

VALUATION

Why Transferable Personal Goodwill Ought to Be Included in the Marital Estate

By Mark G. Filler, CPA/ABV, CBA, AM, CVA

In its 2008 decision in the *Ahern v. Ahern* case, the Maine Law Court found that the personal goodwill portion of a dental practice was not to be included in the marital estate. This decision, while it comports with those of many other states, is troubling for two reasons.

First is the testimony of the valuation analysts. Maine statutes do not require that the standard of value for divorce proceedings be fair market value, which assumes a premise of value in exchange; but fair market value is the usual and customary standard of value. Fair market value is premised on the value of the business in exchange for cash, in a transaction between a willing buyer and willing seller. Both the wife's appraiser and the husband's appraiser utilized this standard. The wife's appraiser, using an excess earnings method, determined the equity value of the practice to be \$538,000, of which (a) the hard assets were \$183,546, (b) the goodwill was \$173,073, and (c) the remaining \$181,381 went unexplained. The husband's appraiser arrived at a value of \$366,000 using a capitalization of earnings method, but did not separately state the value of the tangible and intangible assets.

Both appraisers opined on the amount of post-closing time the husband would need to spend with the buyer to facilitate an orderly transfer of the business. The wife's expert called for an unspecified period of time, and the husband's expert stated that the seller would have to participate in the practice for a "considerable" period of time after its sale. But neither appraiser put a value on the husband's future efforts in this regard. And neither appraiser dealt with the issues of enterprise vs. personal goodwill or saleable personal goodwill vs. non-saleable (i.e., pure) personal goodwill, particularly in

the context of the standard of value and the premise of value, as they both "unequivocally testified that the goodwill value of the dental practice was attributable to [the husband's] skill and reputation."

Second, because it heard no testimony concerning either enterprise or saleable personal goodwill, the Court was forced to accept what had been presented to the lower court and proclaimed that the goodwill in the case was not a species of property but was instead relevant to establishing a professional's future earning capacity. This lack of competent testimony from the experts excused the Court from having to view the concepts of personal and enterprise goodwill through the lens of the statute it quotes in paragraph 5 of its opinion. The Court's decision in *Hess* (a Maine Law Court decision) stated that if goodwill is transferrable and realizable upon a sale of the business, then it is marital property. By contrast, in *Ahern* it came to a conclusion, based on the facts of the case as presented by the experts, which I will show is ultimately at odds with valuation theory and practice and the intent of the legislature when it passed Section 953 of Title 19-A of the Maine Revised Statutes.

PERSONAL GOODWILL OVERVIEW

Before continuing with my response to the Law Court's opinion, I wish to present an overview of the concept of personal goodwill, starting with some definitions. Several organizations have offered definitions of goodwill from a business valuation perspective. In *Valuing a Business*, Pratt and Niculita define goodwill as "an intangible asset category usually composed of elements such as name or franchise reputation, customer patronage, location, products, and similar factors."

In other words, goodwill is a collection of intangible assets that generate income over and above that which would be generated by a business's tangible and separately identifiable intangible assets (e.g., patents, trade names, customer lists, patient files, contracts, website, workforce-in-place, telephone number, etc.). Certain intangible assets contribute to, and are thus attributed to, goodwill if by their very nature they cannot (or cannot without great difficulty) be separately identified for purposes of quantification. This ultimately means that the difference between total asset value and the value of the business's tangible assets is not just goodwill, but rather includes goodwill, be it enterprise or personal, and a host of other saleable and transferable intangible assets. This fact necessarily reduces the amount of unidentified intangible assets, or goodwill, to a much lesser amount than what is usually presented to a court.

These unidentified intangible assets, therefore, fall under the umbrella term "goodwill" by virtue of either the significant degree of difficulty required in their measurement or their inability to be measured. Despite the difficulty in separately quantifying any individual intangible asset within the collection termed goodwill, goodwill itself can be broadly separated into two main categories, personal and enterprise goodwill.

Personal and enterprise goodwill are distinct from those intangible assets of a business that can be identified and measured, such as the aforementioned patents, trade names, customer lists, patient files, contracts, website, workforce-in-place, telephone number, etc.

The proportion of this goodwill, i.e., the business's unidentified and/or non-measurable

intangible assets, which is attributed to personal goodwill, has been appropriately defined in Jim Hitchner's *Financial Valuation* as "goodwill that attaches to the persona and personal efforts of an individual." A prerequisite to broadly separating goodwill into personal and enterprise components is understanding what efforts and attributes of an individual cause goodwill to attach in such a manner.

