REASSESSING OUR APPROACHES TO DETERMINING DIVISIBLE GOODWILL IN A TEXAS DIVORCE

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Rethinking Our Approaches to Determining Divisible Goodwill Upon Divorce

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I. INTRODUCTION. In 1975 the market caps for the five biggest corporations were: IBM ($31billion), AT&T ($29 billion), Exxon ($21 billion), Eastman Kodak ($17 billion), and GM ($14 billion). On July 1, 2020, the ten publicly-traded companies with the highest market cap were Apple ($1.58 trillion), Microsoft ($1.55 trillion), Amazon ($1.4 trillion), Alphabet (Google) ($978 billion), Facebook ($676 billion).[1] What is remarkable about the 2020 list is that the perceived value of most of these companies is based on income derived primarily from intangible tangible assets like "operating systems, product designs, organizational structure, and reputation among customers."[2] Progressing to 2023, Apple's market capitalization has increased to $3.05 trillion, Microsoft's to $2.5 trillion, Google has moved to third place with $1.5 trillion, Amazon dropped to fourth place with $1.3 trillion, and Facebook dropped to eighth place, replaced by Nvidia with a market cap of $1.1 trillion, followed by Tesla at $830 billion, and Berkshire Hathaway at $745 billion.[3] In 2018, the CEO of Aon (a risk management company) estimated that "75 percent of market capitalization is now driven by intangible assets."[4] In a March 2019 speech, Lloyd's of London CEO, John Neal stated: "If you looked at a classic S&P 500 company 40 years ago, 83% of their balance sheet would have been tangible assets. Today, it's only 12%."[5] Our society --in fact our world-- is transitioning away from reliance on tangible (physical) assets to generate value and toward reliance on intangible (non-physical) assets as the generators of income. The accounting profession is lagging behind these changes, but the legal profession is even further behind. The law changes slowly, which in good since that provides a stable platform for our economic and social lives. However, this inertia becomes a disadvantage when it comes to the topic of this discussion, which is dividing the goodwill of a business in a divorce and, more specifically, how to distinguish between goodwill that inheres in a business and goodwill that is personal to the owner.

II. THE IMPORTANCE OF INTANGIBLE ASSETS IN THE "NEW ECONOMY." In the mind of the law, the "goodwill" of a business is some attribute that makes the business more valuable than the sum of its parts. In the past, when business was conducted face-to-face, success in business was associated with location, or buying habits, or personal connections between the business owner and his employees and his customers. This conceptualization dating back to the store on Main Street still persists in many court opinions to this day. However, in the present economy of shopping from mail order catalogues, on cable tv, over the internet, and even on your cell phone, with physical delivery by U.S. mail, Federal Express, UPS, or Amazon Prime, and delivery of software, entertainment and information over telephone lines, coaxial cable, or microfiber wires, of free trade and world-wide price competition, of Walmarts replacing small stores, of HMOs and PPOs and hospitals controlling the delivery of medical care, and of drug manufacturers and lawyers advertising directly to the public fashion, personal loyalty between store owner and customer has been replaced by brand loyalty, convenience, and price, as the factors that bring in new customers and keep old customers returning.

Along side the shift away from personal relationships between business-owner and customers has been a shift of importance to intangible assets as the source of business value.

> The importance of intangible assets is the distinguishing feature of the new economy. By and large, existing financial statements recognize those assets only when they are acquired from others. Accounting standard setters should develop a basis for the recognition and measurement of internally generated intangible assets.

Wayne S. Upton, Jr., *Special Report: Business and Financial Reporting, Challenges from the New Economy*, FINANCIAL ACCOUNTING STANDARDS BOARD (April 2001).[6]

Internally-created intangible assets are becoming increasingly important in business and harder to ignore. An October 2001 report by Leonard I. Nakamura of the Federal Reserve Bank of Philadelphia estimated that 19 years ago U.S. companies invested in intangibles at a rate of $1 trillion per year, which means that "businesses are investing nearly as much in intangibles as they are in plant and equipment (business investment in fixed nonresidential plant and equipment in 2000 was $1.1 trillion)." Nakamura also suggested that a third of the value of U.S. corporate assets were intangibles. By "intangibles" Nakamura meant "private expenditures on assets that are intangible and necessary to the creation and sale of new or improved products and processes. These include designs, software, blueprints, ideas, artistic expressions, recipes, and the like. They also include the testing and marketing of new products that are a necessary sunk cost of their first sale to customers. It is the private expense to create private rights to sell new products." Leonard I. Nakamura, *What Is the U.S. Gross Investment in Intangibles? (At Least) One Trillion Dollars a Year!*[7]

Authors Jarboe and Furrow at the Athena Alliance wrote the following:

> The economy of the United States is now largely driven by intangible assets. These assets include worker skills and know-how, innovative work organizations, business methods, brands, and formal intellectual property, such as patents and copyrights. They are producing an economy very different from the one of the past. As the U.S. moves away from a manufacturing-based economy and toward a technology-and-innovation driven one, intangible asset investments are becoming vital to economic growth and sustainability. Just as physical assets were used to finance the creation of more physical assets during the industrial age, intangible assets should be used to finance the creation of more intangible assets in the information age.

Kenan Patrick Jarboe & Rolan Furrow, *Intangible Asset Monetization: The Promise and the Reality* (April 2008).[8]

III. THE RISE OF HUMAN CAPITAL. Economic theory at one time adhered to the view that land and labor were the only two components of economic life.[9] With the rise of mercantile trade in the 1600 and 1700s, aggregated capital entered the picture, so that land, labor, and invested capital became the three components of economic life. Until the 1950s, economic theory mostly assumed that labor power was static and could not be enhanced.[10] Beginning in the 1950s, economists developed the idea of "human capital," or education, training, medical care, and other additions to knowledge and health that could improve the capabilities of the individual worker.[11] This view approached education and training as an investment rather than a "cultural experience."[12]

Rethinking Our Approaches to Determining Divisible Goodwill Upon Divorce

The use of the term "human capital" in modern neoclassical economic literature is said to date back to Jacob Mincer's pioneering article *Investment in Human Capital and Personal Income Distribution* in the JOURNAL OF POLITICAL ECONOMY in 1958. University of Chicago Professor Theodore W. Schultz, recipient of the 1979 Nobel Prize in Economics, established that the American economy has long had a higher return on "human capital" than on physical capital.[13] In 1964, another University of Chicago Professor Gary Becker, recipient of the 1992 Nobel Prize in Economics, published his book HUMAN CAPITAL, which likened human capital to investments in buildings and machines. Becker argued that one could invest in human capital (via education, training, and medical treatment) and that a person's output depended to a great degree on the rate of return on his or her human capital.[14]

A discussion by Gary Becker of the concept of human capital is available on the internet at <http://www.econlib.org/library/Enc/Human Capital.html>. Some of Becker's important points are:

> To most people capital means a bank account, a hundred shares of IBM stock, assembly lines, or steel plants in the Chicago area. These are all forms of capital in the sense that they are assets that yield income and other useful outputs over long periods of time.
>
> But these tangible forms of capital are not the only ones. Schooling, a computer training course, expenditures of medical care, and lectures on the virtues of punctuality and honesty also are capital. That is because they raise earnings, improve health, or add to a person's good habits over much of his lifetime. Therefore, economists regard expenditures on education, training, medical care, and so on as investments in human capital. They are called human capital because people cannot be separated from their knowledge, skills, health, or values in the way they can be separated from their financial and physical assets.
>
> Education and training are the most important investments in human capital. Many studies have shown that high school and college education in the United States greatly raise a person's income, even after netting out direct and indirect costs of schooling, and even after adjusting for the fact that people with more education tend to have higher IQs and better-educated and richer parents. Similar evidence is now available for many years from over a hundred countries with different cultures and economic systems. The earnings of more educated people are almost always well above average, although the gains are generally larger in less developed countries.
>
> * * *
>
> The economics of human capital have brought about a particularly dramatic change in the incentives for women to invest in college education in recent decades. Prior to the sixties American women were more likely than men to graduate from high school but less likely to continue on to college. Women who did go to college shunned or were excluded from math, sciences, economics, and law, and gravitated toward teaching, home economics, foreign languages, and literature. Because relatively few married women continued to work for pay, they rationally chose an education that helped in "household production"—and no doubt also in the marriage market—by improving their social skills and cultural interests.
>
> All this has changed radically. The enormous increase in the labor participation of married women is the most important labor force change during the past twenty-five years. Many women now take little time off from their jobs even to have children. As a result the value

> to women of market skills has increased enormously, and they are bypassing traditional "women's" fields to enter accounting, law, medicine, engineering, and other subjects that pay well. Indeed, women now comprise one-third or so of enrollments in law, business, and medical schools, and many home economics departments have either shut down or are emphasizing the "new home economics." Improvements in the economic position of black women have been especially rapid, and they now earn just about as much as white women.
>
> Of course, formal education is not the only way to invest in human capital. Workers also learn and are trained outside of schools, especially on jobs. Even college graduates are not fully prepared for the labor market when they leave school, and are fitted into their jobs through formal and informal training programs. The amount of on-the-job training ranges from an hour or so at simple jobs like dishwashing to several years at complicated tasks like engineering in an auto plant. The limited data available indicates that on-the-job training is an important source of the very large increase in earnings that workers get as they gain greater experience at work. Recent bold estimates by Columbia University economist Jacob Mincer suggest that the total investment in on-the-job training may be well over $100 billion a year, or almost 2 percent of GNP.

A majority of states considers a spouse's human capital to be personal to the spouse, and to amount to no more than post-divorce earnings which belong exclusively to the spouse who earns them after divorce. In those states, that human capital, which we call "personal goodwill," is not property divisible on divorce, even if that capital was developed during marriage or enhanced during marriage, or with the assistance of the other spouse.

Businesses can gain value from the human capital of their employees and associates. And a business can have value from the additive effect of established relationships between employees that allow the business to function smoothly and profitably.

An article by John F. Tomer, *Personal Capital and Emotional Intelligence: an Increasingly Important Intangible Source of Economic Growth*, 29 EASTERN ECONOMIC JOURNAL p. 453 (2003),[15] discussed a trend among economists to look beyond physical capital, natural resources, and labor, as bases for wealth creation, and to consider human capital as a basis. Tomer said that "the term capital has increasingly come to refer to intangible factors such as the enhanced human capacities owing to education and training." While a long list of economists dating back to Adam Smith, who wrote THE WEALTH OF NATIONS in 1776 recognized human capital, according to Tomer these economists were contemplating personal skills and abilities. For example, "Paul Romer [1990, 253] breaks down workers' human capital endowment into three types of skills that are relevant for production: (1) physical skills such as eye-hand coordination and strength, (2) educational skills acquired in primary and secondary school, and (3) scientific talent acquired in post-secondary education." Tomer focused on a new type of human capital, what he called social and organizational capital, that "are the product of activities that create social relationships." This type of capital reposes "not in individuals per se but in the relationships or connections between people."

Tomer discussed other terms used to describe human capital, including "social capital," and "psychological capital." Tomer chose to use the term "personal capital," and said:

> Personal capital is a kind of human capital because it relates to a capacity embodied in individuals. However, personal capital differs from standard human capital in that the human capacity involved is not the type developed by academic education or by the usual types of job-related training. The personal capital capacities are fundamentally different from cognitive intelligence or intellectual knowledge. Personal capital relates to an individual's basic personal qualities and reflects the quality of an individual's psychological, physical, and spiritual functioning [Tomer, 1996, 626-27; Tomer, 2001, 251]. Further, it mirrors one's internal biochemical balance, physical health and conditioning, psychological strengths and weaknesses, and purpose in life. A person's stock of personal capital is partly a product of one's genetic inheritance, partly a result of the life-shaping events that one has encountered, and partly an outcome of one's efforts to mature and to grow in nonintellectual ways. It is in part produced intentionally. Personal capital qualities are related to a person's capacity to work or consume in that they underlie the more specific capacities (standard human capital and consumption capital) that a person invests in to be qualified for work tasks or to be able to enjoy consumer goods. Moreover, certain personal capital qualities are a prerequisite for developing successful organizational relationships (social and organizational capital) [Tomer, 1999a, 46-48]. Personal capital capacities expand one's achievement possibilities.

Tomer commented: "Unlike tangible capital, human capital cannot be removed or alienated from an individual to be sold." This type of capital is akin to the personal goodwill that many states exclude from the property division upon divorce.

IV. WHAT IS GOODWILL? George R. Catlett and Norman O. Olson, in their significant booklet Accounting Research Study No. 10, *Accounting for Goodwill*, p. 9 (AICPA 1968),[16] wrote:

> The nature of goodwill, the characteristics which distinguish it from the separable resources and property rights of a business, and its treatment in the accounts are among the most difficult and controversial subjects in accounting. John B. Canning stated, "Accountants, writers on accounting, economists, engineers, and the courts, have all tried their hands at defining goodwill, at discussing its nature, and at proposing means of valuing it. The most striking characteristic of this immense amount of writing is the number and variety of disagreements reached."

A. THE ACCOUNTANTS' DEFINITION OF GOODWILL. The first mention of intangible assets in the United States accounting literature reportedly was the article *Balance Sheet Valuations*, in the April 1916 JOURNAL OF ACCOUNTANCY.[17] The author included in intangible assets patents, leases and contracts, franchises, and goodwill. *Id.* at p. 250. He went on: "There can be no rule laid down for the valuation of these assets, which often have real values and are a part of the earning capacity of many going concerns." *Id.* at 250-52.

The accounting profession has been grappling with idea of goodwill for as far back as history records. In the early part of the 1900s, many accountants charged acquired goodwill (the excess of purchase price above the book value of tangible assets) against equity immediately after the acquisition. There were different motives for this: one was the view that goodwill belonged to the owners and not to the business, and therefore should not be carried as an asset of business. The other was discussed by Sanders, Hatfield & Moore, in their book *Statement of Accounting Principles* (American Institute of Accountants 1938):

> The writing off of such intangible assets as goodwill evokes scarcely any protest, even when it is recognized that substantial goodwill exists. The general distrust of goodwill and the knowledge that it has been widely used to capitalize exaggerated expectations of future earnings leave an almost universal feeling that the balance-sheet looks stronger without it. When actual consideration has been paid for goodwill, it should appear on the company's balance-sheet long enough to create a record of that fact in the history of the company as presented in the series of its annual reports. After that, nobody seems to regret its disappearance when accomplished by methods which fully disclose the circumstances.

Id. at p. 14. Sanders et al. went on to note that accountants had developed certain conventions regarding the balance sheet, including the view that the balance sheet is

> historical in character: it attempts a summary description of the financial aspects of transactions which have already taken place. Thus certain intangible assets, such as goodwill and organization value developed within a business, the creation of which, however, cannot be attributed to any particular past transaction, are omitted from the balance-sheet of the business which developed them. *Id* at p. 56.

Sanders et al. also noted a convention that a going concern has invested "the greater part of its funds in the listed assets with a view to their consumption in operations or to their sale in the future." *Id.* at p. 57. These two conventions lead to a third,

> that the original basis of fixed asset values is cost. Subsequent valuation of them is a process of apportioning their original cost over their useful lives. The amounts set opposite fixed assets in balance-sheets do not record the results of periodic appraisals which attempt to state the present price of the assets.

Id. at 57. It should be noted that in today's economy self-created intangibles are expensed without recording an associated cost, many are designed to be perpetual or self-renewing and not consumed in operations or developed for sale, and many belong to the business and not its owners. It is easy to see that the economic context in which the accounting profession developed the convention of recording goodwill only as an offsetting entry to a credit to cash no longer exists. While the decision to ignore self-created intangibles grew out of custom and not by fiat, that is no justification for the standards-setting authorities of today to decline to revisit this convention.

Returning to ARS No. 10 (1968), Catlett & Olson went on to define "goodwill" from four perspectives:

> The concept of business goodwill value – defined in this study as the difference between the total value of an enterprise and the aggregate value of its separable resources and property rights, less liabilities -- has existed for a long time and much has been written on the subject. However, the proper accounting for goodwill remains one of the most controversial issues in the field of accounting, and the differences in views which exist today are remarkably similar to those which have been expressed over many years.

Catlett & Olson, p. 9. They continued:

> Goodwill, in its broadest sense, is defined in Webster's Third New International Dictionary as "kindly feeling: well-wishing, benevolence, friendliness." The second definition is: "the custom of a trade or business : the favor or advantage in the way of custom that a business has acquired beyond the mere value of what it sells whether due to the personality of those conducting it, the nature of its location, its reputation for skill or promptitude, or any other circumstance incidental to the business and tending to make it permanent." The third definition states that goodwill is: "the capitalized value of the excess of estimated future profits of a business over the rate of return on capital considered normal in the related industry." And the fourth definition is: "the excess of the purchase price of a business over and above the value assigned to its net assets exclusive of goodwill."

Id. at p. 8.

Catlett & Olson described an earlier period, where "goodwill was often of a rather personal nature, attaching in large measure to the particular personality, friendliness, and skill of the proprietor or partners of a business." *Id.* at 10. But as industrialism took root, goodwill came to be viewed as "the various advantages which a business possessed and which contributed to its profitability became less personal in nature." *Id*. at p. 10. Goodwill was seen as "as everything that might contribute to the advantage which an established business possessed over a business to be started anew." *Id.* at p. 10. By the 1950s the view of goodwill was expanding to "included virtually all of the factors and conditions which contribute to or accompany unusual earning capacity." *Id.* at p. 11 (internal quotations omitted). Goodwill was seen as the price a purchaser would pay above the value of the other assets in order to obtain excess profits. *Id.* at pp. 11-12.

Catlett & Olson wrote that goodwill has no accounting significance for the business unless it is sold or combined with another business. *Id.* at p. 17. Goodwill is really a value that belongs to the owner of the business, and not a value to the business itself. *Id.* at pp. 19-20.

In December of 1944, the Committee on Accounting Procedure of the American Institute of Accountants issued Accounting Research Bulletin No. 24, *Accounting for Intangible Assets*. ARB 24, at p. 197, said:

> THIS bulletin deals with some of the problems involved in accounting for certain types of assets classified by accountants as intangibles, including those acquired by the issuance of securities as well as those purchased for cash. [p. 195.]
> ***
> The bulletin does not deal with the problems of accounting for intangibles developed in the regular course of business by research, experimentation, advertising, or otherwise. [p. 195]
>
> The committee believes that the accounting for intangibles has heretofore been regarded as being of relatively minor importance; accounting practices with respect thereto have varied greatly.[18]

ARB 24 dealt only with purchased goodwill, and avoided addressing self-created intangible assets. To this day, 76 years later, the accounting profession still has not addressed how to report self-created intangible assets, even though self-created intangible assets have grown into the major contributor

to the value of many businesses. ARB 24 also adopted the view that goodwill was to be valued at cost, by subtracting net book value from the purchase price of a business, rather placing a market value on the goodwill, based on comparables or by discounting future profits or cash flows.[19]

In August of 1970, the Accounting Principles Board issued APB Opinion No. 16, *Business Combinations*. In para. 11 it said: "A difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill." In para. 22 Opinion No. 16 said: "Measuring fair values of assets acquired is complicated by the presence of intangible assets or other assets which do not have discernible market prices. Goodwill and other unidentifiable intangible assets are difficult to value directly, and measuring assets acquired for stock is easier if the fair value of the stock issued is determinable...." In para. 88, Opinion No. 16 listed assets that could be assigned values in an acquisition, including marketable securities, receivables, inventories, plant and equipment, and "[i]ntangible assets which can be identified and named, including contracts, patents, franchises, customer and supplier lists, and favorable leases, at appraised values"

Also in August of 1970, the Accounting Principles Board issued APB Opinion No. 17, *Intangible Assets, noting*:

> Problem
>
> 1. An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as a part of a group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.

Id. at p. 332. [Note: by defining goodwill itself as an asset, the APB ignored the fact the goodwill consists of the aggregate of many unidentified intangible assets.] Opinion No.17 acknowledged Research Study No. 10 by Catlett & Olson, and then concluded, at p. 334:

> **Conclusions**
>
> 9. The Board concludes that a company should record as assets the costs of intangible assets acquired from others, including goodwill acquired in a business combination. *A company should record as expenses the costs to develop intangible assets which are not specifically identifiable.* The Board also concludes that the cost of each type of intangible asset should be amortized by systematic charges to income over the period estimated to be benefitted. The period of amortization should not, however, exceed forty years. [Italics added.]

Opinion No. 17 noted that intangibles could be classified based on identifiability (separately identifiable or lacking specific identification); manner of acquisition (acquired singly, in groups, or in business

combinations or developed internally; expected period of benefit (limited by law or contract, related to human or economic factors, or indefinite or indeterminate duration); and separability from an entire enterprise (rights transferable without title, salable, or inseparable from the enterprise or a substantial part of it). *Id.* at p. 334.

The Financial Accounting Standards Board (FASB) was established in 1973 and immediately given authoritative status by the Federal Securities and Exchange Commission. In June of 2001 FASB supplanted APB Opinion 17 with Financial Accounting Standard No. 142, *Goodwill and Other Intangible Assets*. In the Glossary FASB defined goodwill as "[t]he excess cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed." [FAS 142 was revised in 2010, but the provisions discussed in this Article were not changed.] FAS No. 142 (R), ¶ 21 provides that "[t]he implied fair value of goodwill shall be determined in the same manner as the amount of goodwill recognized in a business combination is determined. That is, an entity shall allocate the fair value of a reporting unit to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the price paid to acquire the reporting unit. The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill." This definition reflects the accounting profession's interest in goodwill only as a purchased asset to be valued at cost and not an internally-developed one to be valued at true economic value. The FAS 142 definition gives no guidance on how one could determine goodwill of a business absent a sale.

Also in June 2001 FASB issued Financial Accounting Standard No. 141, *Business Combinations* (updated in 2007), which gave directions on how accountants should allocate the purchase price when one business bought another, including how to allocate part of the purchase price to intangible assets and goodwill acquired by purchase. FAS No. 141 supplanted APB Opinion No. 16, but carried forward the requirement that accountants recognize only intangible assets that can be identified. FAS No. 141 required that intangible assets acquired through the purchase of a business be recognized as assets apart from goodwill only if they are "identifiable" under two criteria – the separability criterion or the contractual-legal criterion, concepts brought forward from APB Opinion No. 17.

FAS Nos. 141 and 142 thus are a modernization of the accounting profession's approach to intangible assets, including goodwill. But the accounting profession offers no solution to persons who need to determine the value of a company absent the purchase of the company. The accounting profession still does not recognize self-created intangible assets as separable from goodwill, which means that the more we move toward a world in which companies are investing in self-created intangible assets, the less relevant accounting and financial reporting will be to valuing a business.

On July 9, 2019, FASB issued an Invitation to Comment on *Identifiable Intangible Assets and Subsequent Accounting for Goodwill*.[20] On page 6, the Board asked: "1. What is goodwill, or in your experience what does goodwill mainly represent?" There were 103 responses that give us a fascinating and eye-opening and even remarkable opportunity to see a variety of current perspectives on how to define or describe goodwill.

Letter No. 10 said: "We believe that goodwill is a premium paid by an acquirer for an acquiree over and above the fair value of the identifiable net assets acquired. Presumably, the acquirer is willing to pay this premium because it believes that there is additional intangible value (e.g., synergy or strategic

value) associated with merging the acquiree's business with its business and operations that cannot be attributed to an identifiable tangible or intangible asset. That additional value is expected to result in higher revenues, reduced costs, or higher profit margins over some future period that at least equals the premium paid. This strategic value also could be attributed to a defensive measure to protect a public company's market share or acquiring certain technology that it currently does not possess."

Letter No. 12 said: "We generally agree with the definition of goodwill as described in the basis of conclusions in Statement 141 ® that states that goodwill represents the fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. We do observe, however, that *it is different on each deal* and can represent both items that might theoretically diminish in value over time and those that do not." [Italics added.]

Letter No. 13 (the Japanese Institute of CPAs) said: "The basis for conclusions in FASB Statement 141® describes some of the main components of goodwill, which are also referred to in the ITC as (a) fair value of the expected synergies and other benefits from combining the entities' net assets and businesses, (b) fair value of the "going concern" element which is the ability of the established business to earn a higher rate of return than if the collection of net assets were acquired separately, and (c) fair values of other net assets that had not been recognized by the acquired entity. We recognize through a number of business combination transactions that goodwill is represented by such components and we don't have any arguments with the Board's view on this matter." ... In some cases, goodwill might even end up including a component of 'overpayment' made by an acquirer.... Furthermore, we recognize that goodwill amount represents the acquisition-date value of synergies, excess earning power, and other benefits from combining the entities, which generally decreases over time after the acquisition. For example, it is our understanding that excess earning power generally decreases over time due to competition among entities. Just like in the case of excess earning power, we believe that many of the goodwill components actually have the feature of decreasing in their value over time."

Letter No. 15 (KPMG) said: "How to account for goodwill is a question that has long perplexed the accounting profession, so much so that *goodwill has been defined by what it is not rather than what it is*. Given the challenge of even defining goodwill, we believe there are merits to multiple perspectives about what goodwill represents and how to account for it." (Italics added.)

Letter No. 16 (Regions Financial Corp.) said: "We believe goodwill represents the premium paid above the price supported by the assets acquired. In our view, *this does not represent a probable future economic benefit, but is a deployment of capital*. The acquiring entity will use the acquired identifiable assets with the company's existing assets for future benefit in excess of the fair value of the identified assets." (Italics added.)

Letter No. 17 said: "We believe goodwill represents the competitive, strategic and/or opportunistic value in excess of the fair value of the underlying identifiable assets and liabilities an entity acquires in an acquisition. This is often referred to as synergies in many instances."

Letter No. 19 (Price Watershouse) said: "From an accounting perspective, goodwill represents the excess of the cost of an acquired business over the aggregate amount assigned to the identifiable net assets acquired. From an enterprise valuation perspective, the majority of goodwill cash flows are expected to extend beyond the lives of the identifiable net assets that exist at the acquisition date (e.g.,

the expectational value created through developing new technologies and winning new customers). From an economic perspective, *it incorporates the established reputation of a business, excellence of management, future growth potential, culture, and the worth of corporate identity as well as the value of inseparable but important intangible assets, such as a skilled workforce and institutional knowledge that emerge from, and are maintained by, the ongoing operation of the business*. Goodwill can also be described as the expected value of the ability, as a function of institutional knowledge and excellence of management, to maintain a competitive advantage beyond the life of existing assets (i.e., the expected value of generating excess returns on capital into the future). Goodwill represents the presumption that an established business will continue to identify and successfully execute on new projects, thus earning a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. All of these elements are typically expected to appreciate in value over time as the business grows. (Italics added.)

"Goodwill is fully enmeshed in the fabric and going concern nature of a business, and has value specifically because a business operates and is expected to continue operating in perpetuity. *It is important to understand that goodwill exists in almost all businesses, even in the absence of a transaction*. (Italics added.)

"Synergies are also typically present, particularly in transactions that represent industry consolidation. However, goodwill is not solely a function of synergies. As noted above, goodwill is present in all businesses. Goodwill is present even if synergies are nominal. For example, material goodwill amounts may be recognized in acquisitions by private equity firms that have limited synergies as the acquired business is not being combined with an existing business of the acquirer. Similar to most other elements of goodwill, the value derived from synergies is presumed to be long-lived by market participants. In the cash flow models that support the purchase price and that are the basis for the purchase price allocation, synergies, particularly cost synergies, are typically expected to persist indefinitely. For example, if two businesses combine and as a result, the finance function of one of the businesses is eliminated, this cost reduction is deemed to be permanent."

Letter No. 22 (BDO) said: "We believe that the description from the FASB Master Glossary and the main components identified in FASB Statement No. 141 (revised 2007), Business Combinations, reasonably depicts the concept of goodwill. However, we note that the exact composition of goodwill will differ, sometimes dramatically, between industries and individual acquisitions, and thus *depends on the specific facts and circumstances*." (Italics added.)

Letter No. 70 (from four members of the Business Value Resource Panel of the Appraisal Foundation) said: "We believe that goodwill is a measure of a portion of a business entity's intangible value. Business entity intangible value results from the aggregate investment returns of the business entity exceeding the required investment returns on underlying monetary and tangible assets. These so-called 'excess' investment returns support additional (intangible) value above and beyond the entity's investment in monetary and tangible assets. *Such excess returns indicate the existence of non-tangible elements of the business entity (such as technology, brands, customer loyalty, etc.) which either might be viewed as specifically recognized intangible assets or lumped into an asset designated as 'goodwill'*. Goodwill arises as a recognized asset when applying the acquisition method under ASC topic 805 to a business combination. A portion of the acquired business entity's intangible value is first recognized as individual intangible assets. *Goodwill represents the remaining (or residual) intangible value of the acquired*

business entity which does not meet the recognition criteria for intangible assets. 'Economic goodwill' (as opposed to the accounting notion of goodwill arising from the application of ASC topic 805) can be observed in public securities markets when the market capitalization value of the securities of a publicly traded business entity exceeds the underlying financial accounting 'tangible net worth' of the business entity. Investors in that business entity's securities believe that the investment returns of the entity exceed the returns on the underlying tangible and monetary assets which have been invested in by management of the business entity, due to 'value creation' exhibited by the successful operations of the business entity. Some of the intangible value may have been recognized as part of the 'book value' of the business entity, arising from prior acquisitions. Even when that is the case, additional economic goodwill still may exist as market capitalization often exceeds book value as well as tangible net worth. (Italics added.)

"Most, if not all business entities, on an economic basis, comprise three major sources of asset value which are commonly described as the following categories of assets/business elements: 1) monetary or near monetary assets (i.e. current assets), 2) property, plant and equipment (i.e. tangible assets) and 3) intangible assets/business elements. While recognition and measurement of current and tangible assets, either on an ongoing basis or as a result of a business combination is relatively straightforward, the dividing line between recognized intangible assets and other valuable business elements (which, under the current accounting model would comprise goodwill) is 'set' through the application of accounting principles. Conceivably, this dividing line could be set at either end of the spectrum of intangible value. On one end of the spectrum, for example, under current US tax regulations, most intangible value is classified as IRC section 197 goodwill, and the need to break out individually recognized intangible assets is unnecessary as effectively all intangible value is subsumed into goodwill and amortized and deducted over a 15-year statutory life. On the other end of the spectrum, one could imagine the notion that all intangible elements of value in a business entity are recognized as assets, and either amortized, if they are in the nature of a 'wasting asset' or classified as being of 'indefinite life"'and not amortized, but tested periodically for any decline in value.

"As an alternative, a comprehensive 'fair value' based accounting model, would allow all assets/business elements to be re-measured at their fair value periodically (rather than depreciated or amortized), with any increase or decrease in value being recognized as a gain or loss through the income statement. While such a fair value based accounting model might allow investors in a business entity to fully understand the total increase or decrease in the economic benefits which their investment has experienced over a particular measurement period, the concept of a comprehensive fair value based accounting model has been viewed as being far too administratively burdensome and costly relative to any perceived added benefits to investors of such a model. Further, such an accounting model would represent a departure from the US GAAP tradition of 'accounting conservatism'. As a result, our current accounting model can best be described as a 'mixed model' of amortized/depreciated historical cost measurements and fair value measurements.

"The current accounting model assumes goodwill is initially recognized at its fair value, but can only be re-measured downward if it is found to be impaired. Thus, the initially recognized amount of goodwill may be viewed as being representative of the fair value of all elements of a business entity that do not meet the recognition criteria for intangible assets at that initial measurement date. At a later measurement date, if subjected to an impairment charge, goodwill may again be viewed as being roughly representative of the fair value of all elements of that same business entity that do not meet the recognition

criteria for intangible assets at that later measurement date. However, if the business entity appreciates in value (implying that its goodwill has also appreciated in value), its recognized goodwill is effectively "frozen" at its initial recognition amount.

"To summarize, We believe that, depending on where the dividing line of intangible asset recognition is set, goodwill could represent all or some of the intangible value of a business entity as of a particular measurement date, or goodwill could, in the opposite extreme, not be recognized at all if the entire intangible (residual) value resulting from the application of the acquisition method under ASC topic 805 to a business combination were to be recognized as individual intangible assets on that same measurement date. We believe that investors benefit from information associated with the recognition of intangible assets and goodwill in a business combination."

Letter No. 74 (Ford Motor Company) said: "Goodwill is the difference between the consideration transferred and the identifiable assets and liabilities received in a business combination. A company acquires other companies to achieve specific business objectives, such as achieving synergies, growth, competitive advantage, or improving economies of scale.

"These same business objectives could also be developed internally. *Companies often choose to acquire versus develop internally because it may not be feasible within a reasonable time frame and can be more cost effective.* Therefore, we believe goodwill represents a portion of the cost that a company would have incurred internally to achieve the same business objective." (Italics added.)

Ford Motor Company also wrote: "Intangible Assets. Non-contractual intangible assets are difficult to identify and value in a business combination. Often, entities must incur costs to engage third-party firms to assist with the identification and valuation process. The identification and valuation requires judgment, and as a result, recognition of intangibles separately capitalized on the financial statements is inconsistent. These factors reduce comparability and, ultimately, the value of the information to financial statement users.

"For these reasons, *we recommend that non-contractual intangible assets be subsumed into goodwill*. We believe this approach, along with additional disclosures about the agreements underpinning material intangible assets acquired, will improve comparability, reduce preparer costs, and provide financial statement users more decision-useful information about assets acquired." (Italics added.)

Letter No. 77 (Houlihan Lokey) said: "Under generally accepted accounting principles ('GAAP'), goodwill represents consideration paid to acquire a business, as a going-concern entity, that is in excess of the fair value of the identifiable tangible and intangible net assets. *From a valuation perspective, goodwill represents future cash flows generated by assets that are not identifiable as of the acquisition date.* Stated differently, the business enterprise generates cash flows by utilizing a portfolio of assets in each future discrete time period. The taxonomy of such portfolio of assets migrates from those that existed as of the acquisition date to those that are yet to be developed as the business enterprise continues to evolve over time, into perpetuity, to maintain its competitive advantage. These yet-to-be developed assets may include, but are not limited to, future customers, future technology, as well as management's ability to innovate to remain competitive in order to achieve future growth and profitability as expected by the buyer and as reflected by the agreed upon purchase price. (Italics added.)

"Further, we note that market participant synergies may also be component of goodwill. Synergies are typically created via (i) cost reduction, and resulting enhanced margin, due to the economy of scale in the cost structure of the combined entity; or (ii) the ability to generate incremental revenue streams that would not have been realizable but for the combined entity. These synergies are typically reflected in the deal model in the form of enhanced revenue growth from realizing additional revenue streams; and/or in the form of enhanced profit margins from cost reduction due to the elimination of duplicative positions. The higher level of revenue and profits are typically capitalized into perpetuity in order to derive the proposed purchase price. As such, these synergies are implicitly assumed to persist indefinitely and not waste away. If goodwill comprises future cash flows generated by future assets (such as future technologies, future customers, etc.) and enhanced operational performance due to synergies that are expected to persist indefinitely (as reflected in the capitalization of the elevated revenue and profit into perpetuity when market participants derive proposed purchase price), these fact patterns appear to support the notion that goodwill is not a wasting asset. Therefore, the proposed amortization of goodwill appears to be inconsistent with the nature of goodwill."

Letter No. 78 said: "Value Knowledge response: Under ASC 805, goodwill is currently quantified as residual; it is purchase price minus acquired net assets. Goodwill can also be quantified with a present value of cash flows, by beginning with all the cash flow from the business and subtracting all the cash flows from the acquired net assets. When viewed as cash flows, most of the cash flows attributed to goodwill occur after the economic life of the identified intangible assets and other identified net assets. In a DCF of the business, the cash flows that most resemble the cash flows to goodwill would reside in the terminal value and have a perpetual growth assumption.

"That's what goodwill primarily is: the asset that represents the value of the potential for the business to continue indefinitely. In a going concern business, the DCF value that acquirers and sellers often rely on to understand the expected benefits of business ownership include the assumption of indefinite existence of that business. That assumption of indefinite existence of that business is implicit in almost every DCF-based business valuation. Goodwill, like the business, is expected to be perpetual and outlast the acquired depreciable and amortizable assets.

