potential intangible assets are identified and separately valued.
2. Strengths.
   a. Easier to implement.
   b. More conventional.

3. Weaknesses: The consideration of personal goodwill may involve relatively subjective judgment calls. Care and consideration should be given to the factors that affect personal goodwill.

F. Multiattribute Utility Model (MUM)

1. An allocation model for distinguishing personal vs. enterprise goodwill developed by David Wood.

2. “The Multiattribute Utility Model (MUM) is an allocation model for distinguishing enterprise goodwill from personal goodwill. MUM is a well-defined method used in many disciplines – economic, political, and scientific – to establish decision support for subjective problems. MUM lends itself to consistency, introduces objectivity into an otherwise subjective assignment, and provides for sensitivity analysis of the outcome. Mum’s objective is to determine the value of the two elements of goodwill, personal and enterprise, from the total goodwill, such that a reasonable, well-founded basis for the allocation can be formed and communicated.” – Goodwill Allocation Multiattribute Utility Model

3. There are seven steps in the development of an allocation using MUM. They are as follows:
   a. Define an objective.
   b. Establish alternatives.
   c. Define the attributes.
   d. Measure the “utility” of each attribute.
      i. Importance utility.
      ii. Existence utility.
   e. Aggregate the results.
   f. Evaluate the alternatives.
   g. Express an opinion.

4. Strength: Uses empirical methodology to quantify the allocation of personal and enterprise goodwill.
5. Weaknesses.
   a. Unprecedented in Kentucky.
   b. Assumes valuator has access to business owner and employees to interview.


VII. COURT CASES INVOLVING GOODWILL VALUATION IN MARITAL DISSOLUTION

A. Selected Recent Professional Practice Court Decisions in Divorce

   a. First case in Kentucky to recognize distinction between personal and enterprise goodwill.
   b. Finding personal goodwill is non-marital, enterprise goodwill is marital.

   Dental practice was determined to have professional goodwill, the value of which was "not a species of property subject to equitable division."

   Goodwill is community property but professional degree or license is not subject to community property distribution since it represents future earnings.

   a. Partnership agreement terms.
   b. Incoming partners did not pay for account receivables, work-in-progress or goodwill and leaving partners were only entitled to their share of firm’s capital account.
   d. Wife’s expert used three valuation methods to determine value of husband’s 50 percent interest in accounting firm.
e. Husband did not use a valuation expert or portray himself as a valuation expert but did his own valuation. His position -- firm’s goodwill not community property because had most clients before the marriage.

f. Court rejected the argument stating “goodwill attaches to ownership of a business” and ownership occurred after marriage.

g. Firm interest to value of capital account.

B. Selected Kentucky Cases

   
   a. Failure to value goodwill.

   b. Capitalization of excess earnings is a recommended method but not required. Court of Appeals did not believe optimum decision was reached by trial court. However, evidence was sufficient for decision and not overturned on appeal.


   Neither side had made an effort to distinguish between personal and enterprise goodwill which was issue Kentucky Supreme Court had ruled on in **Gaskill v. Robbins** earlier in same year. Remanded based on adoption of majority rule to consider distinction.


   Capitalization of excess earnings used to value medical practice. Court awarded spouse half of the value of practice including personal goodwill, which was acceptable in Kentucky prior to **Gaskill v. Robbins**. Also awarded wife support based on income stream. Husband appealed claiming this amounted to double counting of the income stream. Appellate court denied appeal stating the method used to value the practice was based on past earnings rather than future earnings.

C. Recent Cases from Other States

1. **McReath v. McReath**, 800 N.W.2d 399 (Wis. 2011).

   Husband was an orthodontist who had purchased his practice from another professional with purchase price apportioned between tangible assets, professional and personal goodwill. Personal goodwill purchased included various elements:
a. Non-compete agreement.

b. Employment agreement.

c. Assistance in transitioning the business.

Personal goodwill in this case was determined to be divisible as marital property based on the fact that it was able to be sold and transferred. This case is important because it is indicative of a growing trend to attempt to subdivide personal goodwill into goodwill that can be transferred as opposed to goodwill that cannot be transferred.


Husband owned .22 percent interest in Ernst & Young (E&Y) accounting firm. Three separate values used and then added together.

a. Consulting practice – used data based upon prior transaction in an internal valuation used for purchase price allocation in actual sale.

b. Ownership interest in E&Y – excess earnings method comparable transaction: sale of Katx Sapper Miller by H&R Block.

c. Pro rata interest in tangible assets.

Dividing and valuing different pieces is not an approach found in accepted valuation methodology.


Finding: Personal goodwill of accounting practice was not marital asset.

4. **Hanson v. Hanson**, 738 S.W.2d 429 (Mo. 1987).

Finding: Personal goodwill of a medical practice is not a marital asset.


Finding: Personal goodwill of a medical practice is not a marital asset.


Finding: Only enterprise goodwill of a law practice is a marital asset.