To facilitate an understanding of how personal goodwill is created, I will use the analogy of a tree and its fruits. Let the tree represent the personal attributes of the seller—his or her skill, intelligence, charisma, knowledge, inherent abilities, determination, will power, grit, drive, ambition, etc. These personal attributes result in revenue enhancement and/or cost and expense reduction by way of customer/client/patient loyalty, reputation, know-how, an effective and efficient workforce, well organized operating systems, sales and marketing plans, product development systems, referral systems, etc. Let these end results represent the fruits of the tree.

Since the tree can never be sold, marketed, or transferred, it belongs exclusively and permanently to the seller, who can use it over and over again in any new business he finds himself in. But most, if not all of the fruits can be sold, marketed, or transferred to a buyer who will pay for them to the extent he can reliably use them. For purposes of valuation in a divorce setting, the tree itself is obviously "personal goodwill" and would not be included in the marital estate. If value is determined under either the market or income approach, with the standard of value being fair market value and the premise of value being value in exchange, then only the transferable goodwill is included in the selling price, and the non-transferable goodwill is excluded from the valuation and the selling price. For example, if the selling dentist had the essential personal attributes to grow his revenue at an annual rate of 7 percent, while the typical dentist managed just a 3 percent rate, the fair market value of the practice would be predicated on the 3 percent growth rate and the seller would not receive a price that reflected the benefits of his personal attributes as contained in the additional 4 percent growth rate.

There seems to be two opposing views concerning personal goodwill in a divorce situation. One camp says that if the benefits of

the seller's personal goodwill are transferable to the buyer, and the buyer will pay for them, then they are only the fruits of the personal goodwill tree, not the tree itself, and hence are included in the marital estate. The other camp considers both the personal goodwill tree and the fruits thereof to be excluded from the marital estate, whether the fruits are transferable or not. So the essential question is: What does personal goodwill for divorce purposes consist of—the tree, the fruits, or both?

SELLER ASSISTANCE AFTER TRANSFER

In its opinion in *Ahern*, the Law Court made a distinction between enterprise and personal goodwill, and quoting its decision in *Lord v. Lord*, intimated that the essential difference between the two is the degree of assistance the seller must provide the buyer through some extended period of continuing employment. However, since neither of the experts in the *Ahern* case opined on this matter in sufficient detail, the Court didn't need to deal with the question of what constitutes an extended period—is it three months or three years? All businesses that are sold require some effort on the part of the seller to accomplish a smooth transfer of all the intangible assets, whether or not those assets contain personal goodwill. In fact, much of that work can be accomplished prior to the closing, and might consist of the buyer and seller jointly meeting and greeting the top 20 percent of all customers or patients or clients, and support staff mailing and /or telephoning the remaining 80 percent. Spending a few weeks or even a few months after the closing finalizing the transfer ought not to be a determining factor as to the nature of what was transferred.

In addition, because of insufficient expert testimony, the Court did not look into the issue of saleable personal goodwill versus pure or non-saleable personal goodwill. When a business is valued using either market transactions or an income method, and the standard of value is fair market value, three underlying assumptions are that (1) the seller is a willing seller, (2) the seller will do whatever is necessary to maximize the selling price, and (3) what is being valued is actually available to be sold. In the instant case, the values concluded by both valuation analysts were based on these three assumptions. While

they might have differed on the value of Dr. Ahern's practice, they had to agree that he was a willing seller, that he was economically rational, and that the value they opined to consisted of all saleable assets. By definition, pure personal goodwill is not saleable or transferable. This means that the values assigned to the practice by the appraisers consisted solely of saleable assets, and since pure personal goodwill walks out of the closing with the seller, then the values opined to could not include any non-saleable personal goodwill. In other words, the tree stays with the seller, but the fruits are transferred to the buyer.

MARITAL PROPERTY

Like many states, Maine has statutorily defined what is marital property, i.e., property that belongs to the marital estate and is divisible by a divorce court as part of a property settlement. Section 953 of Title 19-A of the Maine Revised Statutes states the general principle that "all property acquired by either spouse subsequent to the marriage is marital property." Therefore, since the seller's personal attributes which make up his or her personal goodwill (intelligence, hard work, true grit, determination, business skills, etc.), were all brought to the marriage by the seller, i.e., they were not acquired subsequent to the marriage, then those attributes (the tree itself) must be non-marital. Under Exception E to the general principle, the statute provides that any increase in value (the fruits) of a non-marital asset (personal attributes) is included in the marital estate if that increase is a result of marital labor. Increases in value caused by market forces are not included in the marital estate; but market forces, by definition, cannot affect the fruits of personal attributes as they result strictly from the application of marital effort to those personal attributes by the seller in his or her business situation. Therefore, the transferable fruits result from marital effort being exerted by the selling spouse. This makes them includable in the marital estate.