"The ITC cited the underlying logic in Statement 142: 'not all goodwill declines in value and for goodwill that does decline in value, it does not decline systematically over time. The Board also noted that goodwill may not be infinite lived, but it is indefinite lived.' I agree with that premise. Goodwill also includes workforce, going concern and other assets not quantified such as books and records, but those are minor considerations compared to the long-term ability of the business to continue past the decay of the current identifiable assets that make up the business."

Letter No. 103 (CFA Institute) is a blistering letter, which in part said: "A decision by the FASB to adopt private company accounting for goodwill would result in the write-off (amortization) over ten years of $5.6 trillion of assets on the books of U.S. public companies....

"Goodwill amounts to 6% of all public company assets and 8% of the assets of public companies with goodwill. Goodwill represents 32% and 40%, respectively, of the equity of such public companies. More staggering is the effect this would have on S&P 500 companies. With $3.3 trillion in goodwill, the S&P 500 represent nearly 60% of the goodwill of all U.S. public companies, though S&P 500 companies represent only 8% of U.S. public companies and 37% of the assets of U.S. public companies.

Goodwill represents 10% of the assets and 45% of the equity of S&P 500 companies with goodwill. Adopting the private company approach to goodwill amortization would schedule the write-off (amortization) of a substantial portion of the assets and equity of U.S. public companies and reduce profits of the S&P 500 by $330 billion ($560 billion for all U.S. public companies) for ten years."

FASB published a Comment Letter Summary on the Invitation to Comment.[21] Regarding the definition of goodwill, the summary said:

> 1. The July 15, 2020 Board meeting is a decision-making meeting. The purpose of this memo is to present comment letter feedback received on the Invitation to Comment(ITC), Identifiable Intangible Assets and Subsequent Accounting for Goodwill. The ITC was issued on July 9, 2019,with a 90-day comment period ending on October 7, 2019. This memo provides a summary of the feedback from the comment letters received in response to the document. Accordingly, this memo is intended to be read in conjunction with the ITC.
> ***
> Nature of Goodwill
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> 7. To provide context for the ensuing discussion on the subsequent accounting for goodwill, the ITC asked respondents to consider the conceptual nature of goodwill. Stakeholders' views on the conceptual nature of goodwill often aligned with their views on the appropriate subsequent accounting for goodwill. Accordingly, respondents discussed the nature of goodwill in supporting their views on the various models proposed in the ITC. Those comments are included in the sections that follow related to the subsequent accounting for goodwill. Other general comments on the nature of goodwill are included below.
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> 8. Seventy-seven respondents provided comments on the conceptual nature of goodwill. Respondents often discussed their views of what goodwill represents and where its value is derived, while others stated their positions on the current definition of goodwill.
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> 9. Some respondents noted that goodwill's value represents a capital outlay for the opportunity of future economic benefit. For example, an academic respondent stated that goodwill refers to the opportunity for future economic benefit, rather than an explicit benefit, because expected synergies often do not materialize. Others explained that the benefit goodwill provides frequently requires additional investment of financial or nonfinancial resources to be transformed into identifiable assets. Similarly, a preparer noted that it is increasingly difficult to differentiate between acquired goodwill and internally generated goodwill.
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> 10. Eleven respondents generally agreed with the current definition of goodwill as stated in the Master Glossary. This definition states that goodwill is"an asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not-for-profit entity that are not individually identified and separately recognized. Conversely, two respondents asserted that goodwill does not represent an asset at all because it does not represent a present right or economic benefit.
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> 11. Several respondents, based on their experiences in practice, cited major sources of the value of goodwill. For example, several respondents noted that the value of goodwill is derived

> from the workforce acquired in an acquisition. Other respondents often discussed the components of goodwill as noted in paragraph B313 of the basis for conclusions for FASB Statement No. 141(Revised2007), Business Combinations. Accordingly, respondents often cited the following sources of the value of goodwill:(a)Excess of fair values over the book values of the acquiree's net assets at acquisition (b)Expected synergies created by the acquisition, including incremental increases in earnings potential (c)Going concern value(d)Overpayment by the acquirer.
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> 12. Some respondents noted that while the components of goodwill are generally consistent across the market, the specific goodwill recognized in a given business combination transaction may be made up of different components. For example, two respondents explained that a transaction's goodwill can be made up of various components or specifically one component.
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> 13. Several respondents also commented on the separability of the components of goodwill. Those respondents commented on the difficulty of separately identifying the value of each individual component. On this topic, one preparer expressed concern that a model that separates components would be impractical even among components that have finite and indefinite lives.
>
> 14. Three respondents stated that the term goodwill is problematic and noted that the Board should further clarify what is represented by goodwill and intangible assets.

At the July 15, 2020 meeting, FASB resolved to pursue changes the amortization of recorded goodwill, changes to the goodwill impairment model, consider the accounting for identifiable intangible assets.[22]

B. THE BUSINESS VALUATORS' DEFINITION OF GOODWILL. Business valuators talk about goodwill a lot, especially about personal goodwill. The business-owning spouse – who is the hypothetical seller in the hypothetical sale of the business to a hypothetical buyer at fair market value at the time of divorce – has personal goodwill, which includes his or her human capital, and personal relationships that are important to the business. Most states exclude the value of this personal goodwill from the property division on divorce. But the business itself can (and almost always does) have enterprise goodwill, akin to personal goodwill but generalized to the business as a whole. In determining what portion of the overall goodwill of a business inheres in the enterprise and what portion is personal to the owner, under current conceptions the business valuator has choices: (i) s/he can value the enterprise goodwill, leaving the owner's personal goodwill as the residual value, or (ii) s/he can value the owner's personal goodwill leaving the enterprise goodwill as the residual value, or (iii) s/he can allocate the combined goodwill of the company and the owner based on a purely subjective basis, or (iv) s/he can allocate goodwill based on a theoretical model or formula. In having to distinguish enterprise goodwill from personal goodwill, business valuators face a problem that is not dealt with in accounting.

C. THE LAWYERS' DEFINITION OF GOODWILL. The lawyers, meaning both practitioners and judges, are all over the place in defining goodwill. This is partly because there are more than fifty versions of family law in America, and the law changes in different places at different times. The role of goodwill in a divorce is not statutory law; it is case law. And there are few appellate court opinions in any one state that address goodwill issues arising in a divorce. Unlike the FASB, there is no governing body of lawyers or judges whose task it is to upgrade and modernize the legal conceptual

framework relating to intangible assets and goodwill, and who can standardize practices across the country. This places the responsibility for change on the lawyers and their experts who litigate business valuation issues to be alert to these new developments in our economy, and to pursue them in the court system.

D. WHAT IS GOODWILL? Goodwill can be viewed from a legal perspective and from an accounting perspective and from an economic perspective and from a management perspective and from a business valuation perspective. Because family law in America consists of more than fifty different bodies of law, there is great variety in the legal approaches to goodwill upon divorce. There are some principles that are shared between states due to the common heritage of English law (Louisiana excepted) pertaining to goodwill. There are some principles that are shared between states because of common notions of what constitutes "property." But there are wide differences in the laws of different states on the legal question of what constitutes goodwill, and what goodwill is divisible on divorce.

1. Early Legal Recognition of Goodwill. According to Charles Edward Allan, a Barrister-at-Law of the Inner Temple, in his book THE LAW RELATING TO GOODWILL pp. 3-4 (Stevens and Sons, Ltd. 1889), goodwill first appeared in the law in connection with covenants not to compete.

> Thus, in 1620, we have the case of *Broad y. Jollyfe* [Cro. Jac. 596; Noy, 98], in which was discussed the validity of a promise by a mercer not to keep a shop in Newport, in the Isle of Wight, in consideration of the plaintiff purchasing his old stock at prime cost. The Court held the promise to be good, remarking that "it is but the selling of his custom and leaving another to gain it." The well-known leading case of *Mitchell v. Reynolds* [1 P. Wms. 181; 1 S.L.C. 9th ed. 430] upon agreements in restraint of trade, decided in 1711, arose also in connection with the assignment of a business. In that case the plaintiff had taken over the defendant's lease, for five years, of a bakehouse in the parish of St. Andrew's, Holbom, and the defendant had bound himself not to exercise the trade of a baker within that parish during the term, a condition which was held good.
>
> It was somewhat later, however, before goodwill came to be regarded as of value apart from these personal covenants; possibly the first case in this connection being that of *Giblett v. Reade* [9 Mod. 459], before Lord Chancellor Hardwicke in 1743. In that case a testator had carried on, in partnership, the business of printing and publishing a newspaper, which was continued after his death. The children of the deceased printer claimed from his widow and executrix, "under the will and custom of London," the value of his share in the business, and the claim was held admissible by Lord Chancellor Hardwicke, who remarked, that "all things of this sort ought to be taken according to the known nature of the dealing, and the method of the parties considering these matters and carrying them on." He compared the case with that of the executor of a deceased partner in a shoemaking business, and said:—"Suppose the house were a house of great trade, he must account for the value of what is called the goodwill of it."

The earliest legal definition of "goodwill" was given by Lord Eldon in *Cruttwell v. Lye*, 34 Eng. Rep. 129 (Ch. 1810), which said: "The goodwill which has been the subject of sale is nothing more than the probability that the old customers will resort to the old place." The classic American legal definition of goodwill was given by Justice Joseph Story in his 1868 treatise on partnership law:

> the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

Story, COMMENTARIES ON THE LAW OF PARTNERSHIP § 99 (6th Ed.1868). This definition was cited by the U.S. Supreme Court in *Metropolitan Nat. Bank v. St. Louis Dispatch Co.*, 49 U.S. 436, 446, 13 S.Ct. 944, 948 (1893).

2. Seeking a Better Legal Conception of Goodwill. One member of Congress said this about goodwill, in connection with the savings and loan crisis: "Goodwill is not cash. It is a concept, and a shadowy one at that." 135 Cong. Rec. 11795 (1989) (remarks of Rep. Barnard), cited in *U.S. v. Winstar Corp.*, 518 U.S. 839, 854, 116 S.Ct. 2432, 2445 (U.S. Sup. Ct. 1996).

The U.S. Supreme Court described goodwill as "that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business," in *Des Moines Gas Co. v. City of Des Moines*, 238 U.S. 153, 165, 35 S.Ct. 811, 814 (U.S. Sup. Ct. 1915).

The U.S. Supreme Court more recently said this about goodwill:

> Although the definition of goodwill has taken different forms over the years, the shorthand description of good-will as "the expectancy of continued patronage," *Boe v. Commissioner*, 307 F.2d 339, 343 (CA9 1962), provides a useful label with which to identify the total of all the imponderable qualities that attract customers to the business. *See Houston Chronicle Publishing Co. v. United States*, 481 F.2d, at 1248, n. 5.

Newark Morning Ledger Co. v. U.S., 507 U.S. 546, 555-56, 113 S.Ct. 1670, 1675 (U.S. Sup. Ct. 1993).

The U.S. Court of Claims said this about goodwill:

> Goodwill sometimes is used to describe the aggregate of all of the intangibles of a business.... Since a normal rate of return usually is calculated on tangible assets only, goodwill has been used as a synonym for the return on all the intangibles of a business. In a more restricted sense, goodwill is the expectancy that the old customers will resort to the old place. It is the sum total of all the imponderable qualities that attract customers and bring patronage to the business without contractual compulsion. Another definition equates goodwill with a rate of return on investment which is above normal returns in the industry and limits it to the residual intangible asset that generates earnings in excess of a normal return on all other tangible and intangible assets.

Richard S. Miller & Sons, Inc. v. United States, 537 F.2d 446, 450-51 (Ct. Cl. 1976) (citations omitted).

Other federal courts have described goodwill: *Houston Chronicle Publishing Co. v. United States*,

481 F.2d 1240, 1248 (5th Cir. 1973) (the "ongoing expectation that customers would utilize [a company's] services in the future"), *cert. denied*, 414 U.S. 1129 (1974); *Grace Bros., Inc. v. Commissioner*, 173 F.2d 170, 175-76 (9th Cir. 1949) ("the sum total of those imponderable qualities which attract the customer of a business--what brings patronage to the business"); *Dodge Bros., Inc. v. United States*, 118 F.2d 95, 101 (4th Cir. 1941) ("reasonable expectancy of preference in the race of competition"); *Ithaca Industries*, 97 T.C. 253 (slip op. at 17-18), 1991 WL 151392 (1991) ("While goodwill and going-concern value are often referred to conjunctively, technically going-concern value is the ability of a business to generate income without interruption, even though there has been a change in ownership; and goodwill is a 'preexisting' business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely"), *aff'd*, *Ithaca Industries, Inc. v. Commissioner*, 17 F.3d 684 (4th Cir. 1992).

In *Canterbury v. Commissioner*, 99 T.C. 223, 247 (1999), the Tax Court said: "The essence of goodwill is a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely. *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 233 (1975). Goodwill is characterized as 'the expectancy of continued patronage, for whatever reason.' *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir.1962), *affg*., 35 T.C. 720 (1961); see *Philip Morris, Inc. v. Commissioner*, 96 T.C. 606, 634 (1991), *affd*., 970 F.2d 897 (2nd Cir., June 25, 1992)."

Rev. Rul. 59-60, § 4.02(f), 1959-1 C.B. 237, 241 says this about goodwill: "In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets."

State court appellate opinions describe goodwill in various ways.

▸*In re Marriage of White*, 502 N.E.2d 1084, 1086 (Ill. Ct. App. 1986): "A workable definition of goodwill is that 'goodwill is the value of a business or practice that exceeds the combined value of the physical assets.' . . . The market value of goodwill is the amount a willing buyer would pay for a professional practice in excess of the value of the physical assets. . . . A value based upon the capitalization of excess earnings method is the capitalization at a fair rate of return of the amount by which the average income of the professional practitioner exceeds the hypothetical salary that would be earned as an employee with similar qualifications." [citations omitted]

▸*Yoon v. Yoon*, 711 N.E.2d 1265, 1268-69 (Ind. Sup. Ct. 1999): "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 or 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.' Enterprise goodwill 'is based on the intangible, but generally marketable, existence in a business of established relations with employees, customers and suppliers.' . . . Factors affecting this goodwill may include a business's location, its name recognition, its business reputation, or a variety of other factors depending on the business. Ultimately these factors must, in one way or another, contribute to the anticipated future profitability of the business. Enterprise goodwill is an asset of the business and accordingly is property that is divisible in a dissolution to the extent that it inheres in the business, independent of any single individual's personal efforts and will outlast any person's involvement in the business. . . . It is not necessarily marketable in the sense that there is a ready and easily priced market for it, but it is in general transferrable to others and has a value to others."

▸*Dugan v. Dugan*, 457 A.2d 1, 4-6 (N.J. Sup. Ct. 1983): "Goodwill is generally regarded as the summation of all the special advantages, not otherwise identifiable, related to a going concern. It includes such items as a good name, capable staff and personnel, high credit standing, reputation for superior products and services, and favorable location. See also Accounting Principles Board, Op. 17, 'Intangible Assets,' in FASB Financial Accounting Standards 266-72 (1981). [FN3] In a broad sense goodwill includes a whole host of intangibles including the quality of management, the ability of the organization to produce and market efficiently, and the existence and nature of competition. Some writers have been careful to differentiate between going concern value and goodwill. See Paulsen, 'Goodwill and Going Concern Value Reconsidered,' Mergers & Acquisitions, Winter 1980, at 10. Goodwill is keyed to reputation; going concern value to the enhanced value of the assets due to their presence in an established firm. See Danzig & Robison, 'Going Concern Value Reexamined,' The Tax Adviser, Jan. 1980, at 32. Going concern value has many of the characteristics of goodwill and in many situations will constitute an asset enhancing the value of an enterprise. In that event it will be a component of the property subject to equitable distribution. Going concern value may be prevalent in some law firms. It is probably not significant in an individual law practice. . . .

> FN3. APB Opinions are authoritative statements by the American Institute of Certified Public Accountants of generally accepted accounting principles. See 'Forward,' FASB Financial Accounting Standards, supra; 2 APB Acc'ting Principles (CCH) § 510.08, at 33 (1973).

"Goodwill can be translated into prospective earnings. From an accounting standpoint goodwill has also been perceived of in terms of the extent to which future estimated earnings exceed the normal return on the investment. Walker, 'Why Purchased Goodwill Should be Amortized on a Systematic Basis,' 95 J. Acc'tancy 210, 213 (1953); *accord*, Rev. Rul. 59-60, § 4.02(f), 1959-1 C.B. 237, 241 (stating that value of goodwill 'rests upon the excess of net earnings over and above a fair return on the net tangible assets'). The price paid for goodwill then is equivalent to the excess of actual earnings over expected earnings based on a normal rate of return on investment. Walker, *supra*, at 213; see Kerley, 'Intangible Assets,' in 1 Accountants' Handbook 23-10 (L. Seidler & D. Carmichael 6th ed.1981). When goodwill exists, it has value and may well be the most lucrative asset of some enterprises.

"Variances in the forms of an enterprise do not eliminate goodwill, though they may affect its worth. Goodwill may be present whether that form is a partnership, corporation, joint venture, or individual proprietorship. See *Grayer v. Grayer*, 147 N.J.Super. 513, 520, 371 A.2d 753 (App. Div. 1977); *Scherzer v. Scherzer*, 136 N.J.Super. 397, 400, 346 A.2d 434 (App. Div.1975) (holding no essential difference so far as equitable distribution principle is concerned between an interest in an individual business

and one held in corporate name: "The form should not control"), *certif. den.*, 69 N.J. 391, 354 A.2d 319 (1976). Moreover, goodwill exists in personal service enterprises as well as other businesses. 2 B. Bittker, Federal Taxation of Income, Estates and Gifts ¶ 51.9.3, at 51-53 (1981).

"In a publicly held corporation one can determine the total value of a business whose stock is publicly traded and therefore its goodwill by the market price of the stock. G. Catlett & N. Olson, Accounting for Goodwill 14 (1968). The excess over the book or market value of its assets, however, may also be due to many and diverse conditions affecting the economy as a whole and an industry in particular. The value of stock in a closely held corporation is not fixed by public trading. Its computation depends primarily on the earning power of the business 'since goodwill by nature encompasses all those intangible attributes of a business whose quality can be demonstrated only by a company's ability to make profits.' *Id*. [Strike-over added to avoid confusion]

"The calculation of goodwill may depend upon the purpose for which the measurement is being made. The federal Internal Revenue Service has prescribed a formula approach for income, gift and estate tax purposes. See Rev.Rul. 68-609, 1968-2 C.B. 327. The market place, as noted above, may often provide a different figure. Accountants will usually not reflect goodwill on a balance sheet until after a business has been sold and then state goodwill in terms of the excess paid for the net assets over book value. G. Catlett & N. Olson, *supra*, at 17. Its evaluation may be complex and difficult. Judge Pressler in *Lavene v. Lavene*, 148 N.J. Super. 267, 275, 372 A.2d 629 (App. Div.), *certif. den.*, 75 N.J. 28, 379 A.2d 259 (1977), commented:

> There are probably few assets whose valuation imposes as difficult, intricate and sophisticated a task as interests in close corporations. They cannot be realistically evaluated by a simplistic approach which is based solely on book value, which fails to deal with the realities of the good will concept, which does not consider investment value of a business in terms of actual profit, and which does not deal with the question of discounting the value of a minority interest.

▸*Travis v. Travis*, 795 P.2d 96, 97 (Okla. Sup. Ct. 1990): "As distinguished from tangible assets, intangibles have no intrinsic value, but do have a value related to the ownership and possession of tangible assets. Some intangibles, such as a trademark, trade name or patent, are related to an identifiable tangible asset. Goodwill, which is another intangible, is not. Often referred to as 'the most "intangible" of the intangibles,' D. Kieso & J. Weygandt, Intermediate Accounting 570 (3d ed. 1980), goodwill is essentially reputation that will probably generate future business."

▸*Matter of Marriage of Fleege*, 588 P.2d 1136, 1138 (Wash. Sup. Ct. 1979): "Goodwill is property of an intangible nature and is commonly defined as the expectation of continued public patronage. . . . Among the elements which engender goodwill are continuity of name, location, reputation for honest and fair dealing, and individual talent and ability." [Citations omitted]

Retired University of New Mexico Management Professor Allen M. Parkman, who had an economics and legal background, discussed the legal conception of goodwill in his chapter *A Systematic Approach to Valuing the Goodwill of Professional Practices* (1998).[23]

3. Goodwill as Residual Value. The wide-ranging discussion over what constitutes divisible goodwill upon divorce can be narrowed by refining the concept of goodwill. In some older writings, the term

"goodwill" is used to describe all value of a going business beyond the value of the tangible assets of the business, i.e., goodwill consists of all intangible value of the business. The measure of this form of goodwill is the difference between the price a buyer would pay to buy the going business as a whole and the price a buyer would pay to buy just the tangible assets of the business. But this conception of goodwill is overbroad because it lumps into goodwill intangible assets of the business that can be separately identified and valued on an individual basis.

Modern property law recognizes many intangible assets enforceable property rights, and these enforceable and transferrable intangible property rights should be discussed and valued in the context of their specific legal framework (such as trademark law, trade secret law, contract law applied to employment agreements or covenants not to compete, etc.), rather than being lumped into the catch-all category of residual goodwill. This Article suggests that the term "goodwill" should used to describe the narrower category of the ineffable qualities of a particular business that contribute to profitability, beyond not only cash and tangible assets but also beyond specifically identifiable intangible assets that are legally enforceable or can be transferred with or without the sale of a business. This Article also suggests that the true nature of "residual goodwill" of most companies in the present mobile, digital and world-wide economy, where goods and services are increasingly fungible, has shifted from stable supplier/customer relationship to self-created "human capital" that will stay with the business after a sale, including not only research and development, but also "enhanced human capacities owing to education and training," social and organizational capital of the business, and personal capital of employees who will stay with the business (see discussion of John Tomer, Section III above). These investments, which the business has made in itself, are usually expensed and therefore are not carried as assets on the balance sheet and are not usually thought of as assets with separably determinable value. ("Costs of developing, maintaining, or restoring internally generated goodwill should not be capitalized." FASB Accounting Standards Update 350-20-05-4A (May 2019)). As we develop our ability to identify and value the intangible human and relational capital assets of businesses, then these intangible assets too can be moved out of "residual goodwill" to be recognized as assets of the business, reducing residual goodwill.

This "residual goodwill" must be subdivided in the context of divorce into "commercial goodwill" or "enterprise goodwill" on the one hand and "personal goodwill" on the other hand. In many states, upon divorce "commercial goodwill" or "enterprise goodwill" is part of the value to be divided in the property division, while "personal goodwill" is not.

E. THE LAW ON GOODWILL IN A DIVORCE. Joseph R. Wall, in *The Recognition and Valuation of Professional Goodwill in the Marital Estate*, 66 MARQ. L. REV. 697, 702 (1983),[24] wrote:

> A distinction must be drawn between commercial goodwill and professional goodwill. Commercial goodwill is that which inheres in a business and attaches to its assets. It includes the name, location, a reputation for honesty and fair dealing, and the individual talents and abilities of the members of the organization. The goodwill of a manufacturing corporation is commercial in nature. Professional goodwill, on the other hand, does not inhere in an organization or attach to its assets. Professional goodwill is personal in nature and inheres in an individual practitioner. Factors contributing to a professional practitioner's goodwill include his name, age, health, past earning power, reputation for skill, judgment and knowledge a well as his comparative success. [Footnotes omitted.]

Rethinking Our Approaches to Determining Divisible Goodwill Upon Divorce

According to Wall, the first appellate court to address the divisibility of personal goodwill on divorce was a Washington Supreme Court case, decided in 1927. *Id.* at 704. Wall wrote in 1983 that "[t]he issue of whether a court should recognize professional goodwill in a divorce proceeding is relatively new. Considering the number of practicing professionals, the issue has arisen quite infrequently. A majority of states have not yet decided the question."

In 1993, Professor Grace Blumberg wrote in *Identifying and Valuing Goodwill at Divorce*, 56 LAW & CONTEMPORARY PROBLEMS 217 (Spring 1993):[25]

> Goodwill is ... a highly charged and contested area, one in which ostensibly technical debate may mask fundamental differences about the desirability and optimal extent of family wealth distribution at divorce and therefore one in which technical obfuscation and error are as likely to be instrumental as accidental.

The article goes into some detail about various ways to measure goodwill, and the legal justifications for using them.

In many states enterprise goodwill (sometimes called commercial goodwill or professional goodwill) is divisible on divorce. In some states personal goodwill is divisible on divorce and in some states it is not. Part of the differences in law results from differences in meaning of the term "goodwill." The following discussion breaks the term "goodwill" down into components that can be more accurately discussed. Because some appellate cases use the term "professional goodwill" to mean the enterprise goodwill of a professional business, and other cases use the term "professional goodwill" to mean the personal goodwill of a professional, in order to avoid confusion this Article will not use the term "professional goodwill."

Kelly Schroeder, *Fair and Equitable Distribution of Goodwill in an Ohio Divorce Proceeding,* 31 U. DAYTON L. REV. 83, 87-88 (2005), evaluated the law of goodwill and divorce in 2005, and had this to say:

> There is a split among states regarding the treatment of goodwill in a divorce proceeding. Eight states, including Ohio, have not decided the issue, [FN22] while the remaining states follow one of the following three approaches. The majority position, and the position advocated in this article, holds that enterprise goodwill is marital property, but personal goodwill is separate property. [FN23] The minority position holds that all goodwill is marital property. [FN24] Lastly, four states hold that goodwill is never marital property. [FN25]
>
> [FN22]. Alabama, Georgia, Idaho, Iowa, Maine, Ohio, South Dakota, Vermont.
>
> [FN23]. Alaska, Arkansas, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, Utah, Virginia, West Virginia, Wisconsin, Wyoming. See Richmond, 779 P.2d 1211 (Alaska); Wilson, 741 S.W.2d 640 (Arkansas); Eslami, 591 A.2d 411 (Connecticut); E.E.C., 457 A.2d 688 (Delaware); McDiarmid, 649 A.2d 810 (D.C.); Thompson, 576 So. 2d 267 (Florida); Antolik, 761 P.2d 305 (Hawaii); Talty, 652 N.E.2d 330 (Illinois); Yoon, 711 N.E.2d 1265 (Indiana); Prahinski, 540 A.2d

833 (Maryland); Goldman, 554 N.E.2d 860 (Massachusetts); Sweere, 534 N.W.2d 294 (Minnesota); Singley, 846 So. 2d 1004 (Mississippi); Hanson, 738 S.W.2d 429 (Missouri); Taylor, 386 N.W.2d 851 (Nebraska); Watterworth, 821 A.2d 1107 (New Hampshire); Travis, 795 P.2d 96 (Oklahoma); Lankford, 720 P.2d 407 (Oregon); Solomon, 611 A.2d 686 (Pennsylvania); Moretti, 766 A.2d 925 (Rhode Island); Nail, 486 S.W.2d 761 (Texas); Sorensen, 839 P.2d 774 (Utah); Howell, 523 S.E.2d 514 (Virginia); Holbrook, 309 N.W.2d 343 (Wisconsin); May, 589 S.E.2d 536 (West Virginia); Root, 65 P.3d 41 (Wyoming).

[FN24]. Arizona, California, Colorado, Kentucky, Michigan, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Washington. See Wisner v. Wisner, 631 P.2d 115 (Ariz. App. Div. 1 1981); Lopez, 1974 Cal. App. LEXIS 1040 (California); Huff v. Huff, 834 P.2d 244 (Colo. 1992); Heller v. Heller, 672 S.W.2d 945 (Ky. App. 1984); Kowalesky v. Kowalesky, 384 N.W.2d 112 (Mich. App. 1986); Stufft v. Stufft, 950 P.2d 1373 (Mont. 1997); Ford v. Ford, 782 P.2d 1304 (Nev. 1989); Dugan, 457 A.2d 1 (New Jersey); Hurley v. Hurley, 615 P.2d 256 (N.M. 1980), overruled on other grounds; Moll v. Moll, 722 N.Y.S.2d 732 (N.Y. 2001); Poore v. Poore, 331 S.E.2d 266 (N.C. 1985); Sommers v. Sommers, 660 N.W.2d 586 (N.D. 2003); Hall v. Hall, 692 P.2d 175 (Wash. 1984).

[FN25]. Kansas, Louisiana, South Carolina, Tennessee. See Powell v. Powell, 648 P.2d 218 (Kan. 1982); Pearce v. Pearce, 482 So. 2d 108 (La. App. 4th Cir. 1986); Donahue v. Donahue, 384 S.E.2d 741 (S.C. 1989); Smith v. Smith, 709 S.W.2d 588 (Tenn. App. 1985). . . .

The Author commends a very fine article written by CPA Christopher E. Anderson, of Barr, Anderson & Roberts, PSC, 2335 Sterlington Road #100, Lexington, Kentucky, in 2012 for the Annual Convention of the Kentucky Bar Association. In his article *Goodwill Valuation in Marital Dissolution*,[26] Chris covers both BV theory and relevant case law.

The following list reflects the way various state appellate courts have dealt with goodwill for purposes of property division upon divorce. The cases reflect not only a conception of what constitutes goodwill, but also whether such goodwill is divisible. Where they occurred, descriptions of how goodwill should be valued are included.

Arizona

▸*Mitchell v. Mitchell*, 732 P.2d 208, 211-12 (Ariz. 1987): "We note that some jurisdictions hold that the goodwill of a professional partnership or proprietorship is not a divisible marital asset. . . . However, because the professional practice of the sole practitioner or partner will continue after dissolution of the marriage, with the same goodwill as it had during the marriage, we find that a refusal to consider goodwill as a community asset does not comport with Arizona's statutory equitable distribution scheme. We prefer to accept the economic reality that the goodwill of a professional practice has value, and it should be treated as property upon dissolution of the community, regardless of the form of business." [citations omitted].

Arkansas

▸*Wilson v. Wilson*, 741 S.W.2d 640, 646-47 (Ark. Sup. Ct. 1987): "The prevailing view appears to

be that goodwill of a professional practice or business is a business asset with a determinable value and is marital property, subject to division in a divorce proceeding. . . . Some jurisdictions, however, have held that professional goodwill does not constitute property and should not be considered as marital property divisible in such proceedings. . . . We . . . conclude that, for goodwill to be marital property, it must be a business asset with value independent of the presence or reputation of a particular individual--an asset which may be sold, transferred, conveyed or pledged. Thus, whether goodwill is marital property is a fact question and a party, to establish goodwill as marital property and divisible as such, must produce evidence establishing the salability or marketability of that goodwill as a business asset of a professional practice."

▸*Williams v. Williams*, 108 S.W.3d 629, 642-43 (Ark. App. 2003): "[F]or goodwill to be marital property, it must be a business asset with value independent of the presence or reputation of a particular individual. . . . To establish goodwill as marital property and thus be divisible, the party must produce evidence establishing the salability or marketability of that goodwill as a business asset of a professional practice. The Tortorich and Wilson cases confirm that the burden is on the party who seeks to establish goodwill as a marital asset to produce convincing proof delineating between professional goodwill on the one hand and personal goodwill on the other. . . . Mr. Schwartz admitted in his testimony that he did not attribute any value to Dr. Alonzo Williams' personal reputation. He stated that he '... didn't distinguish between the goodwill that developed between any personal and any professional. . . . Dr. Williams attributes his draw of patients to various factors. Specifically, he testified that he has a group of twenty to thirty physicians with whom he maintains regular contact and from whom he receives referrals. Dr. Williams contends that he receives much of his business based upon referrals. He testified that these referrals keep coming because the referring doctors are his personal friends and know that he will treat the patient well regardless of financial circumstances. Dr. Alonzo Williams testified that the racial makeup of his patient base is over 80% African American. Dr. Williams is one of the only two African American board certified gastroenterologists in Arkansas. The burden of proof is with the Plaintiff, not the Defendant, to delineate the facets of goodwill. The court finds that the Plaintiff has failed to do so.'"

▸*Brave v. Brave*, 432 SW 3d 42, 44 (Ark. Ct. App. 2013), *aff'd*, 433 S.W.3d 227 (2014): "Arkansas has not recognized personal goodwill in a non-professional business; however, under the unique facts of this particular case, we are extending the concept to [the restaurant] because Peter's presence is essential to the success of the restaurant."

▸*Brave v. Brave*, 433 S.W.3d 227, 233 (Ark. Sup. Ct. 2014): "Goodwill is characterized as corporate goodwill and marital properly, subject to division, if the evidence establishes the salability or marketability of the goodwill as a business asset."

California

▸*In re Marriage of Fortier*, 109 Cal.Rptr. 915, 918 (Cal. App. 1973): " the goodwill of respondent's medical practice was, in fact, community property. . . . [S]ince community goodwill may be evaluated by no method that is dependent upon the post-marital efforts of either spouse, then, as a consequence, the value of community goodwill is simply the market value at which the goodwill could be sold upon dissolution of the marriage, taking into consideration the expectancy of the continuity of the practice."

▸*In re Marriage of Foster*, 117 Cal.Rptr. 49, 53-54 (Cal. App. 1974): "The value of community goodwill is not necessarily the specified amount of money that a willing buyer would pay for such goodwill. In view of exigencies that are ordinarily attendant a marriage dissolution the amount obtainable in the marketplace might well be less than the true value of the goodwill. Community goodwill is a portion of the community value of the professional practice as a going concern on the date of the dissolution of the marriage. As observed in Golden, '. . . in a matrimonial matter, the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under the principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business."

▸*In re Marriage of McTiernan and Dubrow*, 35 Cal.Rptr.3d 287, 295 (Cal. App. 2005): "Personal property may be incorporeal . . ., i.e., without tangible substance, and it may be intangible in the sense that it is a right rather than a physical object. . . . But, even if incorporeal or intangible, property must be capable of being transferred. '[I]t is a fundamental principle of law that one of the chief incidents of ownership in property is the right to transfer it.'. . . 'A common characteristic of a property right, is that it may be disposed of, transferred to another. . . .' Husband's 'earning capacity and reputation in his profession as a motion picture director which greatly exceeds that of most persons involved in that profession' or, in the trial court's shorthand, his 'elite professional standing,' cannot be sold or transferred. His high standing among other motion picture directors is entirely personal to him. He cannot confer on another director his standing as No. 13 in cumulative box office revenues during 1985- 1996. He cannot sell this standing to another, because a buyer would not be John McTiernan, no matter how much the buyer was willing to pay. For the same reason, and unlike a law or medical practice, husband cannot transfer his 'elite professional standing.' That standing is his, and his alone, and he cannot bestow it on someone else. Thus, an essential aspect of a property interest is absent. The fact that husband's 'elite professional standing' is not transferable effectively refutes the trial court's conclusion that husband's 'practice' as a motion picture director is like the 'practice' of an attorney or physician. The practice of an attorney, physician, dentist, or accountant is transferable, but husband's 'elite professional standing' is his alone, and not susceptible to being transferred or sold."

▸*In re Marriage of Greaux & Mermin*, 223 Cal.App.4th 1242, 1250-1252 (2014): "It is our view that California's policy affirming that every person should have the right to pursue any lawful employment and enterprise of his or her choice is not undermined when a noncompetition order is imposed as part of a marital judgment, particularly as informed by the analogous statutory scheme governing noncompetition clauses. So, for example, noncompetition clauses are expressly permitted in connection with the sale or dissolution of a corporation (§ 16601), the dissolution of a partnership (§ 16602), or the sale [*1251] or dissolution of a limited liability corporation (§ 16602.5).[4] (*Edwards*, supra, 44 Cal.4th at pp. 943-944.) As a general rule, the "value" being protected by a noncompetition clause is the goodwill of the business. "Where a covenant not to compete is executed as an adjunct of a sale of a business there is an inference that the business had a 'goodwill' and that it was transferred." (*Monogram Industries, Inc. v. Sar Industries, Inc.* (1976) 64 Cal.App.3d 692, 701 [134 Cal.Rptr. 714].) Indeed, noncompetition agreements will not be enforced if a close examination of the purchase and sale agreement demonstrates that no goodwill was included in the sale. "In order to restrain the seller's profession, trade, or business, there must be a clear indication that in the sales transaction, the parties

valued or considered goodwill as a component of the sales price, and thus the ... purchasers were entitled to protect themselves from `competition from the seller which competition would have the effect of reducing the value of the property right that was acquired.'" (*Hill*, supra, 86 Cal.App.4th at p. 903.) Goodwill is often referred to as the expectation of continued patronage that has become an asset of the business. (*Id*. at p. 902, fn. 6.)

