



Allocating Value Between Personal & Enterprise Goodwill

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Whenever assets of a privately held business need to be divided, a valuing expert has to determine whether the assets of the business include goodwill. Black's Law Dictionary defines goodwill as "a business' reputation, patronage, and other intangible assets that are considered when appraising the business, especially for purchase; the ability to earn income in excess of the income that would be expected from the business viewed as a mere collection of assets." It is an intangible asset, that cannot be seen or touched, that does not appear on the books of a private company until it is sold. Then, according to accounting rules, goodwill represents the excess of a purchase consideration over the total value of assets and liabilities. Its value, determined by the open market transaction, would be recorded on the books.

While the issue of the fair division or allocation of goodwill might be part of many cases, such as tax or partner disputes, it has come up most frequently in divorce cases. In divorce proceedings – where the assets of a professional practice are the subject of marital division – the issue of goodwill presents several challenges for attorneys, judges and valuers alike. Does it exist? What is it worth? Is it marketable or realizable and, thus, divisible?

The existence and value of goodwill would be determined by the valuation expert during the process of business valuation. Most likely, the subject business has not been recently sold and there is no transaction evidence and accounting entry to rely on.

Realizable vs. Unrealizable Goodwill

The valuation process will return a number – or a range – that will assign value to goodwill as of a particular date. Can it be converted to cash or, in other words, realized? Can it be divided? Realizable goodwill can be bought and sold in an open market transaction, and is associated with the business rather than the owner/practitioner. Realizable goodwill is also called enterprise goodwill. The unrealizable goodwill, on the other hand, cannot be bought and sold, mainly because it is associated with an individual owner/practitioner. It is called personal goodwill and, most frequently, belongs to a doctor, lawyer, dentist, architect or other professional conducting business as a sole practitioner or with a small number of partners. In those cases, goodwill cannot be separated from the person and when the practitioner leaves the business, there is no goodwill remaining.

Range of Treatment Across Jurisdictions

One can imagine that the divisibility of goodwill during the divorce proceeding would be a vigorously contested issue. There is a variety

of treatments across jurisdictions. Some state courts make no distinction between the two types of goodwill. According to Business Valuation Resources, "Guide to Personal v. Enterprise Goodwill," about 1/3 of court decisions consider both enterprise and personal goodwill to be a marital asset; just over half consider enterprise goodwill as a marital asset and view personal goodwill as exempt; the remaining cases consider neither type of goodwill to be a marital asset. Illinois cases, notably *In re Zells* (143 Ill.2d 251) and *In re Schneider* (2005 WL 120356 (Illinois Sup. Ct. Jan. 21, 2005)), treat personal goodwill as non-marital property as it is unrealizable. Furthermore, dividing personal goodwill would constitute double dipping with alimony and/or maintenance payments. The double dipping concern comes from the idea that a professional's goodwill, as the key factor of the business that maintains the clientele, is the fruit of the skill, the expertise and the reputation of the professional. These attributes would already be reflected in the professional's income generating ability.

The Grey Area

In many cases there is debate over whether goodwill associated with a business is personal or enterprise. For some businesses goodwill is a combination of both. As an example, let us consider a medical practice group formed by a group of doctors of the same specialty (say, pediatricians) that offers good service and enjoys a good reputation. Patients coming to the group might have their favorite doctor, but any doctor in the practice would see them. What makes the group successful is the combination of individual professionals' contributions and a successful business model such as convenient hours, quality of the support staff, ease of appointment scheduling, locations, etc. The medical group's reputation would be, most likely, a combination of individual doctors' reputations and the reputation of the business as a whole. An individual doctor's practice in such a setting, as an equity owner, would generate both enterprise and personal goodwill. When selling a stake in the practice, the professional would realize, through the transaction price, the enterprise goodwill. It will be a function of the earnings from the repeat business from patients that will continue to patronize the group regardless of the doctor's departure. However, some of the patients will choose to follow the doctor with their repeat business rather than to patronize the group. Those earnings will contribute to the personal goodwill.

Illinois is one of the many states considering enterprise goodwill to be a marital asset for the purpose of the just division of marital property. Personal goodwill is not considered a marital asset for that purpose. The allocation of goodwill value between enterprise and personal goodwill pres-

ents a challenge for the valuating expert. The accepted methodologies of valuation, such as capitalization of earnings, excess earnings methods, IRS variation of excess earnings method, and the market method, will return the value of the total goodwill without distinguishing between enterprise and personal goodwill. The allocation itself is a subjective problem and the method to address it was only developed and began gaining recognition a few years ago.

The Solution

The first reported case in Illinois, that divided a medical practice's goodwill between enterprise and personal goodwill, is *In re Marriage of Alexander* (857 N.E.2d 766 (2006)). The valuation expert in this case adopted the multiattribute utility theory (MUM) that has been used in other disciplines such as economics, science and politics. This method offers a disciplined and consistent approach where professional, subjective judgments are applied to a group of attributes resulting in a quantified outcome.

The core steps of the MUM methodology include defining the attributes of personal and enterprise goodwill.

The attributes indicative of personal goodwill are:

- Lacks transferability.
- Specialized knowledge.
- Personalized name.
- Personal inbound referrals.
- Personal reputation.
- Personal staff.
- Age, health and work habits.
- Knowledge of end user.

The attributes indicative of enterprise goodwill include:

- Number of offices.
- Business location.
- Multiple service providers.
- Enterprise staff.
- Systems.
- Years in business.
- Business inbound referrals.
- Marketing.

While the above attributes were utilized by the expert in the *Marriage of Alexander* case, they can be adjusted depending on specific valuation circumstances. What follows, are a series of steps, during which the valuator assigns each attribute a utility of importance and utility of existence values. A simple multiplication of the two values returns a multiplicative utility which points to a particular attribute's contribution to the earnings of the business. The valuator would add all multiplicative utility values within each – personal and enterprise – goodwill attribute groups to arrive at total multiplicative utility value of both the enterprise goodwill attributes and the personal goodwill attributes. These two results will allow the valuator to determine what percentage of the total goodwill is personal goodwill and what percentage is enterprise goodwill. The final opinion is not reached, however, until the valuator critically reviews whether particular attributes should be driving the results in light of all the facts and circumstances, and performs a sensitivity analysis by adjusting the values of the importance utility and the existence utility.

The valuation expert's testimony in *In re Marriage of Alexander* was challenged un-

der *Frye* (293 F.1013 (D.C. Cir. 1923)). The opposing party argued that MUM was a novel scientific methodology not accepted by the relevant scientific community and that the opinion derived from this methodology was inadmissible. The Fifth Circuit Appellate Court of Illinois, however, was convinced that the MUM method did not constitute scientific evidence subject to *Frye*. The methodology employs basic math in a disciplined process that establish a decision support for a subjective problem. The valuator – using his or her observations and experience – creates alternatives, selects attributes and assigns values to each attribute. The valuator's conclusion that is based on experience and observations, combined with basic mathematics and a deductive process familiar to the average trier of fact is, generally, not scientific.

Conclusion

Distinguishing and allocating value between personal and enterprise goodwill can be a difficult and complex process. Valuators that fail to make the proper distinction or allocate too much value to the enterprise goodwill risk overstating the realizable value of the business. Moreover, failing to properly assess personal goodwill can result in double dipping with alimony and or maintenance payment in a divorce settlement. The MUM methodology has proven useful to distinguish between personal and enterprise goodwill. First described in 2004, it passed the court test in 2006 and the method has been gaining recognition among the valuation professionals ever since.