As I mentioned above, the Law Court didn't have to consider this type of analysis because both experts, without the use of any categories of analysis, testified that all the goodwill was personal, and as such, as a general principle, is not a species of property. But this deficient set of facts forced a conclusion that confuses the tree with the fruit and cause with effect.

It is true that the seller's personal attributes are not a species of property, but instead go towards his or her future earning capacity. However, I would argue that what is property is the result (the fruit) of those personal attributes brought about through the application of marital effort. The causes of saleable personal goodwill are the personal attributes of the seller; the effects are those transferable and saleable aspects of personal goodwill. Put another way, that portion of the business's value or economic benefits that can be separated from the seller is saleable or transferable personal goodwill and is therefore includable in the marital estate.

Of course, any sales transaction will include a covenant not to compete given by the seller personally to the buyer. Since this is a restriction on the seller's future earning capacity, its value should be carved out of the enterprise selling price and awarded to the seller as a non-marital asset. It is not, however, a proxy or substitute for personal goodwill, as a covenant not to compete protects *all* the assets purchased by the buyer, not just the transferable personal goodwill of the seller. These covenants are asked for by almost every buyer in almost every business purchase and sale transaction, even if the amount of saleable personal goodwill is negligible. Buyers want to suppress any kind of competition.

COGENT TESTIMONY

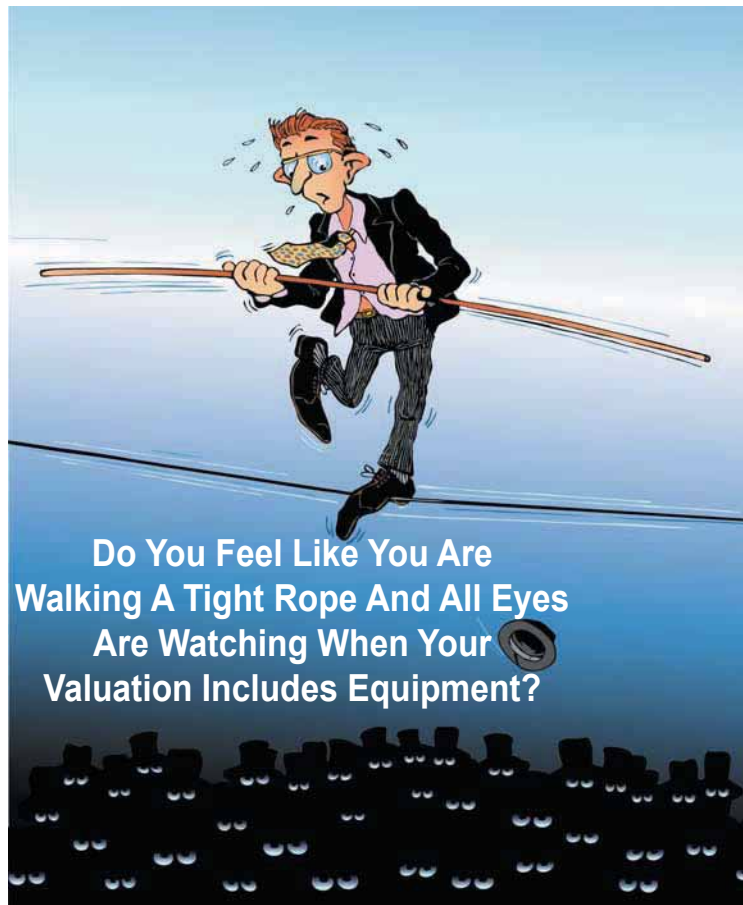
What is needed at this point is for someone to appeal a future divorce court's *Ahern*-based decision, assuming that credentialed experts will have testified and that at least one of them will have offered up competent and cogent testimony that demonstrates the following to the court:

- That the difference between total value and the value of the tangible assets is not necessarily just goodwill, whether enterprise or personal, but consists of other intangible assets
- The ways and means of identifying and measuring those intangible assets
- How to distinguish between enterprise goodwill and personal goodwill
- How to distinguish between saleable, personal goodwill and pure, non-saleable personal goodwill
- That a covenant not to compete is neither equivalent to personal goodwill nor indicative that such exists
- That both the income and market approaches to valuation, if properly applied, generally exclude any pure, non-saleable personal goodwill from the determined value
- That the general rule which defines marital property in Section 953 of Title 19-A of the Maine Revised Statutes does not contain an exception for personal goodwill

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