(2) In connection with the valuation of a business in a dissolution action, the court must decide whether the business has any goodwill, and if so, what is its value. (*In re Marriage of Lopez* (1974) 38 Cal.App.3d 93, 109 [113 Cal.Rptr. 58], disapproved on other grounds in *In re Marriage of Morrison* (1978) 20 Cal.3d 437, 453 [143 Cal.Rptr. 139, 573 P.2d 41].) "Essentially, goodwill in a dissolution context is a portion of the value of the [business] as a going concern. [Citation.]" (*In re Marriage of Rives* (1982) 130 Cal.App.3d 138, 149 [181 Cal.Rptr. 572] (Rives).) A family court's discretion in dividing marital property includes the authority to award a marital business to one spouse as a means to achieve equity in the division of property. (*In re Marriage of Kozen* (1986) 185 Cal.App.3d 1258, 1262 [230 Cal.Rptr. 304]; *In re Marriage of Burlini* (1983) 143 Cal.App.3d 65, 70 [191 Cal.Rptr. 541].) It therefore follows that, if an ongoing marital business is being awarded to one spouse, and if the value of that business includes goodwill, a family court should have the power, pursuant to Family Code section 2553, to issue a noncompetition order so that the value of that asset is preserved, just as a noncompetition clause in a business purchase and sale agreement is designed to protect the value of the asset purchased. Decisions from our sister states [*1252] are largely in accord.[5] (*Fischer*, supra, 834 P.2d 270; *Lord v. Lord* (Me. 1983) 454 A.2d 830 (Lord); *Holland v. Holland* (2001) 2001 WY 113 [35 P.3d 409]; *Cesar v. Sundelin* (2012) 81 Mass.App.Ct. 721 [967 N.E.2d 171] (Cesar); *Carr v. Carr* (1985) 108 Idaho 684 [701 P.2d 304] (Carr).)

Thus, for example, in *Carr*, the parties owned and operated a truckstop, which was primarily under the husband's management. After the separation, the husband chose not to purchase the wife's share of the business, so the truckstop was put up for sale. (*Carr*, supra, 701 P.2d at p. 307.) The prospective purchasers demanded a covenant not to compete in connection with the purchase; the husband refused to sign because he had planned to open a truckstop on property he owned adjacent to the truckstop being sold. (*Ibid*.) The court ordered the husband to execute the covenant so that the business could be sold. The husband did so, but challenged the order on appeal. (*Ibid*.) The court concluded the order was appropriate because, "[i]n effect, ... the magistrate was requiring that the goodwill of the truck stop business be sold along with the tangible assets and the accounts receivable." (*Carr*, supra, 701 P.2d at p. 308.) The court reasoned, "[g]iven the trial court's authority in a divorce action to order the sale of a community business to effectuate property disposition, the issue is whether a trial court may require a business's goodwill to be included in the sale. We hold that it may." (*Ibid*.)

This reasoning supports our conclusion that, as a general proposition, a party to a marital dissolution may be ordered not to compete where it is necessary to protect the value of a marital asset. We believe this rationale applies whether the business is sold to a third party or assigned to one of the spouses as an ongoing concern."

Colorado

▸*Huff v. Huff*, 834 P.2d 244, 256-58 (Colo. 1992): The district court selected a value based on the excess earnings method, which is a generally accepted method for determining the present value of

someone's interest in a business. *See In re Marriage of Bookout*, 833 P.2d 800, 804-805 (Colo. App. 1991) (affirming trial court's use of excess earnings approach); *Dugan v. Dugan*, 92 N.J. 423, 457 A.2d 1, 9 (1983) (adopting excess earnings approach in valuation of law practice for purposes of divorce proceeding); *In re Marriage of Hall*, 103 Wash.2d 236, 692 P.2d 175, 179-80 (1984) (trial court may consider various methods for valuing goodwill of spouse participating in partnership, including excess earnings method or formula in partnership agreement); Alan S. Zipp, *Divorce Valuation of Business Interests: A Capitalization of Earnings Approach*, 23 FAM.L.Q. 89, 102 (1989) (capitalization of excess earnings approach is one of the methods recommended by the American Institute of Certified Public Accountants and is a method relied on by the Internal Revenue Service to value a business for tax purposes). The excess earnings approach capitalizes the amount by which the attorney's historical earnings exceed that which an attorney with similar education, experience and capabilities earned during that period. *See Bookout*, at 803, 805; *Dugan*, 457 A.2d at 9. This method results in a valuation that represents the value of both the tangible assets and goodwill of the husband's partnership interest on the dissolution date. [FN14] *Zipp*, *supra*, at 91, 102. The excess earnings valuation method is an appropriate valuation in a dissolution proceeding because it provides the present value of the partnership interest to the participating spouse and 'avoids the problem of valuing a business on the basis of post-divorce earnings and profits.' *Id.* at 89, 102. . . .

"The husband also argues that the district court's use of the excess earnings method results in a 'double dipping' by the wife into the husband's income. The husband contends that the excess earnings approach converts his future income into property which is then divided between the spouses. He contends that "double dipping" occurs because that same future income is the source from which the wife's maintenance is paid. The husband contends that the wife receives double benefits from the same source: the husband's future income. We disagree.

"As stated above, the excess earnings approach is a valuation method which capitalizes the excess earnings based on a comparison of the husband's past earnings to the past earnings of an attorney in the same area with the same education, experience, and capabilities. Based on these historical earnings, this method provides a valuation which represents the present value of the husband's partnership interest. The excess earnings approach does not convert the husband's future income into property; on the contrary, it avoids valuing a business or partnership on the basis of postdivorce earnings and profits. *See Bookout*, at 804-805; *Zipp*, *supra*, at 102.

‣ *In re Marriage of Bookout*, 833 P.2d 800, 804-05 (Colo. Ct. App. 1992, cert. denied): Next, husband notes that, in capitalizing excess income, his future income stream is valued and divided as property. Therefore, he argues that basing an order of maintenance and child support upon the same income inequitably awards wife a double recovery. We disagree.

"The few courts that consider personal goodwill as nothing more than probable future earning capacity have concluded that goodwill is not a divisible marital asset. *See Kimbrough v. Kimbrough*, 228 Neb. 358, 422 N.W.2d 556 (1988); *Holbrook v. Holbrook*, 103 Wis.2d 327, 309 N.W.2d 343 (1981); *see generally* A.H. Rutkin, FAMILY LAW & PRACTICE § 37.05(1) (1991). However, this minority view is contrary to the law which we have adopted in this jurisdiction. *See In re Marriage of Nichols*, 43 Colo.App. 383, 606 P.2d 1314 (1979) (the value of goodwill incident to a practice is an asset acquired during the marriage).

"Furthermore, the value of goodwill which is to be determined at the time of dissolution is not synonymous with a spouse's expectation of future earnings. *In re Marriage of Lukens*, 16 Wash.App. 481, 558 P.2d 279 (1976); *In re Marriage of Fortier*, 34 Cal.App.3d 384, 109 Cal.Rptr. 915 (1973). *See also Dugan v. Dugan*, *supra* (future earning capacity per se is not goodwill). Such earnings are simply a factor which are considered to decide if goodwill exists, *In re Marriage of Lopez*, 38 Cal.App.3d 93, 113 Cal.Rptr. 58 (1974), and it is this latter asset that is valued and allocated between the parties to a dissolution. *Stern v. Stern*, 66 N.J. 340, 331 A.2d 257 (1975). Goodwill reflects not simply a possibility of future earnings, but a probability based on existing circumstances. *Dugan v. Dugan*, *supra*.

"In a dissolution of marriage proceeding, the value of goodwill should be measured by arriving at a present value based upon past results and not by accounting for the postmarital efforts of the professional spouse. However, the method of valuation that, as here, capitalizes the historical past earnings of the business at an appropriate capitalization rate to identify a value of the goodwill possessed by the business at the date of dissolution avoids the problem of valuing a business on the basis of post-dissolution earnings and profits. *See In re Marriage of Foster*, 42 Cal.App.3d 577, 117 Cal.Rptr. 49 (1974).

"Thus, a valuation on the basis of past earnings represents the advantage currently possessed by the business as shown by its historical ability to earn income in excess of that which would be earned if the owner had invested in tangible property and leased it to other businesses. Zipp, *Divorce Valuation of Business Interests: A Capitalization of Earnings Approach,* 23 FAM.L.Q. 89 at 109 & 111 (1989); see generally Udinsky, *Putting a Value on Goodwill*, 9 FAM.ADV. 37 (1986).

"Goodwill is a property or asset which supplements the earning capacity of another asset, a business, or a profession, and, therefore, it is not the earning capacity itself. *In re Marriage of Hall*, 103 Wash.2d 236, 692 P.2d 175 (1984). Hence, while both a practicing professional and a salaried professional bring an earning capacity comprised of skill and education to their positions, the goodwill directly supplements the earning capacity only of the practicing professional. *In re Marriage of Keyser*, 820 P.2d 1194 (Colo. App. 1991).

"Thus, we conclude that the identification, valuation, and division of husband's goodwill as a portion of his physical therapy practice did not divide husband's future income. Therefore, wife did not receive a double recovery.

▸*In re Marriage of Fischer*, 834 P.2d 270, 272 (Colo. App. 1992): "The husband does not appeal the court's valuation of the business; rather, he asserts that the trial court does not have the authority to order him to enter into a covenant not to compete. We disagree.

"The mechanism employed by the trial court for dividing the marital property is a matter within its discretion. *In re Marriage of Dickey*, 658 P.2d 276 (Colo.App. 1982). * * *

"Husband's expert agreed that a noncompetition agreement was a necessary part of the court's division of the business and also testified that the lack of a noncompetition agreement would substantially reduce the value of the business.

"Thus, we conclude that the transfer of a business interest to one spouse as part of the disposition

of property in a dissolution action is analogous to a sale of the business and, therefore, falls within the exception of § 8-2-113(2)(a)."

Connecticut

‣ *Eslami v. Eslami*, 591 A.2d 411, 418-19 (Conn. Sup. Ct. 1991): "It can hardly be doubted that the increment of value, loosely termed goodwill, that arises from the established reputation of a business for the quality of its goods or services may often be found to enhance the value of professional as well as other enterprises by increasing their ability to attract patrons. Relatively few courts have wholly rejected consideration of the goodwill of a professional practice in determining the value of the property held by the parties in a dissolution action. . . . Several courts have recognized that the goodwill of an established practice may have value, but disapprove of the capitalization of excess earnings method of valuation, insisting upon evidence of value based on comparable sales or partnership withdrawal agreements. . . . We agree with the cases that recognize that goodwill may constitute an element of value distinct from the tangible assets of a medical practice. Its value, however, must be determined on the basis of the price that a willing buyer would pay in excess of the tangible assets to acquire the practice. Obviously, the most persuasive evidence of such value would be prices obtained in comparable sales of similar medical practices, if sufficient information of that kind can be found. We reject the notion that professional goodwill may be evaluated without consideration of the saleability of the practice and the existence of a market for its purchase. . . . To the extent that the goodwill of the practice cannot be detached from the personal reputation and ability of the practitioner through a sale, it cannot be said to have any significant market value, even though it may enhance the earning power of the practitioner so long as he continues to work in the same community. '[I]f goodwill depends on the continued presence of a particular individual, such goodwill, by definition, is not a marketable asset distinct from the individual.' *Taylor v. Taylor*, *supra*, 222 Neb. at 731, 386 N.W.2d 851. A valuation method that does not differentiate between the goodwill of the practice as a saleable entity and the practitioner's own earning power as enhanced by such goodwill may well result in counting the same basis for a financial award in dissolution cases twice, once as an asset of his estate subject to allocation and again, as a component of his earning capacity forming the basis for alimony. In theory, at least, the capitalization of excess earnings method of evaluating goodwill seeks to determine the price a prospective purchaser would pay to acquire the stream of income in excess of the amount he would expect to earn by engaging in the profession through other avenues. In economic terms, if radiologists were so scarce that the demand for such services overwhelmed the supply, there would be little advantage in buying an established practice at a substantial price for the goodwill component rather than establishing a new practice. The supply-demand relationship is theoretically reflected in both components of the capitalization formula, the determination of excess earnings and the capitalization factor. Thus the formula is related to market value, but provides an alternative to the comparable sales method for determining that value. The difficulty lies not in the theory but in its application, particularly with respect to the basis for calculating the amount of excess income and selecting the capitalization rate. Although evidence of comparable sales would ordinarily be more persuasive, we hold that capitalization of excess income is a permissible method for determining the value of the goodwill of a professional practice, despite difficulties in its application. We have previously approved the capitalization of projected net income as a permissible accounting technique for determining the value of a closely held corporation characterized as a 'one-man' business." [Citations omitted]

District of Columbia

‣*McDiarmid v. McDiarmid*, 649 A.2d 810, 814-15 (D.C. Ct. App. 1994): "As the District of Columbia has not heretofore addressed the question of whether professional goodwill is subject to distribution upon dissolution of marriage, we have examined the cases of our sister jurisdictions and considered how they have addressed and resolved this issue. We found that '[t]here is no specific consensus as to a definition of professional goodwill, whether a sole practitioner of any profession can have goodwill, or what method or methods should be used to value professional goodwill.' *Thompson v. Thompson*, 576 So.2d 267, 269 (Fla.1991). The jurisdictions are divided as to whether professional goodwill in a law practice may be marital property subject to distribution upon dissolution of marriage. A number of courts have concluded that professional goodwill in a law practice is not property subject to equitable distribution. These courts have concluded that the concept of goodwill is indistinguishable from future earning capacity and thus too remote and speculative to be valued. . . . A majority of the jurisdictions has concluded, however, that professional goodwill is marital property subject to equitable distribution. These courts classify goodwill as marital property because '[t]o hold otherwise would result in a windfall to the professional spouse.' . . . We adopt the majority view that goodwill of a professional practice acquired during a marriage is marital property subject to valuation and distribution. . . . We also recognize, however, that 'under the facts of a given case, a professional practice may have no goodwill value . . . , and that a case-by-case inquiry into valuation is preferable in these cases.'"

Florida

‣*Thompson v. Thompson*, 576 So.2d 267, 270 (Fla. Sup. Ct. 1991): "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 and reputation 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." [Footnote omitted]

‣*Young v. Young*, 600 So.2d 1140 (Fla. App. 5th Dist.), *rev. denied*, 613 So.2d 13 (Fla. 1992): valuation of the PA of a solo medical doctor was reversed. One expert testified that "excess earnings" represented non-divisible goodwill. The other expert said half the prior year's production was "a good rule of thumb for determining goodwill." The appellate court found a complete absence of evidence of value apart from personal goodwill, and rendered judgment that the business had no value divisible value.

‣*Weinstock v. Weinstock*, 634 So. 2d 775 (Fla. App 5th Dist. 1994): improper to use as comparables businesses that sold where the seller remained with the business after the sale. Property division reversed. Dissenting Justice disagreed, citing *In Matter of Marriage of Fleege*, 91 Wash.2d 324, 588 P.2d 1136 (1979).

‣*Walton v. Walton*, 657 So. 2d 1214 (Fla App. 4th Dist. 1995): where CPA husband was the only name on the door, and when wife's expert admitted that no one would buy the business without a covenant not to compete, there was no evidence of goodwill that was not personal. Divorce reversed.

‣*Hough v. Hough*, 793 So.2d 57 (Fla. App. 2nd Dist. 2001): appellate court refused to discredit BV expert's opinion that substantial personal goodwill existed in vending machine business. However, the valuation was reversed because the expert assumed the loss of certain custody accounts when discounting for personal goodwill while at the same time increasing the discount rate in his income

approach due to the risk of losing those same accounts. The appellate court found that was double-counting the same risk, and reversed.

▸*Erp v. Erp*, 976 So. 2d 1234, 1237 (Fla. App. 2nd Dist. 2008) (involving marketability discount): "The decisions that judges make when valuing businesses in the context of a divorce are fact-intensive and usually heavily dependent upon the opinions of well-trained experts. The question is not whether the trial court can employ one method or another in valuing a business, but is more appropriately phrased as whether an expert may be permitted to testify and render an opinion based upon a valuation method that the expert claims to be acceptable within his or her profession. If the expert is permitted to so testify, then the trial court, as a finder-of-fact, should have considerable discretion in deciding to what extent it accepts or rejects the expert testimony."

▸*Schmidt v. Schmidt*, No. 4D11-3379 (Fla 4th Dist. 2013): wife's expert valued business at $3,519,519, less $974,199 in personal goodwill. Wife's expert said this value assumed that husband signed a covenant not to compete. "Because the $2,520,562 value requires execution of a non-compete agreement, it is clear that such valuation still includes a personal goodwill component. This personal goodwill must be excised from the value assigned to the business for purposes of equitable distribution." Property division reversed.

▸*Shaver v. Shaver*, 793 So.2d 57 (Fla. App. 2nd Dist. 2016): "The wife argues that the trial court erred in determining that $3,550,000 of the value of the husband's business represented personal goodwill constituting nonmarital property not subject to equitable distribution. Contrary to the wife's assertions, the trial court's valuation of the personal goodwill of the husband's business was supported by competent, substantial evidence and we affirm the trial court's valuation of this asset."

▸*King v. King*, 313 So.3d 887 (Fla. 1st Dist. 2021): "To determine the amount of a party's personal goodwill that should be excluded from the valuation of a business, "the evidence should show recent actual sales of a similarly situated practice, or expert testimony as to the existence of goodwill in a similar practice in the relevant market." See Williams v. Williams, 667 So. 2d 915, 916 (Fla. 2d DCA 1996). Here, the trial court adopted the goodwill valuation from Former Wife's expert, Gray. Gray estimated that Former Husband's personal goodwill was 7.3% of KIA's fair market value.

"In reaching the 7.3% figure, Gray relied on data from the DealStats database. In some of the transactions, the database allowed the parties to the transaction to report the value of a covenant not to compete from selling an insurance company. Because the reporting parties valued most of the non-compete covenants at less than 10% of the business transaction, Gray took the average values from the transactions to come up with the 7.3% he assigned to Former Husband's personal goodwill in KIA. But Gray did not provide any specific knowledge about the particulars of the insurance businesses that reported transactions in the DealStats database. Gray did not disclose whether the owners of those businesses also sold insurance (as Former Husband did), how involved the owners of those businesses had been with the companies, or anything about the day-to-day operations of those businesses. And the record showed that many transactions Gray analyzed took place outside Florida, with some dating back almost twenty years.

?For these reasons, Gray's analysis of the selected DealStats transactions and the reported values of the related noncompete clauses do not provide competent evidence to support the trial court's

determination of the amount of Former Husband's personal goodwill in KIA. This is particularly true where the record shows that Former Husband is the CEO of KIA, its largest producer of revenue, and remains involved in all aspects of the business. See Weinstock v. Weinstock, 634 So. 2d 775, 778 (Fla. 5th DCA 1994) (finding no competent evidence when none of the expert's comparables included a situation in which a selling professional did not remain with the buyer in the conduct of the professional practice for a period after the sale); see also Held v. Held, 912 So. 2d 637, 640-41 (Fla. 4th DCA 2005) (finding that former husband's personal relationship with his clients allowed him to obtain their repeat business, and that the court erred in adopting a value that ignored personal relationships). Because the trial court's goodwill determination is not supported by competent evidence, we reverse on this issue, too."

Illinois

▸*In re Marriage of Talty*, 652 N.E.2d 330, 334 (1995): "To the extent that goodwill inheres in the business, existing independently of William's personal efforts, and will outlast his involvement with 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 William, depends on his efforts, and will cease when his involvement with the dealership ends, it should not be considered property. "

▸*In re Marriage of Alexander*, 368 Ill. App. 3d 192, 196, 857 N.E.2d 766, 769 (2006): "On appeal, James does not challenge Wood's qualifications as an expert. James also does not contend that Wood's testimony would not aid the trier of fact in understanding the evidence. *See In re Marriage of Jawad*, 326 Ill.App.3d 141, 152, 259 Ill.Dec. 941, 759 N.E.2d 1002 (2001) (expert testimony is generally admissible if the testimony aids the trier of fact in understanding the evidence before it). James's argument is simply that Wood's methodology, the multiattribute utility theory, which Wood used to determine that approximately two-thirds of the total goodwill in James's medical practice consists of enterprise goodwill, is a novel scientific methodology not accepted by the relevant scientific community and that therefore his opinion derived from this methodology is inadmissible under *Frye*....
***
"[T]he circuit court's order directly contradicts James's assertion that the circuit court failed to consider a covenant not to compete. In discussing goodwill, the order specifically states that if James "was a willing seller, not going into competition with a willing buyer, there is a value to the business which generates the income shown." (Emphasis added.) It is apparent to this court that the circuit court did consider a covenant not to compete in valuing James's medical practice.

"In addition, to the extent that the circuit court based its valuation of James's medical practice on Wood's testimony, the record reveals that in reaching his conclusion Wood also considered a covenant not to compete. Although Wood testified that he did not assign a specific value to a covenant not to compete, his valuation assumed that a covenant not to compete would exist between the buyer and the seller of James's medical practice. Wood testified that similar transactions almost always include a covenant not to compete. Our review of Wood's testimony convinces us that Wood assumed a covenant not to compete when deriving his valuation. Indeed, Wood acknowledged that his valuation of goodwill in the medical practice would decrease if a covenant not to compete did not exist. Wood specifically testified that the value he assigned to personal and enterprise goodwill would 'be greatly diminished' absent a covenant not to compete.'" *Id*. at 203, 775.

Indiana

▸*Yoon v. Yoon*, 711 N.E.2d 1265, 1268-69 (Ind. Sup. Ct. 1999): "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 or 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.' Enterprise goodwill 'is based on the intangible, but generally marketable, existence in a business of established relations with employees, customers and suppliers.' Allen Parkman, *The Treatment of Professional Goodwill in Divorce Proceedings*, 18 FAM. L.Q. 213, 215 (1984). Factors affecting this goodwill may include a business's location, its name recognition, its business reputation, or a variety of other factors depending on the business. Ultimately these factors must, in one way or another, contribute to the anticipated future profitability of the business. Enterprise goodwill is an asset of the business and accordingly is property that is divisible in a dissolution to the extent that it inheres in the business, independent of any single individual's personal efforts and will outlast any person's involvement in the business. . . . It is not necessarily marketable in the sense that there is a ready and easily priced market for it, but it is in general transferrable to others and has a value to others."

Kansas

▸*Powell v. Powell*, 648 P.2d 218, 223-24 (Kan. Sup. Ct. 1982): " The question of whether this court should adopt the theory that good will of a professional practice is a marital asset to be divided at divorce is, in the final analysis, a public policy issue. . . . We are not persuaded a professional practice such as Dr. Powell's has a good will value. The practice is personal to the practitioner. When he or she dies or retires nothing remains. The professional's files and lists of clients are of no use to others. The very nature of a professional practice is that it is totally dependent upon the professional. We refuse to adopt the theory that good will in a professional practice is an asset subject to division in a divorce action."

Kentucky

▸*Clark v. Clark*, 782 S.W.2d 56,59-60 (Ky. App. 1990): "This Court, in *Helle*r, *supra*, specifically ruled that the goodwill contained in a business or professional organization is a factor to be considered in arriving at the value of the practice. This Court explained goodwill in *Heller*. Specifically, professional practices that can be sold for more than the value of their fixtures and accounts receivable have goodwill. *Heller*, *supra*, at 948. Goodwill in essence is the expectation that patrons or patients will return because of the reputation of the business or firm. This goodwill has specific pecuniary value. Goodwill has also been defined as the excess of return in a given business over the average or norm that could be expected for that business. *Hanson v. Hanson*, 738 S.W.2d 429 (Mo.1987). The age, health and professional reputation of the practitioner, the nature of the practice, the length of time the practice has been in existence, past profits, comparative professional success, and the value of its other assets, are all factors of goodwill. *Poore*, *supra*. It is the growing trend of courts in this country to consider goodwill in valuing a corporation. . . . Thus, the trial court was correct in considering goodwill.

"The trial court in the case at bar adopted a capitalization of excess earnings method for evaluating the goodwill of this professional corporation. Under this method, the goodwill value is based in part on the amount that the earnings of the professional spouse exceed those which would have been earned by a professional with similar education, experience, and skill as an employee in the same general area. *Poore*, *supra*, 331 S.E.2d at 271. Specifically, four steps are involved in the capitalization of excess earnings method. First, the court must ascertain what a professional of comparable experience, expertise, education and age would be earning as an employee in the same general locale, determine and average the professional's net income before federal and states income taxes for a period of approximately five years, compare the actual average with the employee norm, and multiply the excess by a capitalization factor. *Taylor v. Taylor*, 222 Neb. 721, 386 N.W.2d 851 (1986). Dr. Mackin, the appellee's expert who calculated the value of the goodwill, used these same steps outlined above. He specifically concentrated on a three-year period of Dr. Clark's earnings. He used a survey of doctors in appellant's OB-GYN specialty who had been surveyed by the American Medical Association. Dr. Mackin used a weighted multiplication factor to gain results that closely correlated with the methods used in the survey. Contrary to appellant's assertion, the method involves calculating the professional's past earnings, not future earnings. There is no indication from the evidence in the case at bar that the trial court incorrectly applied the capitalization of excess earnings method. The findings correctly show the true value of the corporation's goodwill.

"The capitalization of excess earnings method is a widely accepted method and the most often used. *Taylor*, *supra*, 386 N.W.2d at 857; *Poore*, *supra*, 331 S.E.2d at 271; *Levy*, *supra*, 397 A.2d at 380. There are a number of acceptable methods which courts may adopt. There is no definitive rule or best method for valuing goodwill. *Poore*, *supra*; *Hurley v. Hurley*, 94 N.M. 641, 615 P.2d 256, 259 (1980). The determination of goodwill is a question of fact rather than law, and each case must be determined on its own facts and circumstances. *Poore*, *supra*, *Hurley*, *supra*. Thus, the trial court was correct in adopting and applying the capitalization of excess earnings method."

▸*Gomez v. Gomez*, 168 S.W.3d 51, 56 (Ky. App. 2005): "In this case the trial court found the practice of Bluegrass Radiology with respect to those physicians entering or exiting the practice to be significant. Eduardo testified and submitted affidavits from other physicians who had left the practice that when a physician joined or left the group an evaluation of the current accounts receivable was done. Based on that value a physician entering or leaving the practice had to pay or was paid a percentage of the accounts receivable value. No calculation for goodwill was included. The trial court found this evidence to be persuasive along with evidence that when the group had discontinued its practice at another hospital it did not receive any payment for goodwill. The description of how the practice had historically valued itself is, in essence, a buy-sell agreement. And while buy-sell agreements or corporate by-laws have been rejected as the basis for valuing a professional practice where this would not accurately reflect the value of the business, *Clark*, *supra* 782 S.W.2d at 60, they may be used as a factor in reaching a determination regarding the value of a professional business. . . . And while we would have reached a different conclusion on the evidence presented in this case, the trial court's determination that no goodwill existed because of the historical way in which the practice valued itself is supported by substantial evidence."

▸*Gaskill v. Robbins*, 282 SW 3d 306, 314-15 (Ky. Sup. Ct. 2009): "In this first look at the subject, this Court finds the reasoning of *Yoon* and *May* to be compelling. The distinction between enterprise and personal goodwill has a rational basis that accepts the reality of specific business situations. In

a case such as this one, there can be little argument that the skill, personality, work ethic, reputation, and relationships developed by Gaskill are hers alone and cannot be sold to a subsequent practitioner. In this manner, these attributes constitute nonmarital property that will continue with her regardless of the presence of any spouse. To consider this highly personal value as marital would effectively attach her future earnings, to which Robbins has no claim. Further, if he or someone similarly situated were then awarded maintenance, this would amount to "double dipping," and cause a dual inequity to Gaskill. On the other hand, if she were willing to leave her name on the practice, such as "Gaskill's Oral and Maxillofacial Surgery,"" even though she herself did not continue to practice, there arguably could be some reputational reliance that she would stand behind the quality of the practice which could have some pecuniary value. Such scenarios do occur, but this is not the case here. ¶ Additionally, this type of distinction is as susceptible to expert valuation as goodwill on the whole is. If the value of goodwill can be reasonably determined at all, the amount of enterprise goodwill, which is all that can be considered as marital property, can be determined. ¶ Therefore the trial court erred in failing to consider personal and enterprise goodwill."

▸*King v. King*, Nos. 2007-CA-002149-MR, 2007-CA-002199-MR (Ky. App. October 30, 2009): "The value of Dr. King's medical practice was vigorously litigated by the parties and remains a subject of controversy in this appeal. Both parties presented expert testimony. Mr. York, Dr. King's expert, valued the practice at $636,000, and Terry Walker, Karen's expert, valued the practice at $1,013,000. The circuit court was persuaded by Karen's expert and valued the practice accordingly. Dr. King alleges that his expert offered the more accurate opinion because he considered two factors significant to his valuation: The hours worked by Dr. King and the shortage of OB/GYNs in the Daviess County area.

"The data collected by the two experts, and therefore that upon which their opinions were based, substantially differ. Karen's expert based his opinion upon information provided by 1,567 practicing OB/GYNs from across the country to an organization known as MGMA. Based on the data collected, Mr. Walker determined what a professional with Dr. King's experience, expertise, education and age could earn in the Daviess County area. Using the capitalization of excess earnings method, Mr. Walker determined the goodwill of the medical practice by dividing the excess earnings by the capitalization rate. After adjusting for taxes on ordinary income, he concluded that the value of the medical practice was $1,013,000, including $797,841 of goodwill.

"In contrast to the data offered by the 1,567 physicians used by Mr. Walker, Dr. King's expert, Mr. York, relied upon data offered by one local OB/GYN, referred to as the 'Peer Doctor.' Mr. York stressed that the Daviess County area had a shortage of OB/GYNs and, as a result, Dr. King worked 15.4 percent more than the Peer Doctor, or 100 hours per week. He then adjusted Dr. King's earnings by $214,000, representing the excess hours worked and compensated. He valued the practice at $636,000. The difference in the value offered by Mr. York was his reduction in the goodwill attributable to Dr. King's extensive work hours and the shortage of OB/GYNs in the area.

***

"In the present case, no distinction was made between enterprise and personal goodwill. Based on the testimony of both experts, Dr. King's higher than average income was the result of his work ethic and dedication, personal assets that are neither transferrable to others nor have a value to others. ...[A]ny amount attributable to personal goodwill, including that attributable to Dr. King's work hours in excess of the norm in the profession, must be excluded when valuing the medical practice for the purpose

of dividing the marital property."

▸*Monaco v. Stewart*, No. 2009 CA-001193-MR (Ky. Ct. App. April 8, 2011): " we do not find *Gaskill* applicable to the facts herein. Raymond had a 25% interest in an anesthesia practice that operated throughout central and eastern Kentucky. Unlike *Gaskill*, where the skills and reputation of a single individual were at issue, the value and reputation of DMS would be based upon the whole of the practice. *** Quite simply, we are of the opinion that any analysis of Raymond's personal goodwill, separate from the enterprise goodwill of DMS, was negligible and its removal from consideration by the trial court did not affect the overall calculation of business value."

Louisiana

▸*Pearce v. Pearce*, 482 So.2d 108, 111 (La. App. 1986), *writ denied*, 484 So.2d 140 (La..1986): "Goodwill does not form a part of the corporate assets of a sole medical practitioner. Depner v. Depner, 478 So.2d 532 (La. App. 1st Cir.1985). The Depner court specified, and we agree:

"Professional medical competence is personal to the physician and cannot be attributed to the corporation because it is a personal relationship between physician and patient, not between corporation and patient. Since goodwill must adhere to some principal property or right it is therefore dependent upon the property or right of either the corporation or the individual or both. In examining the goodwill in this case we find that it exists independent of the corporation. Absent the corporation it exists, absent the physician it does not exist. Therefore it is not an asset of the corporation. The corporation may profit from this relationship but it cannot share in it. The corporation cannot share in a personal relationship between physician and patient.

"There is no basis on these facts to support Mrs. Pearce's concept and claim for corporate professional goodwill. Dr. Pearce's future earnings have no present value susceptible of partition as a community asset. Mrs. Pearce is not entitled to equity in her ex-husband's potential earnings by claiming one-half as goodwill."

▸*Rao v. Rao*, 2005 WL 2898066,*15 (La. App. 2005): "The evidence clearly supports the conclusion that the hypothetical value postulated by Mrs. Rao's expert accountant was largely based upon goodwill attributable to the personal qualities and patient relationships of Dr. Rao and his fellow stockholder physicians using the corporate facilities as part of their professional practice. Although Louisiana Endoscopy Center, Inc. is not a professional medical corporation per se, we conclude it was intended by the parties to be an extension of a professional medical practice group in accordance with the federal "safe harbor" regulations. It is inappropriate to use such goodwill attributable to Dr. Rao in the valuation of community corporate stock. . . . Although the issue has not been specifically addressed by the legislature and seems to be res nova, we conclude it is likewise inappropriate to incorporate goodwill attributable to the personal, professional qualities of the other physician stockholders in such valuation." [Footnote omitted]

Maryland

▸*Prahinski v. Prahinski*, 582 A.2d 784, 787-88 (Md. Sup. Ct. 1990): "Because the question of whether professional goodwill is marital property is one of first impression in Maryland, we found it beneficial

to review the decisions of the courts of other states which have addressed the issue. This review revealed three positions. The view most often followed treats goodwill as marital property in all cases.] The next largest group considers goodwill to be personal to the practitioner, and therefore not marital property. Finally, a small group of states requires a case-by-case examination to determine how goodwill should be treated. It is interesting to note that the classification of a jurisdiction as a community property state or an equitable distribution state is not determinative of its treatment of goodwill. . . . After reviewing these three alternatives and the rationale of their respective supporting cases, we are of the opinion that the goodwill of a solo law practice is personal to the individual practitioner. Goodwill in such circumstances is not severable from the reputation of the sole practitioner regardless of the contributions made to the practice by the spouse or employees. In order for goodwill to be marital property, it must be an asset having a separate value from the reputation of the practitioner. We are not convinced that the goodwill of a solo law practice can be separated from the reputation of the attorney. It is the attorney whose name, whether on the door or stationery, is the embodiment of the practice. We are cognizant that in this computer age many law practices, and in Leo's practice in particular, much of the research and "form" work is done by nonlawyers. In the final analysis, however, it is the attorney alone who is responsible for the work that comes out of the office. Rule of Professional Conduct 5.3(c). In the instant case, the responsibility is solely Leo's, and no amount of work done by Margaret will shift the responsibility to her. The attorney's signature or affidavit places his seal of approval on the work being done and makes the attorney liable for its accuracy and authenticity. This professional assurance is what might have convinced some clients to use Leo F.X. Prahinski, Attorney-at-Law, instead of going to a title company to have their settlements completed. The assurance would end should Leo somehow remove himself from the practice. Therefore, the goodwill generated by the attorney is personal to him and is not the kind of asset which can be divided as marital property.

▸*Skrabak v. Skrabak*, 673 A. 2d 732 (Md. Ct. Spec. App. 1996): the appellate court discredited valuation approaches which allocated between personal and enterprise goodwill of an anaesthesiologist's practice on an arbitrary basis, and reversed the property division. The court rejected the excess earnings approach without proof of enterprise goodwill. The court also noted the expert's testimony that the selling doctor would have to remain with the practice for some time to "get top value." *Id.* at 730.

Massachusetts

▸*Goldman v. Goldman*, 554 N.E.2d 860 (Mass. Ct. App. 1990): "We reject the wife's most significant claim of error in valuation, the failure of the judge to allocate any amount to the goodwill of the husband's professional corporation. The judge was warranted in accepting the husband's accountant's opinion that there was no goodwill in this one-man professional corporation. For a discussion of the classification of professional goodwill, see generally Gregory, The Law of Equitable Distribution § 6.03 (1989)."

▸*Champion v. Champion*, 764 N.E.2d 898 (2002): "Whether a business takes the form of a corporation, partnership, or sole proprietorship, does not affect the valuation method that a court may use even though some methods may better lend themselves to particular types of business associations. See 2 McCahey, VALUATION AND DISTRIBUTION OF MARITAL PROPERTY § 22.08, at 22-102 & 22-103 (2001). The willing buyer/willing seller test is used to determine the fair market value of a sole proprietorship for Federal estate and gift tax purposes, see id. at § 24.07[2], and the guidelines established for such purposes are relevant in divorce litigation. [FN5] See 2 Budd & Zupcofska, MASSACHUSETTS DIVORCE LAW PRACTICE MANUAL § 14.4, at 14-23 (MCLE 2000). In the absence of a determinable

market value, experts commonly value a closely held business by the assignment of value to the assets of the business, as was done here (inventory and receivables less liabilities), and by the capitalization of earnings. See Kindregan & Inker, FAMILY LAW & PRACTICE § 45.8, at 275 (2d ed.1996)."

▸*Sampson v. Sampson*, 369, 816 N.E.2d 999, 1007-08 (Mass. Ct. App. 2004): "In the instant case, unlike Champion v. Champion, supra, a capitalized income method was utilized by both parties' experts in valuing the wife's business. Such a method requires subtraction from business income of a reasonable salary expense for the operator of the business. . . . Without subtraction of a sum representing a reasonable salary, there is significant concern that the business may be overvalued. Moreover, where such a salary is subtracted, it facilitates the identification of those portions of a given asset providing separate bases of property assignment and alimony as articulated by *Dalessio v. Dalessio*, *supra*.

"Here, however, the expert whose testimony was credited by the judge did not adjust directly for the owner-operator's salary. Rather, while recognizing that an owner-operator's salary should be subtracted, the expert did not do so. Instead, the expert deducted the salary of the business's sole employee other than the wife, a customer services representative whose much lower annual salary had ranged from $17,532 to $23,264 over a five year period. Without explanation in his report, the expert concluded that the customer services representative's salary was an appropriate salary for a "part-time owner." The expert also summarily concluded that the part-time owner could do the work of the customer services representative as well as her own.

"Read closely, other parts of the report raise significant questions about the appropriateness of the smaller salary deduction. For example, the expert recognizes only that it "may be possible" to replace the owner, but not with someone with the owner's familiarity with the agency's operations. The expert's report is also inconsistent. On the one hand, it emphasizes the value of the two-person operation, particularly in terms of its ability simultaneously to maintain its high quality service, market to new customers, and position the agency for future growth; on the other hand, it finds that one part-time owner can perform all these functions for the small salary of the current customer services representative. The judge does not address these critical and questionable aspects of the expert's valuation. *See Redding v. Redding*, 398 Mass. 102, 108, 495 N.E.2d 297 (1986) ("Any failure in the decision-making process to consider and explain the effect of an important fact may require reversal of the judgment in order to permit consideration and explanation of the omitted subject"). The judge simply accepted the $175,000 valuation and assigned the husband $175,000 from the proceeds of the house to offset the value of the wife's business.

"Furthermore, when considering the wife's income for the purposes of determining her need for support, the judge made no adjustments, concluding that she would earn $41,912 a year. The $41,912 was based on what she was earning from the business without recognizing that some of that income had been attributed to the value of the business itself. For that additional income, the husband had already been compensated by providing him with an otherwise disproportionate share of the proceeds from the sale of the house. *See Murphy v. Murphy*, 6 A.D.3d 678, 775 N.Y.S.2d 370 (2004). *Cf. Rattee v. Rattee*, 146 N.H. at 47-48, 767 A.2d 415. Concerns are thereby raised that either the value of the business was inflated by artificially deflating the salary of the owner-operator or, conversely, that the wife's income was inflated when determining her need for support."

Michigan

‣*Kowalesky v. Kowalesky*, 384 N.W.2d 112 (Mich. App. 1986): "We believe that neither Revenue Ruling 59-60 nor any other single method should uniformly be applied in valuing a professional practice. Rather, this Court will review the method applied by the trial court, and its application of that method, to determine if the trial court's valuation was clearly erroneous. [FN1] . . .FN1. Our discussion should not be read as prohibiting trial courts from using Revenue Ruling 59-60 in their decisions if they find it helpful or as prohibiting parties from using it in presenting their cases. Since the trial court in the case at bar did not apply the ruling, we need not decide if doing so is erroneous. We only conclude that use thereof is not required."

‣*Conger v. Conger*, 2000 WL 33388397, *1-2 (Mich. Ct. App. 2000) (unpublished opinion): "The holder's interest method is utilized in divorce proceedings to quantify the present value of a business to its proprietor. One commentator described this valuation method as follows: Applying the holder's interest measure of value to a personal service business such as a professional practice is simply an extension of the principles of case specific valuation commonly used by trial courts in dividing marital assets under equitable distribution principles. Stripped to its core, the holder's interest value means that: (1) If an interest in a personal service business is worth considerably more to the owner (a) under the assumption that he or she will continue to operate the business--and accordingly, continue to reap the financial benefits it provides, than (b) assuming the owner will sell the business to a third party ... (2) then the appropriate value for divorce settlement purposes, that is, for determining the offsetting amount of cash or value of other property for the nonowner spouse, is the value to the owner, not the lower [fair market value].... [A]doption of the holder's interest measure of value simply brings into conformity the valuation of personal service businesses with the way most other marital assets have been valued for years. [Cunningham, *Equitable Distribution and Professional Practices: Case Specific Approach to Valuation*, 73 MICH. B. J. 666, 667 (July 1994).] In the present case, the circuit court recognized its own discretion in choosing the valuation method to apply. The court exercised that discretion by choosing the holder's interest method, reasoning that the closely held corporation was worth more to defendant than the fair market value of the business, based on the assumption that defendant would continue to operate the business after the parties' divorce. . . . Defendant next argues that proper application of the holder's interest method requires the circuit court to distinguish between personal and business goodwill. Although defendant acknowledges that no Michigan court has ever distinguished between business and personal goodwill, he urges this Court to accept the holdings of various foreign jurisdictions and to recognize a distinction between personal and business goodwill for the purpose of business asset valuations. Because defendant failed to raise this issue before the trial court, it is unpreserved for appeal. Further, we are unpersuaded of the need to adopt a distinction between personal and business goodwill, for purposes of valuing business assets in the context of a divorce action."

Mississippi

‣*Singley v. Singley*, 846 So.2d 1004, 1010 (Miss. 2002): "We join the jurisdictions that adhere to the principle that goodwill should not be used in determining the fair market value of a business, subject to equitable division in divorce cases."

‣*Watson v. Watson*, 882 So.2d 95, 105 (Miss. 2004): "A close reading of our opinion in *Singley* reveals that we have not explicitly addressed any distinction between 'personal goodwill' and 'business enterprise goodwill,' although we did note that other jurisdictions recognize both. *Singley*, 846 So.2d

at 1010 n. 2.... We now hold that, although there is a distinction between 'personal goodwill' and 'business enterprise goodwill,' neither should be included in the valuation of a solo professional practice for purposes of a division of marital assets. In such cases, the two are simply too interwoven and not divisible."

▸*Fogarty v. Fogarty*, 922 So.2d 836 (Miss. App., 2006): "The body shop was operated as a sole proprietorship. Our review of the record shows that the body shop did not have any assets. All assets of the body shop were leased from the prior operator of the body shop. The inventory of the shop was held on consignment and was not property of the shop. With the lack of assets, the sole asset of the body shop is the goodwill attributed to Larry. *** In the findings of fact and conclusions of law the chancellor stated that the body shop would be addressed as alimony. We agree that this was proper."

Missouri

▸*Hanson v. Hanson*, 738 S.W.2d 429, 434-35 (Mo. Sup. Ct. 1987): "[G]oodwill is recognized as property in this state; that recognition is not dependent on a traditional mercantile setting. Goodwill may exist in both commercial and professional entities. Irrespective of the setting in which it is found, the meaning of goodwill does not change. It is property which attaches to and is dependent upon an existing business entity; the reputation and skill of an individual entrepreneur--be he a professional or a traditional businessman--is not a component of the intangible asset we identify generally as goodwill. With the caveats which follow, we hold that goodwill in a professional practice acquired during a marriage is marital property subject to division in a dissolution of marriage proceeding. We define goodwill within a professional setting to mean the value of the practice which exceeds its tangible assets and which is the result of the tendency of clients/patients to return to and recommend the practice irrespective of the reputation of the individual practitioner. Our understanding of goodwill is thus consistent with and no broader than the economic, accounting and legal definition which existed prior to the advent of *Dugan*, *Fleege* and cases reaching similar results. Goodwill is not dependent, however, on the manner in which the professional practice is organized nor the size of the practice itself. We recognize, as is implied in *Geesbreght*, 570 S.W.2d at 427, that goodwill will more likely exist in larger professional practices than in the offices of sole practitioners. This is so because reliance by patients/clients on the reputation and skill of the individual practitioner is, in most cases, inversely related to the number of practitioners in the practice. However, to the extent that, for instance, competent evidence exists that clients/patients will return to the place of the practice--or recommend it to acquaintances who have not yet patronized it--irrespective of the presence of the individual professional, goodwill exists in the solo practice. Professional goodwill may not be confused with future earning capacity. We have not declared future earning capacity to be marital property. We do not now do so. Instead, we leave to the trial court broad discretion in striking an appropriate balance between husband and wife in the division of property and any award of maintenance."

Nebraska

▸*Taylor v. Taylor*, 386 N.W.2d 851, 857-58 (1986): "Virtually any income-producing entity, regardless of the nature of the business organization, may have an asset of recognized value beyond the tangible assets of such entity, an intangible asset generally characterized as goodwill. To the extent that such intangible asset's value results from recurrent customer patronage, there is no question that goodwill

is property which may be considered as a part of the marital estate for the purpose of a dissolution proceeding. . . . However, difficulty may arise in valuing a professional practice, because goodwill is likely to depend on the professional reputation and continuing presence of a particular individual in that practice. . . . The particularized question becomes: Is professional goodwill, solely dependent on the presence of a specific individual, marital property within § 42-365 and subject to equitable division in a dissolution proceeding? Courts answering that question in the affirmative have generally adopted a method of evaluation involving capitalization of excess earnings to determine the extent of goodwill as an asset in a professional practice. . . . The concept of professional goodwill evanesces when one attempts to distinguish it from future earning capacity. Although a professional business's good reputation, which is essentially what its goodwill consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business, an actual, separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary. . . . [W]here goodwill is a marketable business asset distinct from the personal reputation of a particular individual, as is usually the case with many commercial enterprises, that goodwill has an immediately discernible value as an asset of the business and may be identified as an amount reflected in a sale or transfer of such business. On the other hand, 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 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."

Nevada

▸*Ford v. Ford*, 782 P.2d 1304, 1309 (Nev. 1989): "Goodwill exists in a going professional practice, whether or not a sale is in the offing. . . . . In the instant case, the district court heard evidence of Dr. Ford's ongoing medical practice. Although Dr. Ford testified that his practice was not salable, potential problems in selling the practice will not eliminate the goodwill which attaches to it, nor its value as an asset to be considered in equitable distribution. *Dugan v. Dugan*, 92 N.J. 423, 457 A.2d 1, 6 (1983). Accordingly, the district court properly declined to follow the restrictive reasoning of *Hanson [v. Hanson*, 738 S.W.2d 429, 435 (Mo. Sup. Ct. 1987)] and correctly found that goodwill existed in Dr. Ford's surgical practice."

New Jersey

▸*Dugan v. Dugan*, 457 A.2d 1, 6 (N.J. Sup. Ct. 1983): "Our limited concern involves the existence of goodwill as property and its evaluation for purposes of equitable distribution under *N.J.S.A.* 2A:34-23 with respect to attorneys and in particular individual practitioners. Though other elements may contribute to goodwill in the context of a professional service, such as locality and specialization, reputation is at the core. Paulsen, *supra,* at 10. It does not exist at the time professional qualifications and a license to practice are obtained. A good reputation is earned after accomplishment and performance. Field testing is an essential ingredient before goodwill comes into being. Future earning capacity *per se* is not goodwill. However, when that future earning capacity has been enhanced because reputation leads to probable future patronage from existing and potential clients, goodwill may exist and have

value. When that occurs the resulting goodwill is property subject to equitable distribution.

"We held in *Lynn v. Lynn,* 91 *N.J.* 510, 453 *A.*2d 539 (1982), that a license to practice medicine and a medical degree were not property. They reflected only a possibility of future earnings. This holding was consonant with the proposition in *Stern v. Stern,* 66 *N.J.* 340, 345, 331 *A.*2d 257 (1975), that potential earning capacity is not property within the meaning of the statute, though relevant on the issues of alimony and of determining equitable proportions for the distribution of property.

"When, however, the opportunity provided by the license is exercised, then goodwill may come into existence. Goodwill is to be differentiated from earning capacity. It reflects not simply a possibility of future earnings, but a probability based on existing circumstances. Enhanced earnings reflected in goodwill are to be distinguished from a license to practice a profession and an educational degree. In that situation the enhanced future earnings are so remote and speculative that the license and degree have not been deemed to be property. The possibility of additional earnings is to be distinguished from the existence of goodwill in a law practice and the probability of its continuation. Moreover, unlike the license and the degree, goodwill is transferable and marketable. Though there is an apparent limitation on the part of an individual practitioner to sell a law practice, the same is not true in a law firm.

"After divorce, the law practice will continue to benefit from that goodwill as it had during the marriage. Much of the economic value produced during an attorney's marriage will inhere in the goodwill of the law practice. It would be inequitable to ignore the contribution of the non-attorney spouse to the development of that economic resource. An individual practitioner's inability to sell a law practice does not eliminate existence of goodwill and its value as an asset to be considered in equitable distribution."

▸*Seiler v. Seiler*, 706 A.2d 249, 251-252 (N.J. Super. Ct. App. Div. 1998): "Whether the goodwill generated by a manager of a "captive insurance agency" is an asset of the manager or of the insurance company which the manager represents has not been addressed in New Jersey. Two other jurisdictions have addressed similar questions, with opposite results.

"In *In re Marriage of Zeigler*, 69 Wash. App. 602, 849 P.2d 695, 696 (1993), the husband was a "captive agent" of State Farm Insurance Company. The husband's agreement with State Farm provided that all sales were limited to State Farm approved products, all policyholder names and information pertaining to the policies were trade secrets of State Farm, the agency's leased computer system, software, and records were the sole property of State Farm, the agency's book of policyholders belonged to State Farm, and the agency could not assign or sell the book of policyholders to anyone. *Ibid*. The husband controlled the organization of and paid the expense of the agency. *Ibid*. The agreement also contained a no-compete clause. *Ibid*.

"The court concluded that "the Agency's captive status means that any reasonable expectation of continued patronage is indistinguishably intertwined with the reputation and goodwill of State Farm." *Id*. at 698. Because State Farm retained the vital rights to the policyholders and the stream of renewals from them, any goodwill attached primarily to State Farm, not its captive agent. *Ibid*. Thus, there was no goodwill in the Agency to equitably distribute. *Ibid*.

"The Colorado Court of Appeals faced a similar situation in *In re the Marriage of Graff*, 902 P.2d 402, 405 (Colo.Ct.App. 1994), and explicitly disagreed with *Zeigler*. *Graff* also involved a State Farm agency run by the husband. *Id*. at 404. The husband set his own hours, decided the location of his office, hired and fired his own employees and set their salary, selected and purchased his own supplies, was characterized in his State Farm contract as an independent contractor, and reported his income as that of a business on Schedule C of his tax return. *Ibid*. The husband was unable to sell his rights to the State Farm contract. *Ibid*. The court found that the restrictions on the transfer of the agency did not preclude the existence of goodwill. *Id*. at 405. Despite the restrictions on the husband's agency, the facts that he controlled his business expenses, that he had stated his interest as a business ownership with the Internal Revenue Service, that the net income of the business had increased substantially under the husband's ownership, and that the husband had no plans to discontinue his relationship, supported the trial court's finding that the agency had goodwill. *Ibid*.

"Despite *Graff*'s criticism of *Zeigler*, we are satisfied that the *Zeigler* ruling is persuasive given the more comparable facts of *Zeigler* to this case. Allstate has established a sales structure to encourage individual initiative and the opportunity to earn significant income. Defendant's ability to earn a substantial income must not blind us to the fact that he is an employee of a major insurance company selling its insurance products in accordance with the terms and conditions established by his employer. The compensation scheme does not transform a person in defendant's position into an independent entrepreneur. He remains a salesman whose job is to aggressively solicit new clients and retain old clients.

"Certainly, defendant has much more discretion and control over the conditions of his employment than many employees; nevertheless, he remains an employee with significant limitations imposed on him by his employer. Unlike an independent insurance agent, he cannot hire and fire employees without the permission of Allstate. He can sell no product other than Allstate. He has no transferrable book of accounts. Like any employee, he can be terminated.

"Defendant's reputation in the community may have generated new business; however, that can be said for any salesman. We cannot ignore that the captive agent, like defendant, is selling a product of a major national insurance company which has fashioned its own reputation for price, quality and service over many years with the assistance of a formidable national, regional and local advertising campaign."

New York

▸*O'Brien v O'Brien*, 66 N.Y.2d 576, 580 (N.Y. 1985): "In this divorce action, the parties' only asset of any consequence is the husband's newly acquired license to practice medicine. The principal issue presented is whether that license, acquired during their marriage, is marital property subject to equitable distribution under Domestic Relations Law § 236 (B) (5). Supreme Court held that it was and accordingly made a distributive award in defendant's favor. It also granted defendant maintenance arrears, expert witness fees and attorneys' fees (114 Misc 2d 233). On appeal to the Appellate Division, a majority of that court held that plaintiff's medical license is not marital property and that defendant was not entitled to an award for the expert witness fees. It modified the judgment and remitted the case to Supreme Court for further proceedings, specifically for a determination of maintenance and a rehabilitative award (106 A.D.2d 223). The matter is before us by leave of the Appellate Division.

We now hold that plaintiff's medical license constitutes [*581] "marital property" within the meaning of Domestic Relations Law § 236 (B) (1) (c) and that it is therefore subject to equitable distribution pursuant to subdivision 5 of that part. That being so, the Appellate Division erred in denying a fee, as a matter of law, to defendant's expert witness who evaluated the license."

▸*Nehorayoff v. Nehorayoff*, 437 N.Y.S.2d 584, 588, 591 (Sup. Ct. Nassau Cty. 1981): "The most vigorously contested issue in this case was the value of Dr. Nehorayoff's half interest in Plaza Women's Medical Realty, Inc., a closely held corporation primarily engaged in the termination of pregnancies and related laboratory work. Each side called an expert witness as to value. Mrs. Nehorayoff's expert testified that in his expert opinion the value of the half interest was in the range of $675,000 to $1,350,000. The Doctor's expert testified that in his expert opinion the corporation had no value. The valuation of closely held and professional corporations is a difficult problem confronting the courts with increasing frequency. To date no consistent approach to valuation has been arrived at. . . . Taking into consideration the actual and imputed earnings of the enterprise, the value of Dr. Nehorayoff's interest in Plaza Women's Medical Realty, Inc. in terms of the capitalization of net earnings is $200,000."

▸*Golub v. Golub*, 527 N.Y.S.2d 946,950 (Sup. Ct. New York County 1988): "There seems to be no rational basis upon which to distinguish between a degree, a license, or any other special skill that generates substantial income. In determining the value of marital property, all such income generating assets should be considered if they accumulated while the marriage endured. If one spouse has sacrificed and assisted the other in an effort to increase that other spouse's earning capacity, it should make no difference what shape or form that asset takes so long as it in fact results in an increased earning capacity. The rationale in both O'Brien and McGowan for awarding the spouse an economic interest in the intangible asset seems to have been based on a view of the asset as "investments in the economic partnership of the marriage and the product of the parties' joint efforts." (*McGowan*, *supra*).

"The noncelebrity spouse should be entitled to a share of the celebrity spouse's fame, limited, of course, by the degree to which that fame is attributable to the non-celebrity spouse (25 UCLA Law Review, 1095). The source of the fame must still be traced to the marital efforts.

"Thus, as in *O'Brien*, if a spouse devotes himself or herself to the family throughout the marriage, giving up career opportunities, and no liquid assets exist, the court should compensate this spouse for his or her contribution enabling him or her to pursue his or her career and not just a terminable maintenance award. For example, if instead of medical school the spouse went to music school and became a celebrated pianist, in equity both accomplishments must be treated equally.

"The question, therefore, presented is should *O'Brien* be extended so as not to prejudice a spouse who is married to a non-professional?

"This court answers the question in the affirmative and holds that the skills of an artisan, actor, professional athlete or any person whose expertise in his or her career has enabled him or her to become an exceptional wage earner should be valued as marital property subject to equitable distribution. Thus, although plaintiff's celebrity status is neither "professional" nor a "license" (*Morimando*, *supra*) its increase in value is marital property; despite the difficulties presented in valuing such property."

▸*White v. White*, 611 N.Y.S.2d 951, 953 (N.Y. Supreme Court, Appellate Division 1994): "The first

point of contention centers on Supreme Court's evaluation of defendant's interest in his law firm and the distribution of 15% of this asset to plaintiff. Supreme Court accepted the opinion of plaintiff's expert that, pursuant to the capitalization of earnings approach, defendant's interest as of April 2, 1990 had a value of $431,000. In contrast, defendant's expert, utilizing the net asset approach, fixed the value at $19,409. Parenthetically, we note that because defendant's professional practice is well established, the valuation of his license is not an issue as it is deemed to have merged and been subsumed by the practice (*see*, *McSparron v. McSparron*, 190 A.D.2d 74, 80-81, 597 N.Y.S.2d 743).

"The capitalization of earnings method is appropriate to use when evaluating a law practice and is apt to more accurately reflect its value than the net asset method (see, Nehorayoff v. Nehorayoff, 108 Misc.2d 311, 437 N.Y.S.2d 584; Annotation, *Valuation of Goodwill in Law Practice for Purposes of Divorce Court's Property Distribution*, 77 ALR4th 683). Thus, Supreme Court did not abuse its discretion in rejecting defendant's evaluation."

‣*McSparron v McSparron*, 87 N.Y.2d 275, 286 (N.Y. 1995): "The "merger" principle on which the Court's decision was based is derived from the Second Department's ruling in *Marcus v Marcus* (137 AD2d 131), in which it was held that a professional license should not be assigned an independent value where the licensee has maintained a professional practice for a substantial period. In that situation, the Marcus Court stated, the license "should be deemed to have merged with and been subsumed by the practice itself" (id., at 139). [*283] The underlying rationale is that "the equitable considerations that * * * motivated the *O'Brien* court are fundamentally different" where the license has been utilized for a substantial period to establish a career or professional practice and to generate tangible assets for the family (*Parlow v Parlow*, 145 Misc 2d 850, 856; see, *Maher v Maher*, 196 AD2d 530, 531).
* * *
In view of these logical and practical difficulties, we conclude that the letter and spirit of our holding in *O'Brien* is best served by eliminating the concept of "merger" from the inquiry. The merger doctrine should be discarded in favor of a commonsense approach that recognizes the ongoing independent vitality that a professional license may have and focuses solely on the problem of valuing that asset in a way that avoids duplicative awards. O'Brien permits the court to include in the marital estate the present value of any increased earning capacity attributable to a professional license earned during the marriage. That increased earning capacity continues to exist, to a greater or lesser degree, throughout the life of the license. Even after the licensee has had the time and opportunity to exploit the license and to realize a portion of the enhanced earning potential it affords, the license itself retains some residual economic value, although in particular cases it [*286] may be nominal (see, Turner, op. cit., at 227-228). That value can be measured and distributed just as a newly acquired license is valued through various actuarial techniques that are well known to valuation experts.

To be sure, the valuation inquiry is made more complicated by the passage of time and the licensee's harvesting of some portion of the enhanced earning capacity that accompanies the license. The value of a newly earned license may be measured by simply comparing the average lifetime income of a college graduate and the average lifetime earnings of a person holding such a license and reducing the difference to its present value (see, *O'Brien v O'Brien*, *supra*, at 582; 2 McCahey, Valuation & Distribution of Marital Property § 30.03 [3], at 30-19 — 30-21). In contrast, where the licensee has already embarked on his or her career and has acquired a history of actual earnings, the foregoing theoretical valuation method must be discarded in favor of a more pragmatic and individualized analysis based on the particular licensee's remaining professional earning potential (see, *Finocchio v Finocchio*,

supra, at 1045-1046; Scheinkman, op. cit., C236B:6, at 48 [1995 Cum Ann Pocket Part]). Moreover, care must be taken to ensure that the monetary value assigned to the license does not overlap with the value assigned to other marital assets that are derived from the license such as the licensed spouse's professional practice. The courts must also be meticulous in guarding against duplication in the form of maintenance awards that are premised on earnings derived from professional licenses.

The existence of these complications, however, is not a sound reason to introduce nettlesome legal fictions or to excise an asset to which the nontitled spouse has contributed from the marital estate. As we stated in O'Brien, the complexity of calculating the present value of a partially exploited professional license is no more difficult than the problem of computing wrongful death damages or the loss of earning potential that is occasioned by a particular injury (66 NY2d, at 588). Nor does it lead to significantly more speculation than is involved in the now-routine task of valuing a professional practice for the purpose of making a distributive award (see, id., citing *Arvantides v Arvantides*, 64 N.Y.2d 1033; *Litman v Litman*, 93 A.D.2d 695, *affd* 61 N.Y.2d 918; *see also*, *Burns v Burns*, 84 N.Y.2d 369, 376-377)."

▸*Moll v. Moll*, 722 N.Y.S.2d 732, 735 (N.Y. Sup. Ct. 2001): "The *O'Brien* analysis is not limited to professional licenses and has been used to find a medical board certification (*Savasta v. Savasta*, 146 Misc.2d 101, 549 N.Y.S.2d 544 [S.Ct., Nassau County]), a law degree (*Cronin v. Cronin*, 131 Misc.2d 879, 502 N.Y.S.2d 368 [S.Ct., Nassau County]), an accounting degree (*Vanasco v. Vanasco*, 132 Misc.2d 227, 503 N.Y.S.2d 480 [S.Ct., Nassau County]), a podiatry practice (*Morton v. Morton*, 130 A.D.2d 558, 515 N.Y.S.2d 499), the licensing and certification of a physician's assistant (*Morimando v. Morimando*, 145 A.D.2d 609, 536 N.Y.S.2d 701), a Masters degree in teaching (*McGowan v. McGowan*, 142 A.D.2d 355, 535 N.Y.S.2d 990), a Master's degree and a permanent certificate in school administration (*DiCaprio v. DiCaprio*, 162 A.D.2d 944, 556 N.Y.S.2d 1011 [4th Dept.1990]), a fellowship in the Society of Actuaries (*McAlpine v. McAlpine*, 143 Misc.2d 30, 539 N.Y.S.2d 680 [S.Ct., Suffolk County]), the celebrity career of an opera singer (*Elkus v. Elkus*, 169 A.D.2d 134, 572 N.Y.S.2d 901), the increase in value of the wife's career as a model and actress (*Golub v. Golub*, 139 Misc.2d 440, 527 N.Y.S.2d 946 [S.Ct., N.Y. County]), the enhanced earning capacity attributed to a former Congressional career (*Martin v. Martin*, 200 A.D.2d 304, 614 N.Y.S.2d 775) and the enhanced earning capacity of an investment banker (*Hougie v. Hougie*, 261 A.D.2d 161, 689 N.Y.S.2d 490 [1st Dept.1999]) all to constitute marital property. All of these decisions, like *O'Brien,* base their finding of marital property on the "enhanced earning capacity" which the "thing of value" provided to its holder. See, *e.g.*, *McGowan v. McGowan*, 142 A.D.2d 355, 535 N.Y.S.2d 990 (2d Dept. 1988)."

▸*Kohl v. Kohl*, 800 N.Y.S.2d 348 (Sup. Ct. N.Y. County, 2004), *aff'd*, 806 N.Y.S.2d 35 (2005): "The husband contends that the theoretical value of the sales and consultancy business is $315,622; the wife contends its value is $1,600,000. These disparate conclusions result from two major valuation differences. First, the parties disagree on the amount of reasonable compensation that should be deducted before determining the value of the business component of the husband's earnings. Only earnings over and above reasonable compensation can form the basis for the valuation of the ownership interest under the capitalization of earnings methodology. The wife argues that a reasonable compensation figure is $400,000 while the husband contends it is $750,000. . . . The court finds $400,000 to be the reasonable compensation figure. Both expert witnesses conceded that no direct, statistical source exists for persons holding comparable positions to that held by the husband. However, the court finds that the wife's expert presented cogent arguments to support his assessment of reasonable compensation.

Mr. Johnson considered the compensation received by the IDI officers, related, statistical sources for corroborative comparison, and the husband's historical earnings. . . . In contrast, Mr. Friedman gave little justification for how he arrived at his $750,000 figure other than from his own experience in auditing and valuing businesses. Moreover, he gave few specifics to justify his conclusion . . . . In sum, the court found Mr. Johnson's assessment of the husband's reasonable compensation more credible.

"The second significant dispute in the valuation concerned what capitalization rate should be applied based on an assessment of the risk factors of the business. In the capitalization of earnings valuation method, after deduction of reasonable compensation, a capitalization rate must be applied to the remaining earnings to determine the value of the business. Both parties agree that the capitalization rate here should be determined using the "build-up method". This approach adds to a risk free investment rate all relevant risk factors, including for the overall market, the particular industry, and the specific business being valued, to ultimately determine the risk a hypothetical buyer of the business would have to assume. From this number, the valuator can calculate the rate of return a buyer would want to receive to assume that risk, thereby arriving at the fair market value of the business. The wife's expert concluded that a 25% capitalization rate (capitalization multiple of 4) was appropriate; the husband's expert proffered a capitalization rate of 44.3% (capitalization multiple of 2.25). . . .

"In performing the build up of the risk factors, the experts were in general agreement through assessing the historical risk premium (the risk factors from a risk free investment through a small capitalized corporation). The major discrepancies arose in determining the risk factors for the specific business being valued. Both experts conceded that the determination of those risk factors is largely subjective . . . . The court concludes that the assessment by Mr. Johnson is more credible and supported by the evidence.

> FN9. Through that calculation, the wife 's expert found a 19% rate whereas the husband's expert found a 17.3% rate. . . .

"The main difference arises from Mr. Friedman's assignment of a 32% risk factor for dependence upon a key person, that being the husband. The court finds that the assignment of such a high risk factor is not reflected in the reality of the business during the period subject to valuation. For instance, Mr. Friedman assigned as a high risk factor the stability of the business's earnings. He contended that the earnings of the business are entirely dependent on the husband and the real estate industry. . . . While this is true, during the period subject to valuation, the husband's earnings increased each year lending weight to the conclusion that the business has stable earnings. Similarly, Mr. Friedman included as a high risk factor the fact that there is no continuity of customer base. In point of fact, the husband often had repeat customers . . . and, both historically and through the valuation period, was able to obtain new jobs without any evidence of difficulty. In addition, although Mr. Friedman noted that the growth potential of the company might be a risk factor, he conceded that the husband's earnings had increased during the period under valuation. Thus, not only was this not a risk factor (Mr. Friedman subtracted 5% from his risk assessment because of the business's growth), but lent support to the conclusion that Mr. Friedman overstated the other risk factors. . . .

"Mr. Johnson acknowledged that certain risk factors exist (e.g. key-person, size premium, customer concentration, etc.) as well as lack of marketability. However, the court finds Mr. Johnson's assessment

that a hypothetical buyer would seek to recapture the purchase price in 4 years reasonable not only with respect to the accounting methodology he employed, but also as supported by the evidence of the success of the business. . . . [Record references and footnotes omitted]"

North Dakota

‣*Kelly v. Kelly*, 806 N.W.2d 133, 144 (N.D. 2011): "We conclude the district court had authority to restrain Karol Kelly's interference with Kelly Insurance to protect the goodwill of the company under the circumstances in this case. Although the provisions for contractual restraints on a business in N.D.C.C. § 9-08-06(1) are not directly applicable to property distributions in a divorce decree, we conclude public policy and legal consistency warrant the district court exercising its authority to distribute marital property in conformity with limitations imposed on contracting parties in N.D.C.C. § 9-08-06. *See Fischer*, 834 P.2d at 272-73. The court restrained Karol Kelly from interfering with the operation of Kelly Insurance for five years. Evidence in this record supports the court's findings and decision. The court's order, however, does not include the geographic limitations of N.D.C.C. § 9-08-06(1), and we remand for application of the limitations of that statute to the restraining order.

Ohio

‣*Hardy v. Hardy*, 2005 WL 2660627, *5 (Ohio Ct. App. 2005): "The parties both offered expert opinion evidence concerning the value of the consulting business. Nancy's expert opined that the business is worth $140,000, using past revenues and a multiplier factor to arrive at projected future revenues on which her opinion was based. Lawrence's expert valued the business on the basis of its capital assets, as well as goodwill and future potential, and opined that the value of the business is only nominal. . . . The magistrate found that the valuation provided in the opinion of Lawrence's expert was more reliable. Nancy objected. The trial court overruled the objection, stating: 'The court finds that defendant's business, L.R. Hardy & Associates, has little or no market value. The business is effectively a consulting business providing personal service to various defense contractors. The business' only product is the personal service provided by Mr. Hardy. There are no capital assets in the business; he has no client base; and he has no individual contracts with any firm that could be sold. There are no appreciable business assets to be divided.' . . . .Lawrence's consulting business is marital property, to the extent that it represents an 'interest' Lawrence has that he acquired during the marriage. . . . Like a professional practice, its value when the marriage terminates may be determined in relation to anticipated future revenues. *See Barone v. Barone*, (Sept. 1, 2001), Lucas App. NO. L-98-1328. However, that depends on the particular facts, including the nature of the activity as well as the owner/ spouse's expected capacity to generate revenues. Those are questions of fact for the trial court to determine. Lawrence was sixty-nine years of age at the time of the divorce. The future revenues of his consulting business are limited by his age and the nature of the business. The trial court could, in its discretion, find that evidence on which Nancy's expert relied is too tenuous to support a finding of any particular value, and instead adopt the valuation offered by Lawrence's expert. [Paragraph numbers omitted]

‣*Clymer v. Clymer*, 2000 WL 1357911, *2-3 (Ohio Ct. App. 2000): "Goodwill is an integral part of the valuation of a professional business in a divorce proceeding. Kahn v. Kahn (1987), 42 Ohio App.3d 61, 64. "The comprehensive definition of 'goodwill' is 'the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from

constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.' " *Spayd v. Turner, Granzow & Hollenkamp* (1985), 19 Ohio St.3d 55, 59.

"The experts' differing values of plaintiff's law practice arise from their assessment of the goodwill of the practice. Several methods for valuing professional goodwill are recognized, including: (1) capitalization of net profits (or straight capitalization), (2) capitalization of excess earnings, (3) the IRS meth od (known as the "formula" approach), which subtracts a reasonable rate of return on tangible assets and salary from average earnings, (4) market value, and (5) buy-sell agreements. *Kell v. Kell* (Dec. 14, 1993), Ross App. No. 92CA-1931, unreported. Nesser employed the "excess earnings" method to calculate the goodwill of plaintiff's law practice. In arriving at the conclusion that the practice had no goodwill, Nesser used plaintiff's actual earnings for each year between 1981 and 1984, initially subtracted the estimated return on assets, and then subtracted the estimated earnings for plaintiff's peer group of similarly situated attorneys. The estimated earnings of plaintiff's peer group was calculated with the help of the Altman & Weil and OSBA reports because the trial court's earlier calculation was criticized in Clymer III for not using factors to make the value representative of plaintiff's peer group. With those reports, the trial court's calculation, premised on Nesser's testimony, considers the factors Clymer III indicated would make the reasonable compensation calculation more accurate, such as the attorney's area of practice, firm size, experience and population where the practice is located.

"Nesser then weighed the difference between actual and reasonable earnings, less the return on assets, to arrive at an excess earnings number, that then was capitalized to arrive at the amount of goodwill possessed by defendant's law practice. In Nesser's calculations, plaintiff made less than the peer group Nesser compared him to in each year and therefore had no excess earnings and, accordingly, no goodwill. . . . The trial court did not abuse its discretion in adopting Nesser's analysis over the analysis of defendant's expert."

▸*Kahn v. Kahn*, 536 N.E.2d 678, 682 (Ohio Ct. App. 1987): "Another contention of the appellant is that by placing a value on the goodwill of a professional practice that we are placing a value on the defendant's medical degree. The Ohio Supreme Court has told us that "a professional degree cannot be categorized as 'property.' " . . . Looking back at the definitions of "goodwill" previously presented shows that much more than the degree is valued in a goodwill calculation. Goodwill is an intangible value of an ongoing medical practice. An ongoing sole professional medical practice, by definition, requires a professional physician with a degree, since it would be both unethical and illegal to have an uneducated or unlicensed doctor practicing medicine as sole practitioner. Furthermore, the value of goodwill can be calculated independently of the value of the degree. "A professional may not have any goodwill; for example, he may just be starting his practice or he may be a salaried employee. Yet, his professional degree and his license to practice are of substantial economic benefit to him." Kennedy & Thomas, *Putting a Value on: Education and Professional Goodwill* (1979), 2 FAMILY ADVOCATE 3, 5. Since goodwill can be calculated independently of the value of the degree it is erroneous to assume that by placing a value on the goodwill of a medical practice that we are treating the medical degree as marital property. . . . We, like the trial court, recognize that goodwill is an integral part of the valuation of a professional business in a divorce proceeding.

Oklahoma

‣*Travis v. Travis*, 795 P.2d 96, 100 (Okla. Sup. Ct. 1990): "This Court has previously found that a law practice can be considered jointly acquired property subject to division as part of a marital estate. . . . In contrast to the physical assets of a law office, the reputation of the lawyer cannot be purchased by another seeking to acquire an established law practice. If Mr. Travis were to cease his practice of law, he would not be free to sell his files to a succeeding lawyer because such a sale would violate Rule 1.8(j) of the Rules of Professional Conduct which prohibits a lawyer acquiring a proprietary interest in a lawsuit. This general rule has its basis in common law champerty and maintenance. See, Comment, Rule 1.8. Mr. Travis would only be able to divide a fee with a succeeding lawyer depending upon the client's agreement to retain the succeeding lawyer, the client's agreement in writing to a fee division, both lawyers' assuming joint responsibility for the representation, and the total fee being reasonable. Rule 1.5, Rules of Professional Conduct, 5 O.S. Supp. 1989, ch. 1, app. 3-A. Establishing earning capacity is much less speculative than trying to establish a good will value of a law practice. Projected earnings can be considered in establishing support alimony which, unlike property division of good will, may be adjusted upward or downward at a later date. . . . Because Oklahoma law allows such an adjustment, and because law practices cannot be bought and sold as can other professional practices, we conclude that a consideration of the earning capacity of a lawyer and subsequent setting of support alimony based upon that earning capacity is more equitable than the speculative division of good will in the law practice of a sole practitioner." [Citations omitted]

‣*Traczyk v. Traczyk*, 891 P.2d 1277, 1279 (Okla. 1995): "Pursuant to 60 O.S.1991, §§ 315 and 316, goodwill of a business is defined as 'the expectation of continued public patronage,' and is considered property transferable like any other property.
***
"Generally, a medical doctor's practice is more easily transferred to another doctor than is a law practice to another lawyer. The expert witness in the instant case noted that typically when transfer of a medical practice is to take place, the selling doctor will introduce the purchasing doctor to the patients to prepare those patients for a transition. Of course, the patients may choose not to continue with the new doctor when their former doctor leaves the practice, but many choose to stay at the clinic with the new doctor. Consequently, some goodwill, "the expectation of continued public patronage," exists when a podiatry clinic is sold, and Wife presented evidence of such goodwill in the case at bar.

"In determining the value of the Bethany Foot Clinic, the expert witness consulted the Goodwill Registry, 'an accumulation of information concerning sales of medical related practices by experts.' From this publication, the expert determined that of the most recent purchases of podiatry clinics, an average of thirty-two percent (32%) of the podiatry patients stay with the clinic after it is sold to a new doctor. The range from which he obtained the average was 21% to 44% of clients staying ....

"Noting that the traditional method used in valuing a medical practice is the previous year's gross income, the expert then took the previous year's gross income at the clinic ($324,201.51) and multiplied it by the 32% figure to arrive at a goodwill value of $103,744.00. Adding this to the value of the remaining business assets, the expert found the total value of the Bethany Foot Clinic to be $152,605.44. The trial court accepted this valuation and used it in determining how much alimony in lieu of property division to award.

"We find that the trial court did not err in considering the goodwill of the Bethany Foot Clinic as a factor in determining the value of the clinic as marital property. The goodwill of the Bethany Foot

Clinic is distinct from the personal reputation of Dr. Traczyk. Although many of Dr. Traczyk's patients would not continue to patronize the Bethany Foot Clinic were Dr. Traczyk to sell to another podiatrist, competent evidence indicates that many would stay. Indeed, Dr. Traczyk may use the goodwill as a selling point to potential purchasers."

▸*Favel v. Favel*, 957 P.2d 556, 561 (Ok. App. 1997): "9 At the outset, it must be noted that the Non-Competition Order filed October 27, 1994, though internally containing a reference to "this covenant," is not a covenant against competition. By definition, a covenant is an agreement. Although the parties [*560] agreed that a non-competition provision might be desirable to preserve the value of marital assets, they did not come to an agreement on any particular terms. There being no agreement not to compete by these parties, the provisions at issue are merely a court-imposed obligation in the nature of an injunction against competition "to protect the goodwill of the business" and thereby preserve the value of certain corporate assets, not a covenant not to compete. * * *

[*561] 13 Despite the existence of general public policy favoring freedom of individuals to contract, with these sections, the Legislature has adopted a public policy so disfavoring restraints of trade that it limits that freedom and prevents parties from "agreeing" to restraints of trade except under limited circumstances. We are loathe to judicially expand those circumstances to include restraints of trade to which the parties have not agreed. * * *

¶ 16 The imposition of such a non-competition order violated another general principle applicable in divorce cases. It is well settled that the future earning capacity of either spouse in a divorce case is not marital property to be divided. *Mocnik v. Mocnik*, 1992 OK 99, 838 P.2d 500. According to the evidence, the existence of a non-competition order or agreement restricting Husband's activities increased the value of the marital corporate assets by ten to forty percent. The higher marital value is at the expense of Husband's right to pursue his chosen line of work, i.e. his future earning capacity. By including in the marital estate the value directly attributable to a restriction on Husband's future earning ability, the trial court treated at least a portion of Husband's future earning capacity as marital property and awarded a portion of the value of that capacity to Wife.

¶ 17 The order imposing a "covenant not to compete" upon Husband must be reversed as contrary to law and public policy. Because the value placed upon the corporations awarded Wife was dependent upon the existence of a non-competition provision, this matter must be remanded for a new determination of the value of the corporations and, in light of those values, what judgment may be required to yield an equitable division of the marital assets." [Footnotes omitted.]

Oregon.

▸*In the Matter of Slater*, 245 P. 3d 676 (Oregon App. 2010): "[W]here a business has no value above and beyond its assets absent 'the owner personally promis[ing] his [or her] services to accompany the sale of the business,' *Lankford*, 79 Or.App. at 745, 720 P.2d 407, there is no goodwill." *** "[W]e return to the precise question presented here: Did the trial court err in premising the value of husband's chiropractic business on the assumption that husband would be bound by a noncompetition covenant? Although no Oregon appellate decision has addressed that question, courts in other jurisdictions have.Among those courts, there is a split of authority, with most having concluded that, to the extent that a noncompetition covenant corresponds to the business's future earning capacity attributable

to an individual's skills, qualities, reputation, or continued presence, the value of that covenant is not cognizable in a marital property division. ... We agree with the majority approach."

Pennsylvania

▸*Solomon v. Solomon*, 611 A.2d 686, 691-92 (Pa. Sup. Ct. 1992): "This is the first time this Court has been presented with the propriety of including the value of the good will of a business as a marital asset, where good will was not subject to the partnership agreement itself. Generally, we agree with the Superior Court that if a business qualifies as marital property pursuant to 23 P.S. § 401(e), then to the extent that such business has established good will, such value should be considered for purposes of equitable distribution." [Footnote omitted]

▸*Baker v. Baker*, 861 A.2d 298, 303(Pa. Super. 2004): "Wife's expert testified the goodwill he attributed to the value of the practice was not based on personal characteristics of Husband. Rather the goodwill value the expert attributed to the practice was based on criteria such as location and customer lists. This aspect of the practice's goodwill was properly subject to equitable distribution. . . . However, the determination of whether a business has established good will is controlled by the nature of the business itself. Since good will is essentially positive reputation, the factors that have given rise to the positive reputation will necessarily control the determination of whether good will exists for purposes of equitable distribution. If the positive reputation is due only to the reputation of a single individual as opposed to the business entity in general, then the business has no good will for purposes of equitable distribution. The value is that of the single individual and not the entity in general, and this value is not capable of surviving the disassociation of the individual from the business entity. However, as the single individual's contributions become less substantial, the good reputation enjoyed by a business entity becomes less related to the single individual and more a product of the business entity in general, and thus, more capable of surviving the disassociation of the single individual. In the case sub judice, the record facts indicate that William was engaged as a sole practitioner of veterinary medicine specializing in the breeding of horses. The Superior Court determined that given the substantial record evidence that the success of William's business was dependent solely on his own expertise, the trial court did not abuse its discretion in finding that William's business had no good will value.

"Kathleen claims that the reputation of the business was based not only upon William's professional contributions, but also upon the contributions of other members of the staff, which included veterinarians, together with the general facilities and commodities of the business unrelated to veterinary practice or the breeding of horses. We disagree.

"It is evident that the trial court paid great attention to the conflicting evidence concerning good will value. The trial court found particularly persuasive the testimony of numerous clients concerning the importance of William's professional expertise in sustaining the various aspects of the business. In contrast, the trial court was not persuaded by Kathleen's claim that the other commodities of the business and the existence of other staff veterinarians supported a finding of good will separate and apart from William's professional reputation. The trial court specifically found that the contributions of other veterinarians were minor in that only two recently graduated veterinarians were employed for a brief period of time and they brought no new business to the practice. Accordingly, the trial court found that William's business possessed no good will value. As there was more than sufficient evidence to support a finding that William's business possessed no good will value outside his

professional reputation, we hold that the Superior Court did not abuse its discretion in affirming the decision of the trial court on this issue."

South Carolina

▸*Donahue v. Donahue*, 384 S.E.2d 741 (S.C. Sup. Ct. 1989): "The decision as to the inclusion of goodwill of a professional practice in a marital estate is, "in the final analysis, a public policy issue." . . . The following is a well-recognized definition of goodwill:

> Goodwill may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

"More specifically, professional goodwill has been held to have the following attributes:

> It attaches to the person of the professional man or woman as a result of confidence in his or her skill and ability. [cite omitted] It 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. It would be extinguished in the event of the professional's death, retirement or disablement.

". . . 'The very nature of a professional practice is that it is totally dependent upon the professional.' [citation omitted] The definitions set forth above indicate the intangible nature of the goodwill asset. It is this intangibility which inevitably results in a speculative valuation. The basis of this Court's concern in *Casey* was the speculative element involved in valuation of goodwill. In light of the definitions above, we see similar problems in the valuation of goodwill of a professional practice. Accordingly, we hold that the family court erred in placing a value upon, and consequently dividing the goodwill of the husband's dental practice."); *Casey v. Casey*, 362 S.E.2d 6, 6-7 (S.C. 1987) ("Courts from other jurisdictions are divided as to whether goodwill is marital property divisible upon divorce. . . . The issue is one of first impression in this state. . . . When the goodwill in a business is dependent upon the owner's future earnings, it is too speculative for inclusion in the marital estate. . . . Moreover, these future earnings are accounted for in an award of alimony. . . . We hold that goodwill in Husband's fireworks business does not constitute marital property subject to equitable distribution."). [citations omitted]

▸*Moore v. Moore*, 779 S.E.2d 533, (S. C. Sup. Ct. 2015): "As noted, Wife's valuation expert, Raymond McKay, opined that "at least" 20-25% of Candelabra's goodwill is personal to Wife. In reaching this conclusion, McKay collected data from the business records, visited the storefront in Mt. Pleasant, interviewed Wife and other Candelabra employees, and prepared a detailed report of the history of Candelabra's operations and pertinent financial information, along with discussions of various accounting and valuation methods and several issues surrounding the value of Candelabra's goodwill. In his valuation report, McKay explained that the factors supporting the existence of Wife's personal goodwill included: Wife's total responsibility for day-to-day management of the business; total control and responsibility for ongoing product selection; Wife's continuing website monitoring, revision, and presentation; Wife's

direct personal contact and dealings with manufacturers and vendors; and Wife's formal, degreed college training in products marketing (with a minor in business administration), along with her extensive previous retail experience. McKay testified that without Wife, Candelabra would not have the ongoing ability to offer a current mix of trendy products and that sales would decline. McKay further opined that no bona-fide third-party purchaser would pay full fair market value for Candelabra without requiring a covenant not to compete from Wife, which signaled the existence of personal goodwill attributable to Wife.[9]

"[*518] Wife's second valuation expert Jay Fishman, a nationally recognized expert on the valuation of closely held businesses, testified as to both the existence and extent of Wife's personal goodwill. Fishman explained that the value of any company is a function of what drives sales/profits in the specific way a particular business operates. After studying Candelabra's financial documents, conducting a thorough examination of Candelabra's website and several competitors' websites, and extensively interviewing various employees, vendors, and suppliers, Fishman concluded that the two major factors driving Candelabra's business were its website/internet presence and its desirable, on-trend product mix selected by Wife. Fishman also testified that, to a lesser extent, Candelabra's value is also attributable in part to its reputation for good customer service and its existing relationships with vendors and suppliers; however, Fishman identified product selection and accessibility on the internet as the most significant factors that drive the value of Candelabra. Fishman emphasized that the design/layout of the website and the product selection the site features are the critical elements that positively differentiate Candelabra from other retailers, prompting customers to purchase from Candelabra instead of another online retailer. Fishman emphasized that this differentiation is critically important when selling non-exclusive product on the internet like Candelabra does because "the competition is fierce [and] the barriers to entry here are rather low."[10]

"Husband's valuation expert was Dr. Perry Woodside, who is also a superbly qualified expert in the field of business valuation. In researching how Candelabra's business operates, Woodside interviewed only Husband and did not visit the store or interview Wife or any other Candelabra employees. Woodside did not calculate personal goodwill as part of his valuation; however, on cross-examination, he candidly acknowledged [*519] that there was "some" personal goodwill in Candelabra but stated that it was "difficult to know" and if pressed to quantify it, then it would be between "5 to 10%." It was this opinion testimony from which the family court assigned Wife's personal goodwill at 10% of the value.

"We find the undisputed evidence is that some of the goodwill value was personal to Wife, especially in view of Woodside's acknowledgement that some personal goodwill existed. The evidence in the record as to Wife's role and involvement in the business, particularly in the area of product selection and format/design of the website, supports the conclusions of McKay and Fishman. Indeed, Wife's testimony was corroborated by that of current and former Candelabra employees and vendors who testified as to the significance of Wife's personal contributions to the business and the impact her unique talents and creativity had on the business. One employee even quipped that if Wife left, "it wouldn't be Candelabra. Whitney is Candelabra."

"We reject Husband's contention on appeal that it is only through professional practices (such as doctors, dentists, accountants, attorneys, etc.) that a spouse can develop personal goodwill. *See Ward*, 755 S.E.2d at 500-01 (affirming family court's determination that one-third of husband's interest in logging business, which operated under the trade name of Advantage Timberland, Inc., was personal

to husband and not enterprise goodwill where Husband possessed key personal relationships with employees and government regulators and performed his duties with exceptional skill and efficiency); see also *Hough v. Hough*, 793 So.2d 57, 58 (Fla. Dist. Ct. App.2001) (affirming the family court's finding that 100% of goodwill in parties' business which owned and operated coin-operated air and vacuum machines on the premises of convenience stores and service stations was husband's personal goodwill because the company derived a large portion of its income from a handful of accounts that were freely or easily terminable by the customers and depended on husband's store of personal goodwill); *McQuay v. McQuay*, 217 P.3d 162, 164 (Okla.Civ. App.2009) (reversing the lower court's inclusion of goodwill in the marital estate where the goodwill in the parties' concrete business was entirely attributable to husband's good reputation as a cement mason); *In re Marriage of Maxwell*, 128 [*520] Or.App. 565, 876 P.2d 811, 813 (1994) (finding all goodwill in self-employed advertising copywriter's sole proprietorship was personal because the continued success of the business is completely dependent on the creative, personal services he provides).

"In so finding, we acknowledge that several circumstances surrounding Candelabra's website indicate the presence of enterprise goodwill. First, the website's domain name, www. shopcandelabra.com, is associated with the business itself and is not specific to or associated with Wife personally. Cf. George Hawkins, *Personal Versus Practice Goodwill: A Visit to the "Plastics" Doc*, Fair Value, Vol. XX, No. 2, Summer/Fall 2013, at 5 (noting website or domain names that are person-specific or promote an individual are not easily transferrable and suggest personal goodwill). Further, in connection with Candelabra's shift in business strategy, the website that initially began as a minor feature of Candelabra's overall marketing strategy was transformed into the central feature of all business operations, now serving as the online portal through which approximately 80% of all sales are placed. Indeed, all three experts agree that Candelabra's internet presence, through the SEO campaign and website format and functionality, significantly drives Candelabra's sales and overall value as a business. See id. at 4 (noting mass- and web-driven marketing strategies indicate enterprise goodwill)."

<u>Tennessee</u>

▸*Smith v. Smith*, 709 S.W.2d 588, 591 (Tenn. App. 1985): "The next question is what elements of a profession are taken into account in arriving at the value of that profession for purposes of making an equitable division. The physical assets, of course, such as the furniture, buildings, library, etc., are things that have an ascertainable value and should be taken into account. The accounts receivable, properly weighted, should have a definite value. The most troublesome question involves the good will of the firm. Is that an asset that can be considered part of the marital property? Other states are split on the question, although a clear majority hold that the good will of the firm should be considered and evaluated in making a division of the marital property. See Annot. 52 A.L.R.3d 1344. We are not persuaded, however, that this state should adopt the rule that professional good will is a part of the marital estate. We find the position taken by the Wisconsin Court of Appeals in *Holbrook v. Holbrook*, 103 Wis.2d 327, 309 N.W.2d 343 (App.1981) to be persuasive."

<u>Texas</u>

▸*Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972): "[I]t cannot be said that the accrued good will in the medical practice of Dr. Nail was an earned or vested property right at the time of the divorce or that it qualifies as property subject to division by decree of the court. It did not possess value or constitute an asset

separate and apart from his person, or from his individual ability to practice his profession. It would be extinguished in event of his death, or retirement, or disablement, as well as in event of the sale of his practice or the loss of his patients, whatever the cause."

▸*Geesbreght v. Geesbreght*, 570 S.W.2d 427, 435-36 (Tex. Civ. App.--Fort Worth 1978, writ dism'd): "'Good will' is sometimes difficult to define. In a personal service enterprise such as that of a professional person or firm, there is a difference in what it means as applied to 'John Doe' and as applied to 'The Doe Corporation' or 'The Doe Company'. If 'John Doe' builds up a reputation for service it is personal to him. If 'The Doe Company' builds up a reputation for service there may be a change in personnel performing the service upon a sale of its business but the sale of such business naturally involves the right to continue in business as "The Doe Company". The "good will" built up by the company would continue for a time and would last while the new management, performing the same personal services, would at least have the opportunity to justify confidence in such management while it attempted to retain the 'good will' of customer clients of the former operators. At least the opportunity to have time to try to preserve the 'good will' already existent and to use it as an entrance into the identical field of operations in a personal service type of business would be present where the name of the business is a company name as distinguished from the name of an individual. Therein does it have value, plus the value of the opportunity to justify confidence in the new management by the customer/clients of the predecessor owner(s). It is as applied to the foregoing that we consider Emergency Medicine to possess what we treat as 'good will' as part of its worth and value under the circumstances of this case, and therefore an asset which would have value to some extent apart from John's person as a professional practitioner."

▸*Austin v. Austin*, 619 S.W.2d 290, 291-92 (Tex. Civ. App.--Austin 1981, no writ): "The good will of an ongoing, noncorporate, professional practice is not the type of property that is divisible as community property in a divorce proceeding. [citing *Nail*.] . . . When good will is not attached to the person of the professional man or woman, it is property that may be divided as community property. [citing *Geesbreght*.] . . . Once a professional practice is sold, the good will is no longer attached to the person of the professional man or woman. The seller's actions will no longer have significant effect on the good will. The value of the good will is fixed and it is now property that may be divided as community property."

▸*Ulmer v. Ulmer*, 717 S.W.2d 665, 667 (Tex. App--Texarkana 1986, no writ): "Rufus Ulmer also argues that the trial court erred in issuing the injunction prohibiting him from engaging in the janitorial services business because the injunction deprives him of his separate property, i.e. the right to engage in his chosen profession, in violation of the Texas Constitution and without statutory authority. An individual's ability to practice his profession does not qualify as property subject to division by decree of the court. *Nail v. Nail*, 486 S.W.2d 761 (Tex.1972). Thus, the trial court further erred in enjoining Rufus Ulmer from engaging in his chosen profession as part of the property division."

▸*Salinas v. Rafati*, 948 S.W.2d 286, 290 (Tex. 1997): "Our Court considered the rights of partners upon dissolution in *Rice v. Angell*, 73 Tex. 350, 11 S.W. 338 (1889). Although that decision is of considerable age, its reasoning remains sound today. The Court in *Rice* very thoughtfully explored the boundaries of goodwill when a partnership is dissolved and one or more of its former members continues to engage in the same type of business. The dispute in *Rice* was between two men who had been partners in an insurance agency. The plaintiff had initially purchased an interest in the

partnership, but after several years, his colleague dissolved their relationship. *Id*. 11 S.W. at 338-39. This Court recognized in *Rice* and later in *Nail v. Nail*, 486 S.W.2d 761 (Tex.1972), that a distinction must be drawn between the goodwill that attaches to a professional person because of confidence in the skill and ability of the individual and the goodwill of a trade or business that arises from its location or its well-established and well-recognized name. *Nail*, 486 S.W.2d at 763-64; *Rice*, 11 S.W. at 339-40. When a trading partnership dissolves, one partner may secure the right to continue the business at "the old stand." *Rice*, 11 S.W. at 340. The probability that customers would resort to the old place of business may be deemed a valuable right. *Id*."
* * *
Subsequently, in *Nail*, we recognized that although goodwill can exist as "an incident of a continuing business having locality or name," the distinction has been drawn that "professional good will is not so much fixed or as localized as the good will of a trade, and attaches to the person of the professional man or woman as a result of confidence in his or her skill and ability." *Nail*, 486 S.W.2d at 763. Nevertheless, there may be goodwill in a professional partnership that is separate from the skills or attributes of an individual member. *Id*. at 764. A case illustrating such a situation is *Geesbreght v. Geesbreght*, 570 S.W.2d 427 (Tex.Civ.App--Fort Worth 1978, writ dism'd), in which a physician owned shares in a professional corporation that provided emergency-room physicians to hospitals. The corporation had contracts with several hospitals and employed about fifty to one hundred physicians on a parttime basis and ten on a full-time basis to satisfy those contracts. The court of appeals drew a distinction between the goodwill built up by the physician personally at the hospital at which he practiced and the corporation's goodwill arising from the opportunity under its contracts to provide service to other hospitals at which he did not practice. *Id*. The court of appeals reasoned that if the physician and other shareholders sold the corporation, the right to do business as that corporation would continue and the goodwill built up by the company would continue for a time. *Id*. at 435-36.

The ultimate holding in *Geesbreght* was that the corporation had goodwill separate and apart from that of the physician as a professional practitioner. The goodwill of the company, apart from the goodwill associated with the physician himself, could be considered in dividing the community estate upon divorce. *Id*. at 436; see also *Taormina v. Culicchia*, 355 S.W.2d 569, 573-74 (Tex. Civ.App.--El Paso 1962, writ ref'd n.r.e.) (holding that when former partners continued business in same place with same name and continued use of trademarks and brands in canning business after dissolution of partnership, goodwill existed separate and apart from individual partners); *Dawson v. White & Case*, 88 N.Y.2d 666, 649 N.Y.S.2d 364, 367-368, 672 N.E.2d 589, 592-93 (1996) (holding that law firm's partnership agreement and history of operations precluded recovery of goodwill upon dissolution, but recognizing that blanket prohibition against goodwill of a law firm has been superseded by the economic realities of the contemporary practice of law). *Geesbreght* and *Nail* illustrate the considerations involved in determining whether an estate includes goodwill. Neither establishes an absolute rule.

This is not a case in which the partnership at issue is an ongoing enterprise. The issue is whether there was goodwill attributable to Rafati's former partnership separate and apart from the skills, personalities, and attributes of the professionals themselves and whether such goodwill survived the dissolution. The Rafatis are claiming that an asset of the dissolved partnership, namely goodwill, has been requisitioned by the former partners and is being used in their new partnership.

The Rafatis' expert candidly conceded that the skills of the physicians were the primary asset of the business. Even had he not done so, it is evident that a valuation based on the earnings of the physicians

improperly takes into account goodwill that is attributable only to the professionals personally. Rafati's former partnership is indistinguishable from the one at issue in *Rice*. Each of the former partners now has the opportunity to compete for the partnership's former business. Indeed, Rafati opened a radiology practice at a new location in competition with Salinas and Salazar. Rafati's true complaint is that he has not been as successful in that competition as he would have liked.

The Rafatis' attempt to harness the future earning capacity of Salinas and Salazar highlights the incongruity of a rule of law that would allow a partner to recover a share of a former partner's ability to generate income under the guise of goodwill. If the Rafatis' theory were correct, Salinas and Salazar could also seek to recover from Rafati the value of the goodwill he took to his new practice. There would be offsetting claims, with the more successful former partners compensating the less successful ones indefinitely. This would defeat the very purpose [*292] of a dissolution of a partnership, which is to sever the ties that bind partners and to terminate the sharing of profits. If we were to accept the Rafatis' arguments, we would be undercutting the right of partners to dissolve their partnership. We would also be engrafting onto the partnership agreement a postdissolution sharing arrangement based on the personal earning capacities of other partners.

Utah

▸*Sorensen v. Sorensen*, 839 P.2d 774, 775 (Utah Sup. Ct. 1992): "It would not be equitable to required him to pay his wife part of the value ascribed to the goodwill, because the goodwill of a sole practitioner is nothing more than his or her reputation for competency. . . . We believe . . . that unless the professional retires and his practice is sold, his reputation should not be treated differently from a professional degree or an advanced degree: both simply enhance the earning ability of the holder."

▸*Karlsson v. Karlsson*, 2005 WL 1119651 (Utah App. 2005): "Karlsson argues that this case falls within the scope of Sorensen. Karlsson, however, has not demonstrated that the goodwill of the catering business is solely attributable to his personal, professional reputation. See id. at 775. Rather, the catering business was cofounded by the parties and both worked in the business. Thus, we see no problem in the award of a limited amount for the goodwill of the catering business."

Virginia

▸*Howell v. Howell*, 523 S.E.2d 514, 520 (Va. Ct. App. 2000): "Discounting future earnings is not an inherently flawed method of valuation because it is based on projected future earnings. The value of goodwill can have two components. Professional goodwill (also designated as individual, personal, or separate goodwill) is attributable to the individual and is categorized as separate property in a divorce action. Practice goodwill (also designated as business or commercial goodwill) is attributable to the business entity, the professional firm, and may be marital property. The commissioner and the trial court carefully distinguished between these two components and selected a value that was solely attributable to the husband being a partner in Hunton & Williams. It represented the premium due to the husband's association with Hunton & Williams, the economic advantage he enjoyed because he was a partner in that firm. It included no value attributable to him personally, and it did not rely upon any earnings due to the husband's own expertise, reputation, experience, skill, knowledge, or personality. As applied, the discounted future earnings method was not a flawed method of valuation. In valuing the goodwill of the partnership interest, courts must take special care not to confuse the

owner spouse's personal future earning capacity with practice goodwill attributable to the law firm in order to avoid double counting. "Further, particular care must be given that future earnings capacity and reputation not be confused with professional goodwill."

Washington

▸*Hall v. Hall*, 692 P.2d 175 (Wash. Sup. Ct. 1984): "The husband here contends that the Fleege doctrine should be reconsidered because (1) it presents confusing and unfair criteria for identifying and evaluating the economic benefit to one spouse or the other, from a professional degree and career; and, (2) it is unfair where, as here, it requires the determination that only one of two spouses, with identical professional educations and earning capacities, has professional goodwill. These contentions are based on the failure to distinguish between professional goodwill and personal earning capacity of the professional. Goodwill is a property or asset which usually supplements the earning capacity of another asset, a business or a profession. Goodwill is not the earning capacity itself. It is a distinct asset of a professional practice, not just a factor contributing to the value or earning capacity of the practice. . . . Discontinuance of the business or profession may greatly diminish the value of the goodwill but it does not destroy its existence. When a professional retires or dies, his earning capacity also either retires or dies. Nevertheless, the goodwill that once attached to his practice may continue in existence in the form of established patients or clients, referrals, trade name, location and associations which now attach to former partners or buyers of the practice."

▸*In re Marriage of Lukens*, 558 P.2d 279, 282 (Wash. App. 1976, rev. denied): "The value of goodwill, which is to be determined at the time of dissolution, is not synonymous with the spouse's expectation of future earnings. . . . Goodwill should be measured by arriving at a present value based upon past results and not by accounting for the postmarital efforts of the professional spouse. . . . Factors to be considered include the length of time the professional has been practicing, his comparative success, his age and health, and particularly the past profits of the practice, which would reflect any income previously generated by his goodwill. Additionally, because goodwill does not exist separately but is incidental to the other assets of the business, attention should be given to the physical and fixed resources of the practice." [Citations omitted]

▸*Matter of Marriage of Fleege*, 588 P.2d 1136, 1138 (Wash. Sup. Ct. 1979): "[W]hile the goodwill of a professional practice may not be readily marketable and the determination of its exact value may be difficult, that element may nevertheless be found to exist in a given professional practice. The determination of its value can be reached with the aid of expert testimony and by consideration of such factors as the practitioner's age, health, past earning power, reputation in the community for judgment, skill, and knowledge, and his comparative professional success. A dentist who has practiced many years and established a good reputation can expect his patients to return to him and to speak of him in a manner that enhances that reputation and encourages others to seek his services. Also, he can expect a large number, if not most, of these patients to accept as their dentist a person to whom he sells his practice. These prospects are a part of goodwill, and they have a real pecuniary value."

West Virginia

▸*May v. May*, 214 W.Va. 394, 589 S.E.2d 536, 547 (2003): "[W]e hold that in determining whether goodwill should be valued for purposes of equitable distribution, courts must look to the precise nature

of that goodwill. Personal goodwill, which is intrinsically tied to the attributes and/or skills of an individual, is not subject to equitable distribution. It is not a divisible asset. It is more properly considered as the individual's earning capacity that may affect property division and alimony. On the other hand, enterprise goodwill, which is wholly attributable to the business itself, is subject to equitable distribution."

Wisconsin

▸*Holbrook v. Holbrook*, 309 N.W.2d 343, 345, 353-54 (Wis. Sup. Ct. 1981): "Originally, goodwill was said to exist only in commercial business, and not in a professional business which depends upon the skill and reputation of a particular person.... Because goodwill has no existence apart from the business to which it attaches, courts have determined that there can be no income tax deduction for loss of goodwill; the loss of goodwill cannot be compensated for in eminent domain proceedings; goodwill cannot be used to satisfy debts; nor is it subject to depreciation.... Even greater problems arise when, after it has been determined that professional goodwill is a marital asset divisible upon divorce, attempts are made to place a dollar value on the goodwill that is part of the marital estate. This would be especially problematic, where, as here, the business involved has several members, all of whom have presumably contributed to the goodwill of the business. Valuation of one individual's goodwill interest in the business would be almost pure speculation. . . . We are not persuaded that the concept of professional goodwill as a divisible marital asset should be adopted in Wisconsin. We are not obliged nor inclined to follow the twisted and illogical path that other jurisdictions have made in dealing with this concept in the context of divorce. . . . The concept of professional goodwill evanesces when one attepts to distinguish it from future earning capacity. Although a professional business's good reputation, which is essentially what its goodwill consists of, is certainly a thing of value, we do not believe that it bestows on those who have an ownership interest in the business, an actual, separate property interest. The reputation of a law firm or some other professional business is valuable to its individual owners to the extent that it assures continued substantial earnings in the future. It cannot be separately sold or pledged by the individual owners. The goodwill or reputation of such a business accrues to the benefit of the owners only through increased salary." [Footnotes omitted]

▸*McReath v. McReath*, 789 N.W. 2d 89, 100 (Wis. App. 2010): criticizes *Williams v. Williams*, 667 So.2d 915 (Fla. DCA1996), for excluding all professional goodwill due to the need of a covenant not to compete. "[W]e note that professional goodwill is sometimes sold by means other than a non-compete agreement. For example, part of the agreement Tim had with the dentist that he purchased from required that dentist "to introduce [Tim] to ... existing patients." In this manner, the dentist with established professional goodwill could vouch for Tim and, effectively, transfer some of that professional goodwill to Tim."

V. FASB'S SEPARABILITY REQUIREMENT FOR RECOGNITION OF INTANGIBLE ASSETS. The FASB requirement that an intangible asset must be separable before it can be assigned a value causes many intangible assets to be relegated to residual goodwill. There are differing views about this in the accounting profession.

A. WHAT CONSTITUTES AN INTANGIBLE ASSET (FOR ACCOUNTING PURPOSES)? Prevailing accounting principles treat self-investment in intangibles as an expense rather than an investment, so the value of this self-investment does not show up on the balance sheet, and the income statement fails to correlate this investment to future income. Thus a business's income appears to

be attributable in a mysterious way to "goodwill" in instances when it is really attributable to self-investment in intangible assets that are not reflected on either the balance sheet or the income statement. The accounting profession has partly rectified this problem, but only for intangible assets that are purchased, not self-created. And the accounting profession specifically excludes work-force-in-place as an intangible, which is the repository for much of the human capital and social or relational capital within the organization.

FASB Concepts Statement No. 6, *Elements of Financial Statements*, issued in December 1985, defined "assets" in the following way:

> 26. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred. Assets commonly have other features that help identify them—for example, assets may be acquired at a cost and they may be tangible, exchangeable, or legally enforceable. However, those features are not essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item's qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the entity in producing or distributing other goods or services. Similarly, although the ability of an entity to obtain benefit from an asset and to control others' access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if the entity has the ability to obtain and control the benefit in other ways.

It is clear that many intangible assets meet this old FASB criteria for "asset," and thus should be considered as belonging to the business, separate and apart from goodwill.

In June, 2001, the Financial Accounting Standards Board issued Financial Accounting Statements 141, *Business Combinations*,[27] and 142, *Goodwill and Other Intangible Assets*.[28] (FAS 141 was updated in 2007 but the language quoted below was not modified). The stated reason for issuing FAS 141 and 142 was that "[a]nalysts and other users of financial statements, as well as company managements, noted that intangible assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many transactions." FAS 141 was revised in 2007. The following text is from the Revised version:

FAS(R) 141 ¶ 3(l) p. 9 [pdf p. 10] defines an "intangible asset" in this way:

> An *intangible asset* is an asset (not including a financial asset) that lacks physical substance. As used in this Statement, the term intangible asset excludes goodwill. FAS141(R)-9 [pdf p. 10]

Intangible assets are distinguished from goodwill in FAS 141(R) ¶ A19, FAS141(R)–28 (pdf p. 29]:

> A19. The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the

> separability criterion or the contractual-legal criterion described in paragraph 3(k). FAS141(R)–28 [pdf p. 29]

FAS 141 discusses when an asset is "identifiable." This is important in determining when an intangible asset should be recognized separately from goodwill. As noted in FAS 141® ¶ A28 FAS141(4)-30:

> A28. The identifiability criteria determine whether an intangible asset is recognized separately from goodwill....

The identifiability criterion is based on either the separability criterion or the contractual-legal criterion in FAS 141(R) ¶ 3(k), p. 9 [pdf p. 10]:

> k. An asset is *identifiable* if it either:
>
> (1) Is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or
>
> (2) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

FAS 141(R) A20 reiterates that the contractual-legal criterion is independent from the separability criterion:

> A20. An intangible asset that meets the contractual-legal criterion is identifiable even if the asset is not transferable or separable from the acquiree or from other rights and obligations.

FAS 141(R) ¶¶ A21 & A22 discusses the separability criterion:

> A21. The separability criterion means that an acquired intangible asset is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability. An intangible asset that the acquirer would be able to sell, license, or otherwise exchange for something else of value meets the separability criterion even if the acquirer does not intend to sell, license, or otherwise exchange it. An acquired intangible asset meets the separability criterion if there is evidence of exchange transactions for that type of asset or an asset of a similar type, even if those transactions are infrequent and regardless of whether the acquirer is involved in them.
>
> A22. An intangible asset that is not individually separable from the acquiree or combined entity meets the separability criterion if it is separable in combination with a related contract, identifiable asset, or liability.

FAS 142 requires that intangible assets of acquired companies must be amortized over their useful lives, or if the useful life is indefinite, that the intangible be tested annually for impairment. This alters

the previous rule requiring intangible assets to be amortized over an arbitrary 40 year period. This also results in business valuators having to evaluate each intangible asset based on the attributes of that intangible asset. And it requires that residual goodwill be tested annually for impairment.

FAS 142 lists in Appendix A the following examples of intangible assets: customer lists, patents, copyright, broadcast licenses, airline route authority, and trademarks. FAS 142 only applies to acquired intangibles, and GAAP does not require that intangibles developed internally by a business must be disclosed on the balance sheet.

The accounting firm Plante Moran posted a useful article by Richard Lies, on *Portfolio acquisitions: Valuing intangibles* (2016).[29] In it he lists a large number of identifiable intangible assets that are market-related, artistic-related, contract-based, and technology-based.

As mentioned above, a researcher for FASB authored a report that dealt in detail with intangible assets: Wayne S. Upton, Jr., *Special Report: Business and Financial Reporting, Challenges from the New Economy*, FINANCIAL ACCOUNTING STANDARDS BOARD (April 2001), on line at <http://www.fasb.org/articles&reports/sr_new_economy.pdf#76>. He describes intangible assets as follows:

> The Intangibles Research Center at New York University offers two possible definitions:
>
> Broad Definition—Intangibles are nonphysical sources of probable future economic benefits to an entity or alternatively all the elements of a business enterprise that exist in addition to monetary and tangible assets. [Footnote reference omitted.]
>
> Narrow Definition—Intangibles are nonphysical sources of probable future economic benefits to an entity that have been acquired in an exchange or developed internally from identifiable costs, have a finite life, have market value apart from the entity, and are owned or controlled by the entity.
>
> The FASB Exposure Draft, Business Combinations and Intangible Assets, offered: Intangible assets are noncurrent assets (not including financial instruments) that lack physical substance.

Id. at 68. [Footnote omitted] Upton describes the long list of intangible assets contained on Exhibit A to FASB Exposure Draft, *Business Combinations and Intangible Assets*, later shortened by FASB. *Id.* at 68-69. Upton observed: "The items on the list of potential intangible assets share a common characteristic. Each is separable from the entity or exists by virtue of contractual or legal rights. Separability and contractual/legal rights are not essential characteristics of an asset, but they are evidence of one characteristic that is essential—control." *Id.* 70-71. Upton's paper contains a thorough discussion of what constitutes an intangible asset of a business. This discussion is an excellent reference for intangible assets that might be differentiated from residual goodwill.

FAS 141(R) says "Goodwill [is] an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized."

An insightful article on the undertaxation of intangible assets is by Professor Calvin H. Johnson, *Organizational Capital: The Most Important Unsettling Issue in Tax*, 148 TAX NOTES 667, 673 (August 10, 2015) ("The smart market can see the organizational capital, even though tax and GAAP accounting cannot... Hulten and Hao find that accounting assets represent only 31 percent of the market value determined by stock quotes, so it follows that 69 percent of all capital is invisible to tax and GAAP accounting.").

B. THE ARGUMENT THAT GOODWILL IS NOT AN ASSET. Walter P. Schuetze was the Chief Accountant, Division of Enforcement, at the U.S. Securities and Exchange Commission up until February, 2000, while FASB was considering the updated treatment of intangible assets. Mr. Schuetze was one of FASB's original seven members. Mr. Schutze for years spoke out against the reporting of imaginary assets on balance sheets, things he said "that only accountants call assets."[30] On August 17, 1998, Mr. Schuetze (a University of Texas graduate who worked as an accountant in San Antonio) gave a speech in which he discussed the FASB's consideration of the question of whether the cost of goodwill should be recognizable as an asset. Walter P. Schuetze, *Enforcement Issues, and Is the Cost of Purchased Goodwill an Asset?*[31] Schuetze argued that goodwill did not fit the definition of an asset and could not have a specific cost assigned to it. Schuetze wrote:

> In paragraph 172 of Concepts Statement 6, the Board said, "Future economic benefit is the essence of an asset. An asset has the capacity to serve the entity by being exchanged for something of value to the entity, by being used to produce something of value to the entity, or by being used to settle its liabilities." The cost of purchased goodwill is simply the amount paid by one entity for the net assets of another entity, or for a controlling equity interest in another entity, in excess of the fair value of the individual, identifiable net assets (assets minus liabilities) of that other entity; the amount said to represent the cost of purchased goodwill is just the excess amount left over–in a word, the lump. But, the lump cannot be exchanged for anything. The lump cannot be used to produce anything of value. The lump cannot be used to settle a liability. I conclude, therefore, using the Board's own words, that the future economic benefit criterion is not met.

C. DIFFICULTY IN VALUING SOME INTANGIBLE ASSETS. In Financial Accounting Standard 141, FASB explained it reason for rejecting other recognition criteria suggested for Statement 141:[32]

> B170. Some respondents suggested that the FASB eliminate the requirement to recognize intangible assets separately from goodwill. Others suggested that all intangible assets with characteristics similar to goodwill should be included in the amount recorded as goodwill. The FASB rejected those suggestions because they would diminish rather than improve the decision usefulness of reported financial information.

FAS 141(R) ¶ B170, p. 135 [pdf p. 83].

> B171. Some respondents doubted their ability to reliably measure the fair values of many intangible assets. They suggested that the only intangible assets that should be recognized separately from goodwill are those that have direct cash flows and those that are bought and sold in observable exchange transactions. The FASB rejected that suggestion. Although the fair value measures of some identifiable intangible assets might lack the precision of

> the measures for other assets, the FASB concluded that the information that will be provided by recognizing intangible assets at their estimated fair values is a more faithful representation than that which would be provided if those intangible assets were subsumed into goodwill. Moreover, including finite-lived intangible assets in goodwill that is not being amortized would further diminish the representational faithfulness of financial statements.

FAS 141(R) ¶ B171, p. 136 [pdf pp.83-84].

D. ASSEMBLED WORKFORCE AS PART OF RESIDUAL GOODWILL. FAS 141(R) rejects assembled workforce as an identifiable intangible asset:

> A25. The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date. For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. An assembled workforce does not represent the intellectual capital of the skilled workforce—the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs. Because the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed into goodwill.

FAS 141(R) , p. 82 [pdf p. 83-84] continues:

> Assembled workforce
>
> B176. In developing Statement 141, the FASB did not consider whether an assembled workforce met either the contractual-legal or the separability criterion for recognition as an identifiable intangible asset. Instead, Statement 141 precluded separate recognition of an assembled workforce because of the FASB's conclusion that techniques to measure the value of an assembled workforce with sufficient reliability were not currently available. IFRS 3 and IAS 38, on the other hand, did not explicitly preclude separate recognition of an assembled workforce. However, paragraph 15 of IAS 38 noted that an entity usually would not have sufficient control over the expected future economic benefits arising from an assembled workforce for it to meet the definition of a separate intangible asset.
>
> B177. In developing the 2005 Exposure Draft, the Boards concluded that an acquirer should not recognize an assembled workforce as a separate intangible asset because it meets neither the contractual-legal nor the separability criterion. The views of respondents who commented on recognition of an assembled workforce were mixed.
>
> Some agreed with its proposed recognition prohibition. Others suggested that the Boards reconsider that prohibition; they generally said that an assembled workforce is already valued in many situations for purposes of calculating a "contributory asset charge" in determining the fair value of some intangible assets. (In using an "excess earnings" income valuation technique, a contributory asset charge is required to isolate the cash flows generated by the intangible asset being valued from the contribution to those cash flows made by other assets, including other intangible assets. Contributory asset charges are hypothetical "rental" charges

for the use of those other contributing assets.) Those respondents opposed a prohibition on recognizing an assembled workforce as a separate intangible asset; they favored permitting acquirers to assess whether an assembled workforce is separable in each situation and to recognize those that are separable.

B178. In reconsidering the proposal in the 2005 Exposure Draft, the Boards concluded that the prohibition of recognizing an assembled workforce should be retained. Because an assembled workforce is a collection of employees rather than an individual employee, it does not arise from contractual or legal rights. Although individual employees might have employment contracts with the employer, the collection of employees, as a whole, does not have such a contract. In addition, an assembled workforce is not separable, either as individual employees or together with a related contract, identifiable asset, or liability. An assembled workforce cannot be sold, transferred, licensed, rented, or otherwise exchanged without causing disruption to the acquirer's business. In contrast, an entity could continue to operate after transferring an identifiable asset. Therefore, an assembled workforce is not an identifiable intangible asset to be recognized separately from goodwill.

B179. The Boards observed that neither Statement 141 nor IAS 38 defined an assembled workforce and that inconsistencies have resulted in practice. In addition, some who objected to the recognition prohibition in the 2005 Exposure Draft apparently consider an assembled workforce to represent the intellectual capital of the skilled workforce—the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs. However, the Boards view an assembled workforce as an existing collection of employees that permits an acquirer to continue to operate an acquired business from the acquisition date, and they decided to include that definition in this Statement (paragraph A25).

B180. The Boards observed that the value of intellectual capital, in effect, is recognized because it is part of the fair value of the entity's other intangible assets, such as proprietary technologies and processes and customer contracts and relationships. In that situation, a process or methodology can be documented and followed to the extent that the business would not be materially affected if a particular employee left the entity. In most jurisdictions, the employer usually "owns" the intellectual capital of an employee. Most employment contracts stipulate that the employer retains the rights to and ownership of any intellectual property created by the employee. For example, a software program created by a particular employee (or group of employees) would be documented and generally would be the property of the entity. The particular programmer who created the program could be replaced by another software programmer with equivalent expertise without significantly affecting the ability of the entity to continue to operate. But the intellectual property created in the form of a software program is part of the fair value of that program and is an identifiable intangible asset if it is separable from the entity. In other words, the prohibition of recognizing an assembled workforce as an intangible asset does not apply to intellectual property; it only applies to the value of having a workforce in place on the acquisition date so that the acquirer can continue the acquiree's operations without having to hire and train a workforce.

The rationales for this refusal to segregate assembled workforce from residual goodwill were expressed in the November 1, 2016 revised minutes from the October 18,2 006 meeting.[33] The minutes of the

meeting indicated:

> *Assembled Workforce*
>
> 1. The Board reaffirmed the existing provision in FASB Statement No. 141, Business Combinations, stipulating that assembled workforce not be recognized as an intangible asset separately from goodwill on the basis that it generally does not meet the separability criterion.
>
> 2. The Board decided that the final Statement should define assembled workforce as a collection of employees that allows the acquirer to continue to operate from the date of the acquisition rather than the intellectual capital of the skilled workforce. [pdf p. 2]

The following lengthy excerpt from the Board minutes is illuminating [pdf p. 4-10]:

> TOPIC 1: Assembled Workforce
>
> 1. Ms. Eastman stated that the Boards have reaffirmed that an identifiable (that is, contractual or separable) intangible asset can be measured with sufficient reliability and should be recognized separately from goodwill. However, the Exposure Draft specifically precludes the recognition of an acquired assembled workforce separately from goodwill, which is consistent with FASB Statement No. 141, Business Combinations. The staff believes that in a principles-based standard, all intangible assets should be subject to the same recognition criteria. Therefore, it would be inconsistent to preclude the recognition of any identifiable intangible asset, including an assembled workforce.
>
> 2. Regardless of what the Board decides on recognition, the staff believes the Board should clarify the meaning of an assembled workforce. Otherwise, there could be an inconsistency in the measurement of an assembled workforce when calculating contributory asset capital charges. Also, there is the potential for double counting in the valuation of intellectual property intangible assets when the fair value of the assembled workforce includes the intellectual capital related to the development of these other intangible assets. There are two general views for the meaning of an assembled workforce:
>
> > a. View 1: An assembled workforce is the intellectual capital of the skilled workforce of which the acquirer has obtained the benefit as a result of the acquisition. This view implies that the assembled workforce is the (specialized) knowledge and experience that the employees bring to their jobs.
> >
> > b. View 2: An assembled workforce is a collection of employees that allows the acquirer to continue to operate on Day One. That is, the acquirer does not need to go through the process of finding, hiring, and training the employees because they are already in place and operating on a continuous "business as usual" basis. This view would eliminate the potential for double counting.

3. Some constituents have raised concerns about the decision usefulness, materiality, and costs of recognizing an assembled workforce separately from goodwill. However, the staff believes that in terms of decision usefulness and materiality, for some industries, particularly those that are service- or people-intensive, the separate recognition of an acquired assembled workforce would provide decision-useful information. The staff also noted that the fair value of an assembled workforce might be immaterial in some industries, particularly if View 2 is chosen, but to preclude recognition altogether is inconsistent with a principles-based standard. In fact, the difference in materiality by entity or industry is one of the reasons that an assembled workforce should be recognized as it gives users an indication of the main value drivers of a business. In terms of the cost of preparation, the staff believes that because assembled workforces currently are valued for the purpose of calculating the contributory asset capital charges for the valuation of other intangible assets, there will be no additional costs involved if the exception for assembled workforce is removed. As for subsequent accounting, the useful life could be estimated from historical employee turnover data. An impairment of the assembled workforce would be evident, for example, when substantially higher turnover occurs than what was assumed in the initial determination of the useful life.

4. Ms. Eastman noted that at the October 19, 2006 IASB Board meeting, the IASB Board supported View 2 (all IASB Board members agreed) and agreed that a separable assembled workforce should be separately recognized (seven IASB Board members agreed; five did not).

5. The Board generally supported View 2 in clarifying the meaning of an assembled workforce (all Board members agreed). However, the Board concluded that an assembled workforce should not be recognized as an intangible asset separately from goodwill because it is generally not separable (all Board members agreed).

6. Mr. Trott stated that for an intangible asset to be identifiable, that intangible asset would have to either arise from a contractual-legal right or be separable. He believes that an assembled workforce neither meets the contractual-legal right criterion nor the separable criterion because an assembled workforce is not contractually based and cannot be sold separately from the business. Ms. Eastman stated that some constituents believe that an assembled workforce is separable in combination with other assets (for example, a division within an organization). An example of a separable assembled workforce would be a consulting firm that “leases” out its employees to other corporations for an extended period of time. She also clarified that the staff is not stating that an acquirer should always separately recognize an assembled workforce; if that assembled workforce is not separable, then the acquirer should not recognize it separately from goodwill. Mr. Trott responded by stating that if the Board was to agree that an assembled workforce is separable in combination with its other related assets, that would defeat the purpose of the separable criterion because the measurement of that assembled workforce would include the measurements of all the other related assets. In the case of the consulting firm “leasing” out its employees, Mr. Trott believes that the consulting firm’s product is the services provided by its employees and, therefore, it is not possible to differentiate between the value of the employees and the value of the services provided by those employees. Mr. Crooch agreed with Mr. Trott. Ms. Seidman added that if the Board was to support the separate recognition for the consulting firm’s assembled workforce, the Board would be

supporting View 1, which is not the Board's view of the meaning of an assembled workforce.

7. Mr. Batavick stated that although he agrees that an assembled workforce is a collection of employees that allows the acquirer to continue to operate on Day One (View 2), he also could envision some circumstances in which the intellectual capital (that is, the specialized skill set of the employees) could be valuable to the acquirer (View 1). As for whether an assembled workforce could be recognized separately from goodwill, he believes that an assembled workforce does not meet the separability criterion and should not be recognized separately from goodwill. Furthermore, he questions the value of the information provided by separately recognizing an assembled workforce from goodwill. Even if one could substantiate that there is value in that information, requiring the separate recognition of an assembled workforce would add complexity to the final Statement on business combinations because not only would the Board have to provide recognition and measurement guidance, it also would have to provide impairment and amortization guidance, which would prolong the business combinations project. He concluded by stating that he believes that an assembled workforce does not meet the separability criterion as stated in existing guidance for intangible assets.

8. Ms. Seidman supported View 2. Paragraph B169 in Statement 141 states that "... replacement cost is not a representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination." In response to the staff's question about whether that statement is valid, she noted that she believes that statement is outdated now that FASB Statement No. 157, Fair Value Measurements, has been issued. Consequently, she believes that statement should be deleted. As for whether the Board should remove the exception for separate recognition of assembled workforce, Ms. Seidman stated that,on-balance she would vote to keep the prohibition. She stated that if one believes that the nature of an assembled workforce is the cost of accumulating the employees, then there are two reasons for disallowing its separate recognition from goodwill. First, to the extent that an assembled workforce needs to be combined with other related assets to meet the definition of separable, not only would that be too broad of an interpretation of the term separable, the valuation of that assembled workforce would include a broad number of elements, which would not provide particularly useful information. Second, the nature of an assembled workforce seems to mirror a transaction cost (that is, the acquirer is basically reimbursing the acquiree for paying the acquirer's costs to assemble these employees). Ms. Seidman emphasized that one of the themes of the Statement on business combinations is that the cost of assembling an asset is not part of the fair value of the asset itself. By supporting View 2, the Board would essentially be clarifying that an assembled workforce is of a different nature than the other types of intangible assets that are separable and recognized separately from goodwill. Mr. Young agreed with Ms. Seidman.

9. Mr. Linsmeier stated that while he believes an assembled workforce has aspects of both Views 1 and 2, he supports View 2. Limiting the definition of an assembled workforce to View 2 would help acquirers account for an assembled workforce because the intellectual capital portion might be recognized in other assets at the acquisition date in a business combination. He stated that while he agreed with the other Board members that an assembled workforce is generally not separable, he questioned whether the Board should make that decision for preparers. If unique circumstances exist in the acquisition whereby the acquirer

could separately value the workforce, that acquirer should be allowed to recognize that assembled workforce apart from goodwill. Although he understood the transaction cost notion as stated by Ms. Seidman, he believes that at the acquisition date, an acquirer is not recognizing a transaction cost. He believes that at the acquisition date, the acquirer is receiving an asset because the acquirer could continue operations without expending resources to construct a workforce. Mr. Linsmeier does not support prohibiting separate recognition. However, if the Board does prohibit recognition, the basis for conclusions should explain that the Board believes it would be a challenge for an assembled workforce to meet the separability criterion and that it would not be a common occurrence for an acquirer to be able to separately recognize an assembled workforce.

10. Mr. Herz agreed with Mr. Linsmeier. He stated that an acquirer is acquiring all the tangible and intangible assets of a business, including a workforce that is trained and ready to operate on the date of acquisition, and all those assets contribute to the value of the acquiree. He believes that whether an assembled workforce is separable would depend on the business model of the acquiree. Similar to Mr. Linsmeier, Mr. Herz stated that the staff should state the reason that the Board supports the prohibition is because it believes that an assembled workforce generally is not separable and should not be separately recognized, whic h is consistent with the principle that only identifiable intangible assets should be recognized separately from goodwill. He clarified that he supports View 2, even though he believes that View 1 is correct from an economic point of view. However, the measurement issues associated with View 1 leads him to support View 2.

VI. FINDING A BASIS TO IDENTIFY NON-SEPARABLE INTANGIBLES. There are places to look to get ideas about how to identify non-separable intangible assets in order to value them.

A. LOOKING TO TAX LAW TO IDENTIFY NON-SEPARABLE INTANGIBLES. Before the adoption of Internal Revenue Code § 197, there was much litigation over whether an intangible asset was or was not depreciable under IRC § 167. A deduction was allowed if the taxpayer proved that the intangible asset (1) had an ascertainable value separate and distinct from goodwill, and (2) had a limited useful life, the duration of which could be ascertained with reasonable accuracy. *Newark Morning Ledger Co. v. U.S.*, 507 U.S. 546, 558, 113 S.Ct. 1670, 1676 (1993). This struggle was supplanted by IRC § 197, which specifies intangibles that can and cannot be amortized. Although not intended for this purpose, the list of self-created intangible assets in Section 197(d) that cannot be amortized could be considered as a list of intangible assets of a business that are separable from personal goodwill in a divorce. Section 197(d) says:

Internal Revenue Code § 197(d) Exclusion of self-created intangibles, etc.

For purposes of this section--

(1) In general. Except as otherwise provided in this section, the term "section 197 intangible" means--

(A) goodwill,
(B) going concern value,

(C) any of the following intangible items:
(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),
(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,
(iv) any customer-based intangible,
(v) any supplier-based intangible, and
(vi) any other similar item,
(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and
(F) any franchise, trademark, or trade name.

The term "customer-based intangible" is defined in § 197(d)(2) to mean "(i) composition of market, (ii) market share, and (iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers."

The term "supplier-based intangible" is defined in § 197(d)(3) to mean "any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer."

Note that workforce in place is precluded as an amortizable intangible. This dovetails with FAS 141, which specifically excludes assembled workforce as a separable intangible asset, because replacement cost (the cost to hire and train a comparable assembled workforce) is "not a representationally faithful measurement of the fair value of the intellectual capital acquired in a business combination" and FASB believes that "techniques to measure the value of an assembled workforce and the related intellectual capital with sufficient reliability are not currently available."

Treas. Reg. § 1.197-2(b)(2) defines "going concern value" as "the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity." Court cases recognize "going concern value" as distinguishable from goodwill. In *Citizens and Southern Corp. v. C.I.R.*, 91 T.C. 463, 481 n. 9, 1988 WL 90987 (1988), *aff'd*, 900 F.2d 266 (11th Cir. 1990), the court said:

> Going concern value as distinguished from goodwill is the additional element of value which attaches to property by reason of its existence as an integral part of a going concern. *VGS Corp. v. Commissioner*, 68 T.C. 563, 591 (1977). Going concern value is 'bottomed on the ability of the acquired business to generate sales without any interruption because of the take-over.' *Winn-Dixie Montgomery Inc. v. United States*, 444 F.2d 677, 685 n. 12 (5th Cir. 1971).

The Tax Court, in *UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1323 (1989), said this:

> Going concern value is an intangible, nonamortizable capital asset that is often considered to be part of goodwill. Goodwill has been defined as the 'expectancy of BOTH continuous excess earning capacity and also of competitive advantage or continued patronage.' *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. 847, 861 (1976). (Emphasis added.) On the other hand, going concern value has also been described as related less to the business reputation and the strength of customer loyalty, than to the operating relationship of assets and personnel inherent in an ongoing business. Going concern value has been defined as 'the additional element of value which attaches to property by reason of its existence as an integral part of a going concern.' *VGS Corp. v. Commissioner*, 68 T.C. 563, 591 (1977); *Conestoga Transportation Co. v. Commissioner*, 17 T.C. 506, 514 (1951). Going concern value is manifested in the business' ability to resume business activity without interruption and to continue generating sales after an acquisition. *Computing & Software Inc. v. Commissioner*, 64 T.C. 223, 235 (1975). While courts have blurred these distinctions between goodwill and going concern value, they are different conceptually. *See United States v. Cornish*, 348 F.2d 175, 184 (9th Cir. 1965); *Computing & Software Inc. v. Commissioner*, *supra* at 234-235; *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 685 (5th Cir. 1971).

B. LOOKING TO MANAGEMENT THEORY TO IDENTIFY NON-SEPARABLE INTANGIBLES. In 1991, Hiroyuki Itami authored a book on MOBILIZING INVISIBLE ASSETS (1991)[34] in which he wrote: "Intangible assets are invisible assets that include a wide range of activities such as technology, consumer trust, brand image, corporate culture, and management skills." In 1992, R. Hall authored a paper[35] in which he wrote: "Intangible assets are value drivers that transform productive resources into value-added assets." In 1994, G. V. Smith authored a book THE NEW ROLE OF INTELLECTUAL PROPERTY IN COMMERCIAL TRANSACTIONS[36] in which he wrote: "Intangible assets are all the elements of a business enterprise that exist in addition to working capital and tangible assets. They are the elements, after working capital and tangible assets, that make the business work and are often the primary contributors to the earning power of the enterprise. Their existence is dependent on the presence, or expectation, of earnings." In 1997,[37] Annie Brooking examined the "intellectual capital" of a business, which she divided into "human-centered assets," "infrastructure assets," "intellectual property assets," and "market assets." Another seminal 1997 book[38] by Leif Edvinsson and Michael S. Malone, divided a business's intellectual capital into human capital, structural capital, and customer capital.[39] For present purposes we will conduct our quick overview of the current thinking about intangible assets of a business based on Wikipedia, which labels all non-separately-identifiable intangible assets of a business as "Intellectual Capital," and divides that into "Human Capital," "Relational Capital," and "Structural Capital."

1. INTELLECTUAL CAPITAL. According to Wikipedia[40]:

> Intellectual capital is the intangible value of a business, covering its people (human capital), the value relating to its relationships (relational capital), and everything that is left when the employees go home[1] (structural capital), of which intellectual property (IP) is but one component.[2] It is the sum of everything everybody in a company knows that gives it a competitive edge.[3] The term is used in academia in an attempt to account for the value of intangible assets not listed explicitly on a company's balance sheets.[4] On a national

> level intellectual capital refers to national intangible capital, NIC.

In this scheme, intellectual capital is classified as consisting of human capital, structural capital, and relational capital.[41]

a. Human Capital. According to Wikipedia[42]:

> Human capital is the stock of habits, knowledge, social and personality attributes (including creativity) embodied in the ability to perform labour so as to produce economic value.[1] Human capital is unique and differs from any other capital. It is needed for companies to achieve goals, develop and remain innovative. Companies can invest in human capital for example through education and training enabling improved levels of quality and production.

+

One YouTube presentation describes human capital simply as "the value people can deliver within an organization."[43]

b. Structural Capital. According to Wikipedia[44]:

> Structural capital [is] the supportive non-physical infrastructure, processes and databases of the organisation that enable human capital to function.[15] Structural capital includes processes, patents, and trademarks, as well as the organization's image, organization, information system, and proprietary software and databases. Because of its diverse components, structural capital can be classified further into organization, process and innovation capital. Organizational capital includes the organization philosophy and systems for leveraging the organization's capability. Process capital includes the techniques, procedures, and programs that implement and enhance the delivery of goods and services. Innovation capital includes intellectual property such as patents, trademarks and copyrights, and intangible assets.[17] Intellectual properties are protected commercial rights such as patents, trade secrets, copyrights and trademarks. Intangible assets are all of the other talents and theory by which an organization is run.

One YouTube presentation describes structural capital as non-physical assets like databases, processes and procedures, protected ideas such as trademarks and patents, brands, the arrangement of the organization, and unique knowledge like trade secrets.[45]

c. Relational Capital. According to Wikipedia[46]:

> Relational capital ... consist[s] of such elements as customer relationships, supplier relationships, trademarks and trade names (which have value only by virtue of customer relationships), licences, and franchises. The notion that customer capital is separate from human and structural capital indicates its central importance to an organization's worth.[18] The value of the relationships a business maintains with its customers and suppliers is also referred as goodwill, but often poorly booked in corporate accounts, because of accounting rules.[19]

A YouTube presentation describes relational capital as "intangible relationships that a company has, including customer, supplier, third party partnerships, licenses, trademarks; the amount of value a

company has in the relationships that it maintains."[47]

d. Annie Brooking's Components of Intellectual Capital. Annie Brooking is the author of one of the early books on intellectual capital, Intellectual Capital: Core Asset for the Third Millennium Enterprise (International Thomson Business Press, New York, 1996). In her book, Brooking listed the following components of intellectual capital:

Market assets

- Service brands
- Product brands
- Corporate brands
- Champions
- Customers
- Evangelists
- Customer loyalty
- Repeat business
- Company name
- Company name
- Backlog
- Distribution channels
- Business collaborations
- Franchise agreements
- Licensing agreements
- Favorable contracts

Intellectual property assets

- Patent
- Copyright
- Design rights
- Trade secrets
- Know-how
- Trade marks
- Service marks

Human-centered assets

- Education
- Vocational qualifications
- Work-related knowledge
- Occupational assessments and psychometrics
- Work-related competencies

Infrastructure assets

- Management philosophy
- Corporate culture
    - Management processes
- Information technology systems
- Networking systems
- Financial relations

In a more recent writing,[48] Brooking described four areas of categories of assets, particularly for high technology companies, that generate value:

> (i) Market assets. Market assets include brands, positioning, customer base, company name, backlog, distribution channels, collaborations, franchise agreements, licensing agreements, favorable contracts, etc.
>
> (ii) Infrastructure assets. Infrastructure assets are assets are "the elements which make up the way the organization works." This can include management philosophy, corporate culture, management and business processes, compliance to standards such as FDA, financial relations, methodologies and IT systems which enable the organization to function and communicate with its customers. Examples include methodologies for assessing risk methods of managing a sales force, financial structure, databases or market or customer information, email and teleconferencing systems. This category also includes the financial status of the business, whether it be stable or at risk, wealth or constantly seeking funding.
>
> (iii) Intellectual property. Intellectual property assets are products of the minds that belong

to the company and are protectable in law, such as patents, copyright, design rights, trade secrets, and trade marks.

(iv) Human Centered Assets. Human-centered assets include "the collective expertise, creative, problem solving capability, leadership, entrepeneurial and managerial skills embodied by the employees in the organization." This includes knowledge of aspects of the business, market knowledge, and management expertise. Human-centered assets also include how well individuals work in a team or under stress. These assets are qualities of the employees and do not belong to the business but they can be acquired by the business through employment agreements.

Brooking notes that market, infrastructure and intellectual property assets can be sold, while human-centered assets cannot.

e. Measuring Intellectual Capital. According to Wikipedia[49]:

> An intellectual capital audit is an audit of a company's intellectual capital to monitor and oversee the intellectual capital of a firm in order to capitalize on intellectual capital already within the company, and to identify opportunities to increase the intellectual capital of the company.[31]
>
> Early methods of intellectual capital measurement include the balanced scorecard framework (BSC), the Skandia Navigator, and the Intangible Asset Monitor. Additionally, the Value-Added Intellectual Coefficient method (VAIC) was introduced in 1993 to measure the value created by intellectual capital.[32]

Professor Luthy, in his 1998 article *Intellectual Capital and its Measurement*,[50] suggests that there are two methods for measuring intellectual capital: a component-by-component evaluation, and measuring the value of intellectual assets in the aggregate.

Approaches to valuing intellectual capital include:

- Direct Intellectual Capital Method: valuing each intellectual capital item.

- The Calculate Intangible Value (CIV): developed by NCI Research to determine the fair market value of intangible assets of a business. The method uses a three-year average of pre tax earnings and tangible assets to arrive at company's return on assets to compare with the industry average.[51]

- Market Capitalization Methods (noting the difference between market cap and equity of guideline companies (e.g. market-to-book-value ratio).

- Baruch Lev's knowledge capital valuation: knowledge capital is calculated as the difference between normalised earnings and earnings from tangible and financial assets. The value is calculated by dividing knowledge capital by the knowledge capital discount rate.[52]

- Paul Strassmann's knowledge capital valuation: Knowledge capital is calculated as the difference between profits and financial capital rental. Knowledge capital is divided by interest rate of cost of long-term debt.[53]

- Return on Assets Method: compares pre-tax average income to an average capital unit calculation.

- Balanced Scorecard: developed by Robert Kaplan and David Norton in 1992,[54] identify various components of intellectual capital and assign indices to measure these components.

- Skandia Navigator: developed by Leif Evninsson in 1995.

An informative article is Associate Professor Herman A. van den Berg's *Models of Intellectual Capital Valuation: A Comparative Evaluation*.[55] A useful PowerPoint presented by Michael J. Mard and James R. Hitchner and others presented to the FASB in 2002 is worth review.[56]

Much of the ongoing published work on intangible assets is being done at the government level, attempting to move the macroeconomic discussion away from the production of goods and the provision of services to a focus on the increase in value attributable to knowledge, efficiency, health, and well being. Business literature is pursuing improved management of non-identifiable intangible assets. The insurance industry is preaching the importance of insuring intangible assets that are largely ignored. Over time, all interested parties are slowly adapting historical practices to the reality of a world dominated by intangible capital. Business valuators need to take note of these changes.

f. Valuing Workforce in Place. Willamette Management Associates takes the view that assembled workforce can be valued. In Pamela J. Garland and David M. Chiang, *Valuation of the Assembled Workforce Intangible Asset for Property Taxation Purposes* p. 52 (Spring 2006),[57] the authors wrote this:

> Most industrial and commercial organizations recognize their employees—and other forms of human capital—as a valuable intangible asset. Recognizing the value of a company's assembled workforce is not a new concept. Companies often analyze the value of their human capital intellectual property (e.g., an assembled workforce) for a variety of transactional, financing, accounting, taxation, and litigation purposes.

Id. p. 52. The authors went on to say:

> Many corporate CEOs have publicly stated that the assembled workforce is one of their company's most valuable assets. However, few companies incur the effort or expense to periodically quantify the value of their assembled workforce intellectual property. Numerous court cases have concluded that an entity's assembled workforce is a discrete intangible asset that has a measurable value.

Id. at 54. The authors cite: *Ithaca Industries, Inc. v. C.I.R.*, 17 F.3d 684 (4th Cir. 1994); and *Burlington Northern R.R. Co. v. Bair*, 815 F.Supp. 1223 (S.D. Iowa, 1993), *aff'd*, 60 F.3d 410 (8th Cir. 1995). The authors went on to discuss how to value workforce in place. If assembled workforce is valued,

and it is established that it will stay with the company if the business is sold, then the value of assembled workforce can be withdrawn from the category of residual goodwill, and avoid being treated the way that undifferentiated goodwill is treated in litigation, including divorce.

Willamette Management Associates published another article on the subject, by Michael A. Harter, PhD, and Justin M. Nielsen, *Valuing a Trained and Assembled Workforce* (Summer 2016).[58] They discussed "the valuation of an assembled workforce using the cost approach, including a brief discussion of the information gathering process and obsolescence considerations." They went on to discuss how reproduction cost and replacement cost can be determined.

The article by Richard Lies[59] suggests information to gather if valuing workforce in place:

Assembled Workforce

1. Utilize a listing of all the Company's employees as of the closing date of the transaction that has the following information:

    a. Annual salary
    b. Employee benefit levels
    c. Estimated hiring and recruiting costs (often estimated as a $ value per employee or a % of total annual compensation, by job function)
    d. Estimated training period and level of productivity over this period. For example, the Company may have a three month training period for new supervisors and they are estimated to be 50% productive (on average) over this training period. This training period is expected to be lower for low skilled jobs (1-2 months) and higher for executive positions (3-12 months).

If benefit levels are not available by employee, estimates as a percentage of total salary are often used for employee benefit levels. Oftentimes, this is provided as a different percentage for different types of employees. Note that this data does not need to be provided for each individual employee. Categories of employees with common characteristics are often presented as a group (e.g., accounting, HR, general labor, etc.).

g. Customer-Related Intangibles. There are methods to value customer-related intangibles. The Lies article lists information to gather to value customer related intangibles:

Customer Related Intangible

1. Understand the nature of the company's customer relationships by determining

    a. What customers generate revenue every year?
    b. Which customers have periodic needs for services?
    c. Which customers nonrecurring?

2. Determine if the company's experience with a particular customer gives it a competitive advantage when that customer has future needs.

3. Understand any contractual agreements with any customers.

4. Determine the most important factors that the company's customers consider (e.g., price, reputation, quality).

5. Analyze detailed customer revenue information for as long a period as available including customers lost (customer turnover). The objective is to identify the length of time and frequency customers remain. The following is an example of the format that could be used for this information:

	2010	2011	2012	2013	2014
Customer Name					
Customer A					
Customer B					
Customer C					
Customer D					
Other					
Total Revenue"					

VII. ENTERPRISE VERSUS PERSONAL GOODWILL. In light of the foregoing, it is possible for business valuators to go much further than the accounting profession has gone in discussing what makes up the goodwill of a business. Given that the value of a business consists of (i) the cash assets, plus (ii) the value of tangible assets, plus (iii) the value of intangible assets that are "identifiable," plus (iv) the commercial or enterprise goodwill of the business, plus (v) the goodwill that is personal to the selling owner so that it is lost to the business when the seller leaves, the first step for the business valuator in a divorce is to determine the overall goodwill of the business, and then to allocate goodwill between enterprise goodwill and the personal goodwill of the owner.

A. DETERMINING TOTAL GOODWILL. The Tax Court recognizes three ways to measure the value of goodwill of a business: (i) the bargain of the parties (where agreement was reached as a result of arm's-length bargaining between parties with adverse legal interests); (ii) the "residual" or "gap" method (subtract the value of the tangible assets, i.e. cash, cash equivalents and other tangible assets from the purchase price, and the remainder constitutes aggregate intangible asset value); (iii) the capitalization method (calculate the annual earnings of the business and subtract a fair return on tangible assets). *Concord Control, Inc. v. Commissioner*, 78 T.C. 742, 745-46 (1982). *See R.M. Smith, Inc. v. Commissioner*, 591 F.2nd 248, 252-253 (3rd Cir. 1979) (the residual method is inaccurate whenever the buyer paid too little or too much for the interest in the business); *Philip Morris, Inc. and Consol. Subs. v. Commissioner*, 96 T.C. 606 (1991), *affd. without published opinion*, 970 F.2d 897 (2nd Cir. 1992) (residual method rejected because a control premium was included in price paid). Under the excess earnings approach to valuing goodwill reflected in Rev. Rul. 68-609, 1968-2 C.B. 327, the income attributable to tangible assets is deducted from net income of the business, and the remaining income is attributed to goodwill, which is then capitalized. *Philip Morris Inc. and Consol. Subsidiaries v. Commissioner*, 96 T.C. 606, 633 (1991).

1. Goodwill is Total Value Less Identifiable Assets. In a divorce, there is no set sale price to permit a simple subtraction to determine goodwill. Instead, a value for the business must be projected by

the valuator using either the market approach or the income approach or some combination of the two, and the goodwill under that valuation can be determined by subtracting from the fair market value the aggregate value of cash, tangible assets, and identifiable intangible assets (leases, intellectual property rights, employment agreements, covenants not to compete, etc.). In a personal service business, the valuator must exclude from the date-of-divorce value the value of any post-divorce labors. In a professional practice where tangible assets are negligible, goodwill is usually determined using the excess earnings method after subtracting the cost or value of the owner's future labor. In a solo practice, the personal goodwill is likely dominant. Where there are other professional co-owners or employees, the enterprise goodwill will increase in importance.

2. Beware Strategic Acquisitions. When one business is motivated by strategic considerations to acquire another business, the normal analysis of enterprise value may not apply. As mentioned in Letter No. 16 on p. 10 above, the buyer may not be purchasing a future excess income stream but may instead be making a capital investment. The relevant cash flow stream would not be that of the acquired company; the relevant cash flow stream would be the cash flow stream of the combined companies after the acquisition. That cash flow stream obviously is outside the scope of the business valuator's projection of future excess profits attributable to goodwill for the business that might be acquired. The important rate of return to apply is the buyer's ROI, not the seller's. As mentioned in Ford Motor Company's Letter No. 74 on p.13 above, the buyer may be motivated by the cost or time frame of internally developing capabilities to buy those capabilities at a lower cost or on shorter time frame by acquiring a company that has already developed those capabilities. In that instance, the value of the target business to the buyer may exceed the value in the hands of the seller, premised on the metrics of the target company alone. The possibility that a strategic value to a certain buyer may result in a higher purchase price than can be predicted from applying business valuation techniques to the target company can cause enterprise value, and thus enterprise goodwill, to be undervalued. When a business is being groomed for a take-over, not only may the value of the company to a strategic buyer be understated by ordinary business valuation techniques, but personal goodwill might diminish or vanish in a take-over of the company.

B. DETERMINING ENTERPRISE GOODWILL. Valuing a business using the or market data or income approach yields a value for the business based on the use of <u>all</u> cash and tangible and intangible assets combined, including enterprise goodwill and personal goodwill. The value of tangible assets can be determined by appraisals, and a reasonable rate of return on that invested capital can be determined. The value of intangible rights that are recognized under contract law or intellectual property law or are otherwise separable from residual goodwill can, admittedly with more difficulty, be valued and a reasonable rate of return on that invested capital can be determined. Then the business valuator must tackle the valuation of the "intellectual capital" of the business. After adding the cash, plus the value of the tangible and identifiable intangible assets, and adding the value of the business's intellectual capital, what is left unallocated is the personal goodwill of the selling owner. Using this approach, the value of the personal goodwill of the owner does not need to be calculated, because it is the residual value after all other value has been determined.

1. Identifying Unidentified Intangible Assets. An important step in the process of determining commercial or enterprise goodwill is assigning values to the identifiable intangible assets of the business. This reduces the portion of intangible value that must be allocated to residual goodwill. A checklist of intangible assets of a going business could be drawn from Internal Revenue Code § 197(d), including:

going concern value; workforce in place; business books and records, operating systems, or any other information base; any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item; any customer-based intangible (i.e., composition of market, market share, and any other value resulting from future provision of goods or services pursuant to relationships, contractual or otherwise, in the ordinary course of business with customers); any supplier-based intangibles (i.e., value resulting from future acquisitions of goods or services pursuant to relationships, contractual or otherwise, in the ordinary course of business with suppliers of goods or services to be used or sold); any government-granted license, permit, or other right; any covenant not to compete entered into in connection with the acquisition of part or all of the business.

In a divorce calculation, the value of customer-based and supplier-based intangibles (and workforce in place) must be reduced to reflect the effect of the owner leaving the business and under Texas divorce law even competing with it.

The valuation of intangible assets that are recognized as separable or legally enforceable is more concrete in the sense that these non-goodwill intangible assets are more susceptible to an amortized value or replacement cost analysis or a market data analysis, and a reasonably accurate capitalization of earnings attributable to those assets can be achieved. For example, several cases have found that all goodwill of a franchise business resided in the franchise agreement. *See Canterbury v. Commissioner*, 99 T.C. 223, 249 (1992), and cases cited therein.

2. Why Not Skip Valuing Intangibles? The effort to individually value separable intangible assets, that are not carried on the balance sheet, can be time-consuming and therefore costly. Limited funding in a divorce may force the valuator to subsume all intangible assets into residual goodwill for purposes of valuation. As an alternative, the valuator could forego valuing the intangibles of the business and instead focus on determining the personal goodwill. Once personal goodwill is determined, enterprise goodwill can be determined by subtracting personal goodwill from total goodwill.

Why bother with the preliminary step of assigning values to other intangible assets? Doing so reduces the scope of the fight over what is commercial or enterprise goodwill and what is personal goodwill. Valuing non-goodwill intangible assets forces the valuator to be concrete on as many components of enterprise goodwill as possible, and it reduces the size of the "residual goodwill" that must be allocated between enterprise goodwill and personal goodwill.

C. DETERMINING PERSONAL GOODWILL. Mark O. Dietrich, in *Identifying and Measuring Personal Goodwill in a Professional Practice*, PP. 6-11 CPA EXPERT (Spring 2005)[60] [reprinted in Dietrich, *Segregating Personal and Enterprise Goodwill*, THE FIRST EVER AICPA/ASA NATIONAL BUSINESS VALUATION CONFERENCE p. 30-14 (2005), [hereinafter cited as "Dietrich"], a copy of which is attached to this Article, described *personal* goodwill in the following terms:

> Personal goodwill, then, is the asset that generates cash profits of the enterprise that are attributed to the business generating characteristics of the individual, and may include any profits that would be lost if the individual were not present.

Dietrich, p. 6. Associate Professor of Law Darian M. Ibrahim said this about personal goodwill:

> Distinguishing personal goodwill from business goodwill is often difficult and always fact-specific. Personal goodwill may be mistaken for business goodwill, and vice versa. In addition, goodwill may belong to both a business and its owner, making valuation problematic. There is also a danger, due to the prevalence of business goodwill as a legal concept and the relative obscurity of personal goodwill as a legal concept, that buyers and sellers—not to mention the courts and the IRS—will routinely treat all goodwill as business goodwill. [Footnotes omitted].

Darian M. Ibrahim, *The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions*,30 DEL. J. OF CORPORATE LAW 1, 10-11 (2005).[61] Professor Ibrahim cited: *Bateman v. United States*, 490 F.2d 549 (9th Cir. 1973); *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); and *Norwalk v. Commissioner*, 76 T.C.M. (CCH) 208 (1998), as cases that distinguished enterprise goodwill from personal goodwill.

In connection with valuing the selling owner's personal goodwill, the Author of the current article proposes a thesis that the reduction in future profits attributable to the business's loss of the seller's personal goodwill contains three components: (i) the loss associated with losing the seller's knowledge, skill and experience; (ii) the loss associated with losing employees, suppliers, customers, or referral sources as a result of the seller <u>leaving</u> the business; and (iii) the loss associated with losing employees, suppliers, customers, or referral sources as a result of the seller <u>competing</u> with the business. (Further discussion is warranted about the extent to which the possible loss of valuable employees not under long term contracts, and who might leave with the owner, should be factored into personal goodwill.) Prong (iii) subsumes prong (ii), suggesting that assessing prong (ii) is not necessary if prong (iii) is calculated.

1. How Does Personal Goodwill Compare to Human Capital? It is evident that the human capital of the seller has many of the earmarks of personal goodwill, which many states say is not part of the marital estate to be divided upon divorce. It is legally easier to use alimony, and not property division, to address the income disparity arising from the spouses' investment during marriage in increasing the breadwinning spouse's human capital. But in property divisions, the marital estate's interest in a business should not be overvalued or undervalued due to an inaccurate view of what constitutes the tangible and intangible assets of the business, and what constitutes enterprise versus personal goodwill.

Even if the case law in a particular state has not recognized human capital as an asset to divide or as a factor to consider in awarding alimony upon divorce, a lawyer may want to prove up the value of the spouse's human capital or personal goodwill in support of an unequal property division, or some alternative theory of recovery, perhaps in equity, perhaps in some other area of law.

In states that have alimony, the forensic accountant may be asked to give opinion testimony about the actual cost of the spouses' investment in human capital during marriage, the enhancement of the working spouse's post-divorce earning capacity, the forgone income-earning capacity of the spouse who did not develop a career during marriage, and the projected difference in post-divorce earnings.

Lastly, while the human capital of the business owner may not be divisible in a divorce in certain states, the intellectual capital of the business is part of enterprise goodwill, which is divisible in most states.

2. Adjusting for the Seller's Knowledge, Skill and Experience. Mark Dietrich wrote in his personal goodwill article that "some portion of the personal goodwill issue can often be minimized by properly addressing reasonable compensation." Dietrich, p. 8 (italics deleted). That is to say, the human capital component of the selling owner's personal goodwill should be assessed separately from the second and third components of personal goodwill, because the cost of hiring a replacement employee with knowledge, skill and experience comparable to that of the selling owner is built in to projected future not profits, while the loss of profits to the business resulting from the seller's leaving, or leaving and competing, cannot be made whole simply by hiring a new employee (although some buyers or replacement hires may bring their own personal goodwill). In normalizing the selling owner's compensation, a highly skilled, experienced manager or professional is entitled to a higher-than-average level of compensation reflected in national and regional compensation surveys. See Dietrich, p. 8. For example, in a survey of all physicians, including all years of practice, an experienced physician would tend toward a higher percentile than younger physicians, and a specialist would tend toward a higher percentile than nonspecialists. If the physician in question is board certified, and the survey data reflects compensation of similar specialists, then a high level of skill may be assumed for all, and perhaps no special consideration of pushing the physician to the higher median levels is warranted, in that the level of skill is already expressed in the survey data. At any rate, in normalizing the selling owner's historical compensation, a compensation level will be reached that should permit the business to hire a replacement employee with knowledge, skill and experience comparable to the seller's, in which event the value of the selling owner's human capital will be reflected in the future profit stream. That allows the analysis of personal goodwill to focus on the loss to the business of the selling owner leaving and of the selling owner competing.

3. Don't Double-Count the Seller's Human Capital. In setting a reasonable salary for purposes of projecting the future profitability of the business, the compensation level should be at a level to attract a replacement employee with the same level of experience and skill as the selling owner. In this way, the selling owner's human capital is built into the estimate of future profits, and should not be counted again in assessing personal goodwill.

The loss to the business of losing the seller's ties to employees, suppliers, customers, and sources of future business cannot be replaced by hiring a new employee with equivalent knowledge, skill and experience, since the new employee will have none of the seller's relationships with employees, suppliers, customers, and sources of future business. These are the types of relationships discussed above in connection with John Tomer's concept of "social capital," as distinguished from the more traditional concept of "standard human capital," such as knowledge, skill and experience. The only way to avoid this relationship-related loss is to keep the seller as an employee or consultant of the business, or through some public relations arrangement to maintain the appearance of the seller's continued connection with the business (i.e, keeping his/her name on the door, face in advertisements, etc.). (Think of Colonel Sanders Kentucky Fried Chicken.) *See Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 207 (1998) ("This court has long recognized that personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation. Those personal assets are entirely distinct from the intangible corporate asset of corporate goodwill).

4. Not All Relational Capital is With an Individual. Note that a business's relationship-based connections to suppliers, customers, and sources of future business are not necessarily based on *personal* relationships. They could be based on perceptions arising from advertising, or celebrity sponsorship,

or word-of-mouth, or prominence in the community, or association with a certain church, or connections based on race, gender or ethnicity, or any other attribute, so long as the attribute is perceived to be connected to the business or to an employee of the business, or to a trademark or brand name, etc. To the extent that the goodwill is associated with a trade name or brand that will remain with the business, that goodwill is not personal to the seller. Additionally, some suppliers and customers may be resistant to changing established practices, which will diminish the effect of a change in ownership.

5. Distinguish Leaving from Competing. The distinction between the effect of the seller leaving versus the effect of the seller competing is supported by the fact that a seller can leave a business without competing with it, such as by death, retirement, or relocation to another market. A buyer will pay more for the business when the seller has died, retires, or moves to a different market, than the buyer will pay if the seller is expected to compete with the business after the sale. Also, securing a covenant not to compete does not protect the business from losses resulting from the simple fact that the seller has left the business. Any ties to the business that are based on the seller's personal relationships are at risk of loss just because the seller leaves, even if he or she does not compete.

If the seller competes with the business after the sale, then suppliers and customers and sources of future business may not just drift away to other businesses – they may actually follow the seller to his/her new business. This loss due to competition can be avoided by paying the seller for a covenant not to compete in states where such covenants are enforceable. The <u>cost</u> of the covenant not to compete can be determined from the payment made to obtain the covenant (which can be arbitrary depending on tax motives and other factors unique to the buyer and the seller). The <u>value</u> of the covenant not to compete can be measured by the avoidance of the projected loss in profits attributable to the seller's competing with the business, as opposed to just leaving the business without competing.

Looked at from the opposite perspective, valuing the covenant not to compete does not measure the entire personal goodwill of the seller, because the covenant not to compete does not retain for the business the value of the seller's knowledge, skill, experience, and it does not allow the business to avoid the loss of employees, suppliers, customers and sources of future business that occur because the owner has left the business.

In sum, the loss of the seller's knowledge, skill or experience, traditionally viewed by courts as a component of the seller's personal goodwill, will have no effect on business profits *provided that* the seller's historical compensation is normalized to a level that matches the seller's level of knowledge, skill and experience, so that a suitable replacement employee can be hired at the appropriate compensation level. However, the loss to the business which results from termination of personal relationships between the seller and employees, suppliers, customers, and sources of future business, cannot be erased by hiring a new employee with equivalent knowledge, skill and experience, because the new employee will have none of these personal relationships. This loss of relationships must be gauged separately, by projecting the increased cost and lost revenue that the business will suffer because those historical ties have been severed. The business may suffer a loss in future profits arising from the seller's mere departure, even if the seller does not compete. One the other hand, if the seller does compete, the losses in future profits occasioned by the seller's mere departure may be subsumed into the losses occasioned by the seller's competing.

6. What's Left is Entity Goodwill. If you determine total goodwill, and then subtract personal goodwill,

what's left is enterprise goodwill.

So valuing personal goodwill first avoids having to allocate values to cash, tangible assets, and identifiable intangible assets, and non-separable intangible assets, in quest of enterprise goodwill. Instead of all that, the business valuator can value the business as a whole assuming the owner remains with the business, then value the business without the owner's continued participation or with the owner competing, and the difference is personal goodwill. The personal goodwill is not included in the property division, but the rest of the value is included. If personal goodwill is valued, there is no reason to expend the energy and incur the cost in assessing enterprise goodwill.

7. Beware Comparable Sales. The differentiation of enterprise from personal goodwill in comparable sale transactions is complicated by the fact that in many comparable transactions some of the personal goodwill may actually transfer with the sale of the business if the previous owner (i) continues to work for the business or (ii) lends the use of his name or image to the business. In almost every comparable sale, the buyer will have insisted that the seller sign a covenant not to compete, which makes the transaction less comparable to a divorce.

VIII. THREE TECHNIQUES FOR VALUING PERSONAL GOODWILL. This Article explores three techniques for allocating between enterprise and personal goodwill.

A. COVENANTS NOT TO COMPETE. Mark Dietrich wrote that the lost-profits approach to determining personal goodwill is equivalent to the method of determining the value of a covenant not to compete. Dietrich, p. 30-5 states: ("Measuring profits attributable to the seller is analogous to determining personal goodwill versus the enterprise (business) 'goodwill' or intangible value." According to Dietrich, in determining the value of a covenant not to compete, the valuator must prepare an "alternate valuation" of the business, assuming that the seller leaves the business and competes with it. Dietrich, p. 30-5. The difference between the normal business valuation (assuming a continuation of historical profitability) and the alternate valuation is the value of the seller's personal goodwill. Where the seller leaves the business but does not intend to compete (death, retirement, relocation to another market), the "alternate valuation" would reflect the loss of future profits attributable to the seller leaving without competing.

Dietrich correlates a covenant not to compete to personal goodwill. The price paid for a covenant is the purchase price for the seller's personal goodwill. Hence, the price of covenants not to compete in comparable sales becomes a way to measure personal goodwill. The argument can be extended to claim that the personal goodwill of the seller can be measured by the difference between the price at which a business would sell with a covenant and the price at which it would sell without a covenant. In most instances, a business will sell for far less if the seller does not agree s/he will not compete. If this proposal were to be adopted across the board, it would greatly diminish the divisible value of businesses in divorce, based just on this mental construct. There are problems with this line of reasoning.

First, the willing buyer-willing seller construct is a legal fiction, and there is no actual sale in a divorce. There is therefore no reason to limit the value of the marital estate's interest in the business to what it would sell for without a covenant not to compete. (It's the same reason why punitive buy-sell provisions should not be triggered by a divorce.)

Second, if business valuators were to be limited in selecting comparables to sales with no covenant not to compete, comparables would be very scarce – perhaps too scarce to perform a market approach valuation.

Third, the price of covenants not to compete in comparable transactions is often not a real indicator of the true bargain, since such covenants are frequently intertwined with employment agreements and consulting agreements, and often are arbitrarily priced for tax reasons or other reasons.

Fourth, many states have a common law prohibitions against a seller damaging the business s/he has sold. These take the form of common law protections of customer lists, prohibitions against soliciting employees or customers, a tort remedy for interference with business relations or contracts, a claim based on promissory estoppel, a claim based on fraud, etc. While in modern days lawyers typically draft contractual language to protect the buyer, even without such a contract the common law protections for the buyer still exist.

Fifth, in states that do not tightly enforce covenants not to compete, the value of such a covenant, theoretically at least, should be diminished, and any market data regarding the sales of comparable businesses in that state may not be as comparable. An example is given in Dietrich, p. 7. Dietrich discusses Texas Business & Commerce Code §15.50, which provides that covenants not to compete involving a physician cannot deny to the physician access to a list of his patients whom he has seen or treated within one year of the termination of employment. However, the language of the statute evidently relates to covenants not to compete incident to employment, and may not apply to covenants not to compete relating to the sale of a medical practice. Dietrich notes: "Valuators should be aware that the various states might have one standard for enforcing covenants not to compete in an employment setting and another for enforcing a covenant in a purchase and sale of a business." Dietrich, p. 7. Sales information from states with weak enforcement of covenants not to compete should be studied to see whether the combined sales price and cost of a covenant not to compete is less than in states that robustly enforce such covenants. In states with weak enforcement the impact of a covenant not-to-compete may prove to be less than we imagine.

Lastly, there might be situations in which a business could not be sold without a covenant not to compete at a price in excess of tangible assets and identifiable intangible assets, or could not be sold at all. To argue that a business is worth less than its tangible and identifiable intangible assets violates a tenet of business valuation theory, and suggests that there is more going on with covenants not to compete than just buying personal goodwill.

B. THE "WITH AND WITHOUT" APPROACH. The "with and without" approach requires the business valuator to estimate two values for the business, one assuming that the selling owner remains involved in the business after the sale, and one assuming that the selling owner does not remain involved. The difference between the "with" and the "without" scenarios represents the personal goodwill of the selling owner. The "with" estimate involves ordinary business valuation techniques that rely on past performance projected into the future. The "without" scenario requires the business valuator to make assessments (assumptions) based on the loss of employees, suppliers, or customers who discontinue their ties to the business because the selling owner has left. This requires the business valuator to engage in a task that is more speculative than the "with" scenario.

The “without” scenario can be avoided by the buyer keeping the selling owner as an employee or consultant or otherwise associated with the business long enough to transfer the seller’s personal goodwill to the new owner or to other employees of the company or to the business itself. If the selling owner is paid a market rate for his/her labor and the labor is actually delivered, then the buyer has no extra cost associated with this method of perpetuating or transferring personal goodwill. However, if the selling owner doesn’t have to show up for work, then the salary is essentially monetizing the transfer of personal goodwill. The mere fact that a buyer may desire or require that the seller remain with the business for a period of time suggests that the buyer might be trying to set up a transfer of personal goodwill. But it goes too far to say that the price of a covenant not to compete is the measure of personal goodwill, or worse that the value of the business with the owner staying, less the price at which the business would sell without a covenant not to compete, is the measure of personal goodwill.

Under the “with and without” approach, the valuator determines the reduction in profits resulting from the seller leaving the business, or competing with it, as the case may be. Capitalizing the remaining profit yields the business’s commercial or enterprise goodwill. This Article proposed that the first step in determining personal goodwill is to remove the factor of knowledge, skill and experience from the goodwill determination by including that factor in the adjustment made to normalize the owner’s historical compensation. The remainder of the goodwill can then be divided into the seller’s relationship-based personal goodwill and commercial or enterprise goodwill.

Determining how the seller’s leaving the business, or competing with it, will affect that business will vary from business to business. When the valuation is undertaken in connection with a divorce, the valuator cannot uncritically accept non-binding statements by the owner and his “buddies” that valued employees, or favorable supply relationships, or customers, or sources of future business, will sever connections to the business if the owner sells. The risk of such severances should be objectively analyzed. While loyalty does exist, most people make business decisions based on self-interest, when the cost of loyalty is high.

C. THE MULTIATTRIBUTE UTILITY MODEL (MUM). The Multiattribute Utility Model has been suggested as a way to approach the allocation between enterprise and personal goodwill in a more concrete way. Attributes of the business are listed, separating Personal Goodwill Attributes from Enterprise Goodwill Attributes, then each attribute is assigned a degree of importance and degree of likelihood. Those two numbers are multiplied, and the residual goodwill of the company is allocated based on the relative weight of all Enterprise Goodwill Attributes compared to the weight of all Personal Goodwill Attributes. This result is then compared to the earlier assumptions and further adjustments are made if indicated.

The MUM was first suggested for use in the allocation of intangible value between enterprise goodwill and personal goodwill by David N. Wood, a CPA/ABV located in Illinois. His seminal 2003 article, *An Allocation Model for Distinguishing Enterprise Goodwill from Personal Goodwill*, published in 18 AMERICAN JOURNAL OF FAMILY LAW #3, p. 167 (Fall 2004), is attached to this Article.

The first case to discuss MUM was in *In re Marriage of Alexander*, 368 Ill. App. 3d 192, 198–202, 857 N.E.2d 766, 771–74 (2006), an Illinois divorce. The Court said:

> In the instant case, Wood testified that in reaching his conclusion on what portion of the total

goodwill in James's medical practice constituted enterprise goodwill and what portion constituted personal goodwill, he employed the multiattribute utility theory.2 Wood testified that he believed he was the first to use this approach in reaching his conclusion. Wood also testified that his approach was scientific. According to Wood, the multiattribute utility theory works as follows.

First, the valuator (Wood in this case) sets forth an objective. In the instant case, the objective set forth by Wood was to form a conclusion on the value of the elements of total goodwill in James's medical practice that represent personal goodwill and enterprise goodwill.

Next, the valuator establishes "alternatives." An alternative is a "range of percentages" that will define the choices "in which the method will result." Wood chose five alternatives but acknowledged that there is no set rule for the number of alternatives that a valuator must choose.

Each alternative is then assigned a "range." Wood assigned a range of 20% for each alternative. To illustrate, Wood created a graph containing five rows and two columns. The rows were labeled "alternative 1" to "alternative 5," and the two columns were labeled "[personal] goodwill" and "enterprise goodwill." Where the rows and columns intersect, Wood inserted the range. For example, where personal goodwill and row 1 intersect, Wood inserted a range of "0 to 20 percent." Where enterprise goodwill and row 1 intersect, Wood inserted a range of "80 to 100 percent." Where personal goodwill and row 2 intersect, Wood inserted a range of "20 to 40 percent." Where enterprise goodwill and row 2 intersect, Wood inserted a range of "60 to 80 percent." This continued to row 5, where the range for personal goodwill was "80 to 100 percent" and the range for enterprise goodwill was "0 to 20 percent."

After the objective and the alternatives are set, the valuator must then define the "attributes." An attribute is an element of goodwill to which the valuator must assign a value. Examples of attributes are personal reputation and business location. Attributes are categorized as either personal or enterprise. Wood does not contend that there are universal attributes that must be defined in every situation. Wood also does not contend that there is a set number of attributes that must be defined. Instead, Wood leaves the creation ***373 **772 and categorization of attributes to the discretion of the valuator.

In the instant case, Wood created the following personal attributes: (1) lacks transferability, (2) specialized knowledge, (3) personalized name, (4) inbound referrals, (5) personal reputation, (6) personal staff, (7) age, health, and work habits, and (8) knowledge of end user. Wood created the following enterprise attributes: (1) number of offices, (2) business location, (3) multiple service providers, (4) enterprise staff, (5) systems, (6) years in business, (7) outbound referrals, and (8) marketing. Wood acknowledged that the attributes could be described as "opposite sides of the same coin" and testified that "if one valuator placed an attribute into the [personal] category and another valuator [placed the same attribute] into the enterprise category, the model would correct for this during the measuring process."

After defining the attributes, the valuator is then to assign a value to each attribute. This involves a two-step process. First, the valuator assigns a value known as an attribute's "utility of importance." The utility of importance is a value placed on an attribute based on how important

the valuator feels the attribute is to the value of goodwill. The value assigned is taken from a range created by the valuator. Wood created a utility-of-importance range of 1 to 5, with 5 being most important and 1 being least important. Wood then assigned a utility-of-importance value to each attribute he defined.

Next, the valuator assigns a value known as an attribute's "utility of existence." The utility of existence is a value placed on an attribute based on the valuator's determination of the presence of that attribute in the business that the valuator is analyzing. The value is also taken from a range created by the valuator. Wood created a range of 0 to 4, assigning 0 to an attribute that has a weak presence and 4 to an attribute that has a strong presence. The values that Wood assigns to the utility of importance and the utility of existence are derived solely from his subjective opinion.

After assigning each attribute two values (a utility-of-importance value and a utilityof-existence value), the valuator then "aggregates the results." Aggregating the results simply involves multiplying the values assigned to an attribute to come up with a final value for that *200 attribute. For example, in the instant case, for the personal-reputation attribute Wood assigned a utility-of-importance value of 5 and a utility-of-existence value of 3, to give it a final value, or "multiplicative utility" as Wood calls it, of 15. Once each attribute has a final value, the valuator then takes the sum of the final values for each attribute from its assigned category (personal or enterprise) and derives a "total multiplicative utility" for that category. Wood calls the total value for the personal attributes the "total multiplicative (PGA) utility" and the total value for the enterprise attributes the "total multiplicative (EGA) utility." The valuator then adds the total multiplicative (PGA) utility to the total multiplicative (EGA) utility and comes up with a "total multiplicative (TMU) utility." The valuator then employs simple division to determine what percentage of the total multiplicative (TMU) utility consists of the total multiplicative (PGA) utility and what percentage consists of the total multiplicative (EGA) utility. At this point, the valuator has before him or her what percentage of the total goodwill is personal goodwill and what percentage is enterprise goodwill.

In the instant case, Wood calculated the total multiplicative (PGA) utility for the personal attributes at 52 and the total multiplicative (EGA) utility for the enterprise attributes at 114. Accordingly, he ***374 **773 found a total multiplicative (TMU) utility of 166 (52 plus 114). Employing the simple division set forth above, Wood concluded that the personal goodwill attributes constitute 31% of the total goodwill (52 divided by 166) and that the enterprise goodwill attributes constitute 69% of the total goodwill (114 divided by 166).

According to Wood, once these figures are reached, the valuator is then to "evaluate the alternatives" by examining where the final results fit into the range of alternatives that was established at the beginning of this methodology. The valuator also must analyze his or her conclusions by looking at each attribute individually in light of the attribute's total contribution to the total utility, and the valuator must ask himself or herself if certain attributes should be "driving the results." After performing this analysis, the valuator then reaches his or her ultimate opinion.

Wood testified that although a valuator would most likely find it tempting to simply use the

final percentage that is derived from the math above (in this case, 69% for enterprise goodwill and 31% for personal goodwill), he believes that "it is more effective and proper" to select the midpoint of the range that exists in the appropriate alternative. Accordingly, if the percentage for enterprise goodwill fell anywhere within the 20–to–40% range, Wood believes that the figure 30% should be used for the final percentage of enterprise goodwill. In *201 the instant case, because Wood calculated 69% for enterprise goodwill, for his conclusion he used 70%, which is located at the midpoint of his 60%–to–80% range. As noted above, the circuit court did not use 70% as suggested by Wood but instead used a two-thirds ratio.

After conducting a thorough examination of Wood's multiattribute utility theory, we are convinced that this method does not constitute scientific evidence subject to a *Frye* hearing. The methodology employed by Wood does not rely on the application of scientific principles but incorporates basic math with the observations and experience of the valuators. As Wood points out, the creation of the alternatives, the creation of the ranges, the creation of the attributes, and the values assigned to the attributes are all derived from the subjective determinations of the valuator. Wood never contends that there are universal alternatives, attributes, utility values, or ranges that must be applied in each and every situation. Furthermore, he does not allege that there are constant or universal values that must be assigned. Wood leaves just about everything to the sole discretion of the valuator.

Although Wood repeatedly describes his approach as "scientific," this does not make it so for purposes of subjecting it to a *Frye* hearing. Wood acknowledged that the "whole process" is "subjective" and that the methodology he uses simply attempts to make a "precise decision from imprecise and subjective criteria." In addition, to the extent that mathematics is employed in Wood's methodology, the types of mathematics employed by Wood (addition, multiplication, and division) are certainly not novel. Most people are at least familiar with these basic mathematical principles, although certainly some are more versed at applying them than others. But suffice it to say, to the extent that mathematics is employed in Wood's methodology, this does not make it a scientific methodology subject to *Frye*. However, even if it were sufficiently scientific to trigger a *Frye* hearing, the evidence would pass the general-acceptance test because elementary mathematics has gained general acceptance in all fields of science and engineering. *Southern Energy Homes, Inc. v. Washington*, 774 So.2d 505, 518 (Ala.2000).

On appeal, James argues that the methodology employed by Wood relies on literature and the expertise of others. We disagree. Although Wood may be using an equation or a process utilized by others in other fields, how Wood reached his opinion is no different from how the experts in Harris reached their opinion. Wood's opisnion was derived from his own observations and experience. Wood's methodology involved assigning a value, as determined by Wood, to certain attributes of James's practice that Wood subjectively determined, based *202 on his experience and observations, to be attributes that relate to the enterprise or personal goodwill value of James's medical practice. Wood then relied on simple math to quantify his opinion. We do not believe that Wood's approach is scientific for purposes of a *Frye* hearing. *See Harris*, 302 Ill.App.3d at 369–70, 235 Ill.Dec. 795, 706 N.E.2d 55 (if one's conclusion is based on experience and observations, combined with a deductive process familiar to the average trier of fact, it is generally not scientific). Wood does not employ a methodology that is beyond the realm of an average juror's understanding. Again, essentially "how" Wood

reached his opinion was derived from his observation and experience.

The appellate court heroically gave a very detailed description of Wood's theory and application. The usefulness of this case outside of Illinois is limited by the fact that Illinois has not adopted the standard for reliability of expert testimony set out in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). Instead, Illinois applies *Frye v. United States*, 293 F. 1013 (D.C. Cir. 1923), which requires that, when an expert's opinion is based on scientific principles, those principles must be generally accepted. The appellate court in *Alexander* held that the MUM was not science, so *Frye* did not apply.

If the MUM encountered a *Daubert* challenge, things would go much differently. The MUM methodology has a "air" of mathematical certitude about it, but it remains fundamentally subjective, in the selection of alternatives, ranges, and attributes, in assigning values to the utility of importance and utility of existence, and in reassessing the output in light of original assumptions about range and importance. *Daubert* gave a non-exclusive list of five non-exclusive factors to be considered:

1. Whether the theory or technique can be and has been tested;

2. Whether it has been subjected to peer review and publication;

3. Its known or potential error rate;

4. The existence and maintenance of standards controlling its operation; and

5. Whether it has attracted widespread acceptance within a relevant scientific community.

The MUM would fail the first four factors. The MUM is not susceptible to scientific testing or determination of error rate because there is no absolute measure of enterprise vs. personal goodwill to test MUM against. MUM has not been subjected to peer review (up to the standards of a scientific journal). There are no standards controlling its application.

The MUM could be tested for *interrater reliability*, to see what degree of agreement there is between different business valuators applying the MUM to the same hypothetical fact scenario. Because all components of the MUM are subjectively determined, the results would probably show interrater reliability no better than what would be achieved if you ran the same test with the same facts while no one used the MUM. The MUM would begin to have a path toward measurable reliability if the alternatives and attributes were fixed, and the valuator was required to assign values of zero or higher to this fixed set of parameters. At this point in time, one must say that the reliability of MUM is undetermined if not nil.

Interested parties would have a hard time assessing the *validity* of the MUM. There is no way to assess *construct validity* or *content validity*, because the MUM framework is not standardized, since the alternatives and attributes are not fixed and will vary from evaluator to evaluator and from situation to situation. In essence, each MUM construct is unique, so no generalized sense of validity is possible.

An off-hand comment by an expert that the MUM is "widely used" or "generally accepted" should be examined more closely. The MUM *may have* attracted some degree of acceptance, but we are lacking

comprehensive surveys that would establish that the acceptance is widespread.

However, since the MUM is not science, it doesn't fall under *Daubert* anyway. The pertinent legal standard is contained in the *Joiner* and *Kuhmo Tire* cases. In *General Electric Co. v. Joiner*, 522 U.S. 136 (1997), the Supreme Court said: "Trained experts commonly extrapolate from existing data. But nothing in either *Daubert* or the Federal Rules of Evidence requires a district court to admit opinion evidence which is connected to existing data only by the ipse dixit of the expert. A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered." In *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (U.S. 1999), the Supreme Court said: "Rules 702 and 703 grant all expert witnesses, not just 'scientific' ones, testimonial latitude unavailable to other witnesses on the assumption that the expert's opinion will have a reliable basis in the knowledge and experience of his discipline."

Viewed in the light of "a reliable basis in the knowledge and experience of his discipline," the MUM does serve as a device to require the evaluator to identify and state relevant factors and to weigh their relative importance in a way that can be reviewed by others. But the implicit assumption of the MUM that subjective factors can be averaged in a mathematical fashion may actually deviate from a reliable basis in the discipline, where the accepted norm is for the valuator to rely on his/her education, experience, and judgment, in processing multiple factors into a single conclusion. The MUM actually could present a danger if it convinces the fact-finder that the MUM is somehow less subjective or more reliable than the purely subjective assessment of a valuator.

A final note about the averaging function of the MUM that gives it the seeming objectivity attributed to mathematics. In *Gaskill v. Robbins*, 282 S.W. 3d 306 (Ky. Sup. Ct. 2009), one of the valuation experts used four different approaches to valuation and then averaged them. The Supreme Court of Kentucky was not kind:

> In this case, both experts testified to multiple accounting methods of measuring value. Wheeler chose a specific method, gave his reasons for choosing that method, and explained where his data came from. Callahan, in contrast, did not directly obtain data, and calculated the value of the practice using four different methods, with a different value derived from each. He found all the methods to be reliable, and unable to choose, averaged the numbers to get a value.
>
> While the trial court is free to determine the credibility of any witness, it cannot make a determination that is clearly erroneous or an abuse of discretion. **Using an average to obtain a value, without some basis other than an inability to choose between conflicting and competing valuation methods, is nothing more than making up a number, for there is no evidentiary basis to support that specific number. Employing all four methods, then averaging them, is tantamount to no method at all.** If an expert believes four methods are valid, yet each produces a different number, this provides little or no help to the trial court. The trial court must fix a value, and there should be an evidence based articulation for why that is the value used. **While an average may present the easiest route, it lacks the proper indicia of reliability.** Thus, the trial court abused its discretion in relying on Callahan's estimate of $669,075 as the value of the practice." [Bold added]

The MUM was litigated in *In re Marriage of Preston*, 2018, Il. App.2d 170656-U (Ill. App. 2nd Dist.

August 1, 2018) (unpublished). The expert Hutler used the "with-and-without method" of allocating between enterprise and personal goodwill. The expert Richardson, who had never split goodwill before, applied the MUM, selecting ten attributes for each of two categories, assigning a value of one for significant presence, or zero for weak or no presence. This resulted in a score of six for personal goodwill and three for enterprise goodwill, so Richardson allocated 2/3 of goodwill to personal goodwill and 1/3 to enterprise goodwill. Hutler admitted that the MUM was "accepted in the valuation industry." *Id.* at ¶89. The trial court accepted Richardson's allocation and the appellate court affirmed. The sensitivity of the MUM in this case was diminished by reducing all differences to either one or zero. The averaging of th++e scores was an abdication of the exercise of professional judgment. It seems likely that the "air" of mathematical certainty of the MUM persuaded the fact-finder to prefer it over the more prevalent "with and without" approach.

The MUM was discussed in *Banchefsky v. Banchefsky*, No. 09AP–1011, 2010 WL 3527578 (Ohio Ct. App. 2010). During the pendency of the divorce, the husband sold his solo dental practice, along with the trade name, telephone and fax numbers, email addresses, website and web address, in an arm's length transaction for fair market value. *Id.* at ¶¶ 5 & 37. The sale included a covenant not to compete within a ten mile radius for five years except as an associate of the business. *Id.* at ¶¶ 10 & 15. The husband had to work as an independent contractor for the business for up to six months after the sale. *Id.* at ¶ 5. The court found that the husband had received additional income generated by other employees of the practice. *Id.* at ¶ 10. The sale price was $580,000. *Id.* at ¶ 5. The purchase agreement allocated the payment: Dental supplies and office furniture, $126,000; Dental Supplies, $3,000; Patient Records, $20,000; Covenant-not-to-Compete, $15,000; Goodwill, $416,000. *Id.* at ¶ 38. The husband 's expert, named Russell, reviewed another pre-sale valuation report, and gave the husband a self-report goodwill questionnaire. *Id.* at ¶ 40. Russell determined overall goodwill by subtracting the value of tangibles (furniture, supplies, and records) from the total sale, resulting is goodwill of $431,000. Russell said the allocation of $15,000 to the covenant was arbitrary, and he offered a conclusion based on the MUM that personal goodwill and the true value of the covenant not to compete was $215,000. The trial court "acknowledged the utility of the MUM in determining the impact an individual's departure might have on the fair market value of a business," but decided that the allocations in the purchase agreement controlled and set aside $15,000 as non-divisible property. *Id.* at ¶ 41-43. The appellate court wrote: "We agree with the trial court's conclusion that although the MUM may be useful in determining the fair market value of a business, its application and use is inappropriate in the instant case. Here, there was an actual, not hypothetical, sale of appellant's dental practice.... [I]t was simply unnecessary to determine a business model pertaining to the hypothetical sale of a hypothetical business." *Id.* at ¶ 44. The court concluded that the covenant was nonmarital property, and affirmed the $15,000 value set by the trial court. *Id.* at ¶ 45.

The MUM was mentioned in a pretrial ruling in a Federal district court case, *Muskat v. U.S.*, Civil No. 06-cv-30-JD, 2008 WL 138052, Jan. 10, 2008 (Dist. New Hampshire). At issue was the sale of a business, and whether the $1 million payment for a noncompetition agreement should be taxed as ordinary income or whether it was a payment for the taxpayer's personal goodwill that should have been taxed an a capital gain rate. *Id.* at *1. [See Dietrich, p. 11.] The taxpayer's expert asked the seller and the former senior vice-president of finance to submit a list of attributes for the MUM, and based on that determined that 73.06% of the goodwill in the transaction belonged to the taxpayer and 26.94% to the company. *Id.* at *3. The trial court questioned the relevance of this allocation to the question of the $1 million paid to the seller, but reserved that decision until trial. The government also attacked

the qualifications of the expert to testify. The trial court said: "A ruling on whether O'Brien is qualified to give his opinions based on the 'MUM' analysis, under Federal Rule of Evidence 702, will be made at that time." *Id.* at *4.

NACVA has put on the WWW a Powerpoint by David Wood discussing MUM, accompanied by various of his writings.[62]

For further reading on the MUM, Business Valuation Resources published an article by Thomas Gillmore, a Florida CPA, Thomas Gillmore, *Simplified MUM for Determining Personal Goodwill*, 22 Business Valuation Update #2, (Feb. 2016).[63]

IX. TAKE-AWAYS. This Article is accompanied by a PowerPoint presentation that gives a visual synthesis of this work. Like the PowerPoint presentation, this Article will end with a list of take-aways:

1. Goodwill is no longer confined to the continued patronage of existing customers.
2. Ignoring self-created intangibles is no longer viable in the new economy. They need to be recognized at current value, not cost.
3. Residual goodwill under current accounting standards is overbroad. Many unidentifiable intangible assets can in fact be identified and valued separately or in a group.
4. Enterprise goodwill can be determined by valuing intangible assets of the business that are currently recognized for accounting purposes together with those that are not currently recognized.
5. The Intellectual Capital of a business can be valued. Turn to economists and management theorists to learn how.
6. Assembled workforce can be valued using standard business valuation techniques.
7. If enterprise goodwill is valued first, the rest of the goodwill is personal goodwill.
8. If personal goodwill is valued first, the rest of the goodwill is enterprise goodwill.
9. The cost or value of a covenant not to compete does not capture all of the seller's personal goodwill. Costs may rise or revenues drop just because the seller leaves, even if s/he does not compete.
10. Comparing the "with and without" assessment against the MUM, both are subjective but the MUM has an "air' of mathematical accuracy that is unwarranted, while "with and without" is data-driven.
11. The MUM is helpful for organizing thoughts, and it makes the chosen factors visible and subject to review by others, but the mathematical component of the MUM is not mathematical.
12. Business valuators must do what the accounting profession has refused to do for over 80 years--that is to put a value on the goodwill of a business in the absence of a sale.
13. Economists are attempting to measure Human Capital at the aggregate level. Look to national and world-wide studies for guidance.
14. The management profession is more awake to the importance of Intellectual Capital than the accounting profession. Look to management theories for guidance.
15. Business valuation techniques applied to a company on the assumption that it will continue in its current form ignore the analytics of an acquiring company that will integrate the resources of the acquired company into a combined organization. In valuing goodwill, business valuators may be using the wrong company's metrics.
16. A buyer's strategic considerations (entering a market, eliminating a competitor, etc.) may increase what the buyer would pay above a valuation based solely on the target company's metrics.
17. In light of paragraphs 15 and 16, valuing a business based on its own metrics may be the minimum value that a willing buyer might pay.

18. Is a valuation based on a likely acquiring company's projected ROI or strategic gains too speculative to be admissible in court?
19. There's lots more to talk about. Let's start talking about it.

END

ENDNOTES

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IDENTIFYING AND MEASURING PERSONAL GOODWILL IN A PROFESSIONAL PRACTICE

By Mark O. Dietrich, CPA/ABV

Author's Note: This article builds upon the concepts originally laid out in my article "Valuing Covenants Not to Compete in a Professional Practice," which appeared in the Summer 2000 issue of CPA Expert. *That article contained a detailed quantitative model for such a valuation.*

In many situations, most notably valuation for marital dissolution and allocation of purchase price for tax or financial reporting purposes, distinguishing personal goodwill from enterprise goodwill is a critical undertaking.

In the marital arena, personal goodwill is not a divisible asset in some jurisdictions, and the status is uncertain in many, and therefore cannot be awarded by the Court. Given this norm, it is curious that many valuation analysts fail to provide evidence as to the separate values of personal and enterprise goodwill.

In tax planning, particularly for C Corporations, allocating the proceeds of a sale of a business to personal goodwill and/or a noncompete agreement can reduce or eliminate the amount recognized as corporate gain and the related corporate level tax. In valuation for purposes of a sale of a business, properly attributing value to different intangible assets may be critical to both buyer and seller obtaining the proper measure of the bargain.

There are two fundamental issues in differentiating personal from enterprise goodwill:

1. Identifying which portions of cash flow are attributable *directly* to the individual's characteristics.
2. Identifying which cash flows attributable to otherwise enterprise-level tangibles and intangibles would be lost if the individual competed.

ILLUSTRATIVE EXAMPLES

1. Personal goodwill flowing from individual characteristics
   - A physician at a renowned medical center is well known for his skill in diagnosing complex diseases. His ability to do so is due to his intellectual skills, knowledge base, and experience in similar cases.
   - An attorney has won several high profile cases because of her ability to relate to the jury and make complex issues understandable. In her current firm, she is also the principal "rainmaker."
2. Enterprise goodwill flowing from individual characteristics
   - The same physician is part of a group practice. Subsequent to the diagnosis, other group physicians, some of whom are employed, may treat the patient. The employed physicians generate a profit in excess of their compensation that the practice owners share.
   - The same attorney has attracted dozens of new cases and is unable to handle most of them, which are assigned to other partners or members of the growing staff. The "points system" in the law firm allocates profits based in large part upon who generated the underlying business.

Observation

*The second set of examples is perhaps subject to some dispute in jurisdictions that treat personal goodwill as a non-divisible asset in marital dissolution. Some judges may treat any profit resulting from the personal goodwill of a marital litigant as non-divisible. For example, in a Florida appellate case (*Weinstock *v.* Weinstock *634 So. 2d at 777), the Court ruled that a dental practice had no divisible goodwill because the expert testified that a noncompete agreement would be required in any sale of the practice as well as the dentist's continued presence for a six-month patient transition period. Valuation analysts need to obtain a clear understanding from legal counsel as to the proper interpretation of state law or precedent.*

Personal goodwill, then, is the asset that generates cash profits of the enterprise that are attributed to the business generating characteristics of the individual, and may include any profits that would be lost if the individual were not present.[1] The value of a Noncompete[2] with that individual is the value of those cash profits, adjusted for the probability of the individual competing in each future year where the potential of competition exists. Thus, the noncompete is a portion of the value of personal goodwill and cannot exceed that value. Unless the probability of competition is 100%, the personal goodwill will always exceed the value of the noncompete.

ENFORCEABILITY OF NONCOMPETES

How much is an unenforceable promise to pay worth? Or, better yet, how much will the hypothetical buyer pay for an unenforceable contract with a hypothetical seller? "Not much" would seem to be the answer. To illustrate the concepts involved in

1 Subject to jurisdictional precedents.

2 A lawyer once told me to capitalize key terms to call attention to them.

factoring enforceability into the value of a noncompete, the following section looks at the statutes and precedents of several states.

Observation

The enforceability of noncompetes is a volatile area of law. Courts in many states have moved to restrict enforceability when public policy is an issue, such as noncompetes that by their nature restrict the free access of a patient to his or her physician. Other states have liberally interpreted noncompetes, finding that separate consideration is not necessary.

Representative State: Texas

The Texas Business and Commercial Code, §§15.50 provides that in order for a noncompete to be enforceable, it must be "ancillary to or part of an otherwise enforceable agreement at the time the agreement is made." If there is only an *at-will* employment relationship, the covenant is not enforceable. The term "at-will" appears to be interpreted as one in which the agreement has no specific term. If the relationship is other than at-will, the limitations of the covenant in time, scope, and geographic area must be no more than necessary to protect the goodwill of the employer or other entity.

Noncompetes among *physicians* are subject to a special set of provisions. To be enforceable, the agreement must conform to the statutory provisions including not denying the physician access to a list of his patients whom he had seen or treated within one year of termination of the contract or employment and the covenant must provide for a buy out of the covenant by the physician at a reasonable price.

Therefore, *the value of the covenant must exclude the value of that patient list.*[3] The provision in subparagraph (C) would appear to require that the covenantor[4] receive an electronic copy of medical records if they are kept in that fashion. As a logical consequence, the Enterprise Value of a medical practice in Texas is different from an identical practice located in another state that has no limitations on the enforceability of a noncompete and does not require that the physician be given a patient list! Where Fair Market Value is the standard, hypothetical buyers and sellers must be assumed to be familiar with the law in the state in which the transaction takes place—as should valuation analysts.

Representative State: Pennsylvania

It is likely that a November 2002 Pennsylvania Supreme Court decision has significantly altered the law as it applies to the transfer of a business including employment contracts. The case, *Hess* v. *Gebhard & Co., Inc.*, involved the sale of an insurance agency. As an employee of the agency, Hess's employment contract contained a covenant not to compete within a 25-mile radius for a five-year post-employment term. Significantly, *the contract contained no language regarding the transferability of the contract.*

The related Purchase and Sale agreement allocated no value to the Hess employment contract. Hess did not continue employment with the purchaser[4] and sought a position with another insurance agency. In the process, Hess solicited a customer of his former agency. As a result of threatened legal action, the new agency did not hire Hess. Hess then sued for interference with contractual relations.

The Pennsylvania Supreme Court ultimately held that the noncompete was not transferable to a subsequent purchaser absent a specific transferability provision: "We hold that a restrictive covenant not to compete, contained in an employment agreement, is not assignable to the purchasing business entity, in the absence of a specific assignability provision, where the covenant is included in a sale of assets." Perhaps a different result would have been reached if a sale of *stock* had been at issue.[5] It seems that, in Pennsylvania at least, when valuing the assets of a business, the analyst should read any employment contracts to see if the noncompete is transferable.

Observation

Valuators should be aware that the various states might have one standard for enforcing covenants not to compete in an employment setting and another for enforcing a covenant in a purchase and sale of a business.

REASONABLE COMPENSATION

In the typical valuation of any professional practice or small business, the analyst's key assumption relates to reasonable compensation for services—there will not be any excess earnings to capitalize or any cash profit to discount if the professional does not earn more than "reasonable compensation." The higher the reasonable compensation relative to the total compensation earned (of course) the lower the value of any goodwill.

Arguably, if there is no business/practice profit before normalization of the income statements, then some portion of the compensation earned must be coming from the return on tangible assets of the enterprise, namely Net Working Capital and Fixed Assets. Later in this article, in the section titled "Mechanics of Valuation," we address the importance of this analysis. The analyst must understand not only how much compensation is earned, but also what the sources of that compensation are.

3 Always ask: Would the hypothetical buyer pay for something they already own?

4 He was not offered a position he was interested in.

5 And, may I further add that this is but *one* dramatic difference between asset sales and stock sales, suggesting that a hypothetical buyer should pay a different price for assets than for stock.

The other critical aspect of determining reasonable compensation is the *work effort* of the individual, typically referred to as "productivity." Many analysts determine reasonable compensation for their valuation models by taking the median or mean (average) compensation for a particular position, without considering the individual's productivity compared with the median or mean.

For example, the Medical Group Management Association (MGMA) data is commonly used for valuing physician practices. MGMA reports not only median and mean compensation, but also the 25th, 75th and 90th percentiles of compensation. It reports the same percentiles for *productivity*, as to both charges and collections for professional services. The analyst should ask, "Can I hire a replacement physician for this practice at a *median* salary if the practice owner is producing at the 75th percentile?"[6] Given that most medical practices, as well as accounting and law practices, compensate their senior associates and partners at a percentage of production, the answer is almost surely "NO." For those practices and businesses in which compensation is a function of piecework (patients seen, hours billed/collected, etc.), reasonable compensation must be a function of productivity.

Proper compensation analysis is critical to the overall quest to value goodwill because an understatement of reasonable compensation will result in an overstatement of goodwill. To the extent that reasonable compensation is *understated*, the amount of personal goodwill included in total goodwill will be greater. Alternatively stated, *some portion of the personal goodwill issue can often be minimized by properly addressing reasonable compensation.*

CATEGORIES OF INTANGIBLES

Perhaps the most easily identified discreet intangible in a professional practice is the value of a trained workforce, or *Workforce-in-Place.* This asset is also one of the easiest to measure, typically being based upon a percentage of payroll reflecting longevity and skill, along with training and recruiting costs.[7] An initial analysis should be considered to determine if the practice owners can leverage junior or support staff such as associates (as in a law firm), staff (as in an accounting firm). For example, one of the reasons dental practices are readily saleable and at significant prices is that they afford the owner an opportunity to profit from providing cleaning (prophylaxis) through hygienists. Workforce-in-Place should thus be divided into two components: one for direct revenue producers such as dental hygienists or staff accountants, and another for support personnel such as medical assistants, secretaries, and the like. Direct revenue producers can be valued similar to any other intangible using their associated profit stream, while support personnel can be valued in the conventional manner based upon costs of recruiting and training, as a percentage of payroll.

A Simplified Example[8]

The analyst determines that $45,000 of annual free cash flow is derived from profits on non-partner professional staff who are direct revenue producers, and that this profit stream will continue to grow at a constant rate.

Free cash flow from direct revenue producers	45,000
Cap rate from weighted average cost of capital	16.17%
Value	278,336

Often missed in the analysis of personal goodwill is the potential impact of the presence or lack of a *Nonsolicitation* provision. Such a provision would preclude the signer from seeking to employ the practice's personnel after terminating. As such, *a portion of the value of Workforce-in-Place can be attributable to the Noncompete if it contains a nonsolicitation provision and the analyst believes that certain employees would leave if the covenantor were no longer with the business.* This could result from the covenantor operating a competing business or simply no longer being associated with the sold enterprise. A standard Purchase and Sales document would typically contain both a noncompete and a nonsolicitation provision. Nonsolicitation provisions may also apply to the business's clients, patients, and customers.

MECHANICS OF VALUATION

It is critical that the analyst consider the three principal categories of assets included in Business Enterprise Value (BEV) when assessing the profits attributable to the seller: Net Working Capital (NWC), Fixed Assets, and Intangible Assets. Just as the right-hand side of the BEV equation has a rate of return or discount rate for each of Equity and Debt, the left-hand side has a return on each of the assets. It does not seem reasonable for the return on Net Working Capital or Fixed Assets to be attributed in its entirety to a seller and therefore the Noncompete.

Once the BEV is known, it is typically possible to calculate the value of NWC using the historical balance sheets; certainly, if a DCF is used, the working capital requirement needs to be estimated. Fixed assets can be valued by an appraisal. Once these two values are known, they are subtracted from the BEV to determine the aggregate value of the intangibles.

Constructing a Noncompete DCF is best accomplished *after* estimating

6 Certainly, if one looks at Tax Court cases involving reasonable compensation, the Court always focuses on hours worked, responsibilities, etc. Why should it be any different in 'regular' valuation engagements?

7 See, for example, *Financial Valuation,* Hitchner et al; *Medical Practice Valuation Guidebook,* Mark O. Dietrich.

8 I use capitalization of cash flows here assuming the profit stream qualifies for capitalization.

the value of each of the asset categories; it may also require calculating the value of certain individual components for each category, such as the Workforce-in-Place described above. This assists the analyst in gauging a reasonable total value for the Noncompete. The analyst should also consider whether any portion of the value of fixed assets or working capital is attributable to the covenantor.

One approach to making this determination is to differentiate between the *going concern* value of these two categories of assets—which requires to one degree or another the continued presence or forbearance of the seller—and their *liquidation* or other value. For example, fixed assets are likely to have a significantly greater *value in use* as part of a going concern than as an *assemblage **not*** in a going concern or in *liquidation.* In liquidation, a buyer will not pay for the in-use value and is likely to consider the cost to transport and a mark-up to resell. The value of working capital may or may not be different in a going concern context depending upon the collectibility of receivables for example.

Estimating that value may also require establishing a discount rate for each asset and allocating the cash flow based upon the discount rate.[9] The weighted average of those discount rates must, of course, be equal to the Weighted Average Cost of Capital (WACC) determined from the right hand side of the BEV equation. Therefore, the analyst must also consider the portion of the value of each category that would be financed with debt.

Observation

*Notwithstanding the disdain with which some in the valuation community regard the Excess Earnings method, it is the classic example of a left-hand side of the equation approach to **capitalization** rates, and, by adding the appropriate long-term growth rate, deriving discount rates. Unfortunately, users of the method rarely calculate the capitalization rate derived by weighting the respective returns on tangibles and intangibles and comparing it to the traditional WACC approach for reasonableness. **Note:** The weighted average cap rate based on assets should then be used in the Capitalization of Cash flows method.*

Table 1 shows the result of a DCF valuation along with an allocation of fair market to the three major categories of assets and their percentage of total BEV.

Table 2 is the calculation of the WACC used in the DCF model; note that the WACC is based upon the fair market value of debt and equity, not book values.

Table 3 is the computation of the WACC, based on returns for the individual categories of Assets. Fixed assets are financed with 50% debt (the pre-tax rate is 6%, the after-tax rate is 3.54%, using a 41% tax rate) and 50% equity; net working capital is financed with the remainder of the debt and the balance with equity. Intangible assets are financed entirely with equity.

The analyst determines equity returns for each asset category. The aggregate weighting should agree with the WACC used in the original DCF.[10] The appropriate discount rates will vary from industry to industry and subject to subject. Bear in mind that intangible assets are generally the most risky and therefore have the highest expected rates of return.

Table 4 on page 10 is a condensed version of the DCF from which the Table 3 values are determined.[11] The analyst has concluded that a net of 55% of the free cash flow is attributable to the seller and

Table 1: Allocation of FMV to Asset Categories and Percentage of BEV

	Value	% of Value
Fixed Assets	975,000	34.97%
Net Working Capital	1,064,217	38.17%
Intangible Value	749,141	26.87%
	2,788,358	100.00%

Table 2: Calculating the WACC in the DCF Model

	Weight	Capital	Discount rate	WACC
Debt	25.00%	697,088	3.54%	0.89%
Equity	75.00%	2,091,268	23.71%	17.78%
		2,788,358		18.67%

Table 3: Computing the WACC-Based Returns for Each Category of Asset

Category (Cat)	Value	%	Debt	Cost of Debt	Equity	Cost of Equity	Cat WACC	Return	Total WACC
Fixed Assets	975,000	34.97%	487,500	3.54%	487,500	17.25%	10.40%	101,351	3.63%
Net Working Capital	1,064,217	38.17%	209,589	3.54%	854,628	17.50%	14.75%	156,979	5.63%
Intangible Value	749,141	26.87%			749,141	35.00%	35.00%	262,199	9.40%
	2,788,358	100.00%	697,089		2,091,269			520,530	18.67%

9 This process is described in *Financial Valuation* as well as *Valuation for Financial Reporting,* Mard, Hitchner, Hyden, Zyla.

10 This is easier said than done using a DCF and individual WACCs for each asset category because discount rates (WACCs) are different for each category and there is not a linear relationship between discount rates and present value; the solution can only be found iteratively. It is comparatively easy to do using capitalization rates since the cash flow is fixed in the first period.

11 Note that the free cash flow in any year is not equal to the "return" shown in Table 3. As noted earlier, an iterative process is required in the actual reconciliation of the individual WACCs with the entity WACC, in part because year to year cash flows are, in fact, variable, as shown in Table 4.

would be lost to the buyer in the event of competition.[12] This is approximately equal to that percentage of the total return represented by the Intangibles as reflected in Table 3. This does not suggest, however, that only intangible value is relevant to the determination of cash flows attributable to the seller, since some of the Workforce-in-Place value might not be lost in the event of competition, and some of the fixed asset value might be lost. For example, if the valuation subject was a medical practice using medical equipment for diagnostic testing, the departure of a physician might lower the volume of tests and therefore the value in use of the equipment.[13] The analyst can also utilize these allocated cash flows to assess the reasonableness of the annual cash payment for a non-compete.

Tables 5, 6 and 7 show the calculation of the probability-adjusted lost cash profits assuming that competition begins in year 1 (Table 5), year 2 (Table 6) and year 3 (Table 7). In this example, if competition does not commence before the end of year 3, it is assumed never to commence.

Table 4: Condensed Version of DCF in Table 3

Base Valuation		1	2	3	4	5	Terminal
Free Cash Flow	3,002,869	489,819	552,804	580,024	577,724	450,838	351,660
Present Value	2,788,358	449,645	427,635	378,109	317,365	208,702	1,006,901
Gross % Attributed To Seller		50.00%	50.00%	50.00%	50.00%	50.00%	50.00%
Attributed To Seller	1,394,179	224,822	213,818	189,054	158,683	104,351	503,451
Net % Attributed To Seller[14]		55.00%	55.00%	55.00%	55.00%	55.00%	55.00%
PV Seller's Free Cash Flow	766,798	123,652	117,600	103,980	87,275	57,393	276,898

Tables 5, 6, and 7: Calculation of the Probability-Adjusted Lost Cash Profits

Table 5: Year 1

Year	1	2	3	4	5	Terminal
PV Net Profits Attributed To Seller	224,822	213,818	189,054	158,683	104,351	503,451
Net % Attributed To Seller	55.00%	55.00%	55.00%	55.00%	55.00%	55.00%
Net $Profit Attributed To Seller	123,652	117,600	103,980	87,275	57,393	276,898
Probability of Competing	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
PV of Lost Profits By Year	12,365	11,760	10,398	8,728	5,739	27,690
PV of Year 1 Lost Profits	76,680					

Table 6: Year 2

Year		1	2	3	4	5	Terminal
PV Net Profits Attributed To Seller			213,818	189,054	158,683	104,351	503,451
Net % Attributed To Seller			55.00%	55.00%	55.00%	55.00%	55.00%
Net $Profit Attributed To Seller			117,600	103,980	87,275	57,393	276,898
Probability of Competing			18.00%	18.00%	18.00%	18.00%	18.00%
PV of Lost Profits			21,168	18,716	15,710	10,331	49,842
PV of Year 2 Lost Profits	115,766						

Table 7: Year 3

Year		1	2	3	4	5	Terminal
PV Net Profits Attributed To Seller				189,054	158,683	104,351	503,451
Net % Attributed To Seller				55.00%	55.00%	55.00%	55.00%
Net $Profit Attributed To Seller				103,980	87,275	57,393	276,898
Probability of Competing				21.60%	21.60%	21.60%	21.60%
PV of Lost Profits				22,460	18,851	12,397	59,810
PV of Year 3 Lost Profits	113,518						

Total: $305,964

At first glance, Tables 5, 6 and 7 may appear to count the same cash flows multiple times.[15] The way to be certain that there is no double counting is to check the Joint Probability Table (see Table 8). The probability of possible outcomes must total exactly 100%. For example, adding the *probability-adjusted* present value of lost profits for year 3 from each of Tables 5, 6 and 7 totals $51,574, less than the *total* present value of year 3's profits attributable to the sellers

12 As more fully explained in the original article, there may be a difference between the gross profits attributable to the sellers and what profits the buyer would lose if the sellers competed. This gives recognition to such intangibles as location.

13 The analyst could isolate the profit on the equipment and determine that profit's present value.

14 Original article, ibid, footnote 15.

15 As noted by one reviewer, thereby prompting this explanation.

of $103,980. Assuming the rest of the model is properly constructed, the probability check assures that there is no double counting.[16]

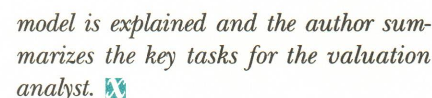
Table 8: Joint Probability Table

	Year 1		Year 2		Year 3		
Year	Compete	Don't Compete	Compete	Don't Compete	Compete	Don't Compete	Joint Probability
Compete Year 1	10.00%						10.00%
Compete Year 2		90.00%	20.00%				18.00%
Compete Year 3		90.00%	80.00%	30.00%			21.60%
Never Compete		90.00%		80.00%		70.00%	50.40%
							100.00%

If the probability of competing were 100% at the beginning of year 1, the value of the noncompete (see Table 4) would be $766,798, slightly more than the total intangible value. This value could be compared to the value of Workforce-in-Place and any other discretely measured intangibles while considering the probability that the sellers would take some portion of the value of those intangibles with them if they competed, as well as any diminution in the value in use of fixed assets. The $766,798 represents all of the present value of future profits attributable to the seller and is therefore also the value of personal goodwill.[17]

The distinction between the value of personal goodwill and the value of a noncompete is less important in equitable distribution than for tax purposes. For the latter, the noncompete is ordinary income to the covenantor while personal goodwill should be long-term capital gain.[18] It is prudent for the analyst to value both the noncompete and the personal goodwill where tax considerations are important.

In the Summer 2005 issue of CPA Expert, *a single period capitalization model is explained and the author summarizes the key tasks for the valuation analyst.*



The author expresses his gratitude to Kevin R. Yeanoplos, CPA/ABV, ASA for his thoughtful critique of the concepts explored in this article, as well as for his corrections to my use of English language grammar.

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16 The second test, as discussed in the following paragraph, is to determine the value of the noncompete if the probability of competition is 100%; any probability less than 100% in year 1 should result in a lower value for the noncompete.

17 I caution that the example has personal goodwill in excess of total intangible value. I do not mean to imply or suggest that this is, or is not, the norm or that the analyst should not carefully consider the implications.

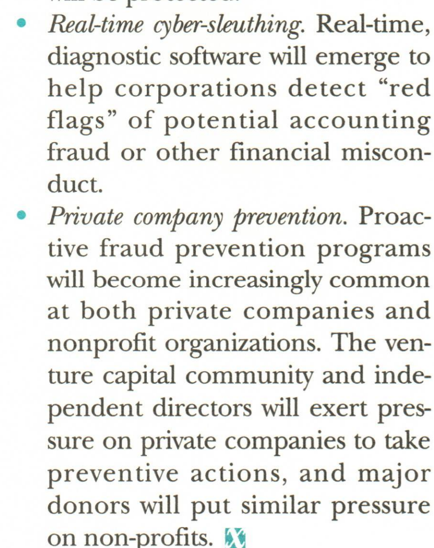
18 With respect to tax issues, see, e.g., *Martin Ice Cream* 110 TC 189 (1998) and *Norwalk* v. *Commissioner* TC Memo 1998-279.

FYI...

FOCUSING ON FRAUD PREVENTION AND INVESTIGATION

FIRSTGlobal Investigations, a division of BDO Seidman LLP, predicts that in 2005 companies will focus more on fraud prevention and investigation efforts. These predictions include the following:

- *Proactive prevention.* Corporate boards will turn their attention to creating an anti-fraud environment by implementing proactive prevention and training programs. Because of recent amendments to the Organizational Sentencing Guidelines, these efforts will respond to the shift in responsibility for overseeing a corporation's fraud prevention activities to the board of directors and the increased risk of liability in the event of serious compliance lapses.
- *Proactive detection.* In addition to proactive fraud prevention programs, some companies will bring in third-party "SWAT teams" of forensic accountants to focus on potential problem areas of the company's accounting business operations.
- *Whistleblower anonymity.* To comply with Sarbanes-Oxley, companies must provide a method to ensure the anonymity of whistleblowers. Because employee tips are the most common means of fraud detection, whistleblower activity should pick up in 2005 as rank-and-file employees become more confident that their anonymity will be protected.



- *Real-time cyber-sleuthing.* Real-time, diagnostic software will emerge to help corporations detect "red flags" of potential accounting fraud or other financial misconduct.
- *Private company prevention.* Proactive fraud prevention programs will become increasingly common at both private companies and nonprofit organizations. The venture capital community and independent directors will exert pressure on private companies to take preventive actions, and major donors will put similar pressure on non-profits.

In the KNOW

By James R. Hitchner, CPA/ABV, ASA

Did you know that there are six levels of value, not four? Years ago there were only three levels, but like many things in valuation, defining levels of value has gotten a bit more complicated. The four levels of value adhered to for a while were as follows:

1. Control strategic
2. Control standalone
3. Minority marketable
4. Minority nonmarketable

Financial Valuation Applications and Models (New York: John Wiley & Sons), which I edited and coauthored, presents five levels of value, which I will discuss below with some slight modifications. I will also add another level of value that Dr. Shannon Pratt has been presenting in newsletters and conferences. Here we go.

- Control strategic (public or private company)
- Minority/control standalone liquid (public company)
- Control liquid (private company)
- Control standalone (private company)
- Minority restricted (public company)
- Minority nonmarketable (private company)

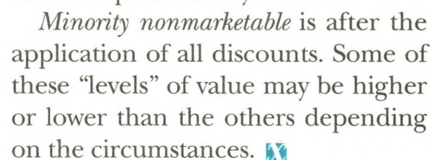
Control strategic can be for a public and a private company.

An example of *minority/control standalone liquid* is the value resulting from the application of the guideline public company method. Some analysts believe it is a minority value and some believe it is minority and control. Either way, without adjustment, it assumes the liquidity of a public stock.

An example of *control liquid* is the value derived from the application of the income approach (with control cash flows) in which the discount or cap rate is based on returns from the public marketplace, again with public company liquidity.

Control standalone is the value of a private company after application of the income approach (or guideline public company method) with a discount to reflect the lesser liquidity of a control interest in a private company vs. public stock.

Minority restricted (public company) is the intermediate step in applying a discount for lack of marketability to a private company when relying upon restricted stock studies, which are based on public companies. This is the new level presented by Dr. Pratt.



Minority nonmarketable is after the application of all discounts. Some of these "levels" of value may be higher or lower than the others depending on the circumstances.

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