

Present Positions on Professional Goodwill: More Focus or Simply More Hocus Pocus?

by
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Professional goodwill and its components of “personal” and “enterprise” goodwill have been a quagmire for courts in dissolution of marriage proceedings. The reasons for its inclusion in or exclusion from the marital or communal estate can be as diverse as the different methods employed in valuing it. As one court recently stated: “Accountants, writers on accounting, economists, engineers, and 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 the disagreements reached.”¹

This article is intended to summarize the present state of the law on professional goodwill among the states. In its current posture, it would not be too much of a stretch to categorize the cases on the subject into three simple groups—the black group, the white group and the gray group.

However, before categorizing the groups, it is important to understand the meaning of “goodwill.”

I. Defining and Distinguishing “Goodwill”

“Goodwill” is an intangible asset. In general terms, it is the expectation of continued public patronage or the value of a business or practice that exceeds the combined value of the net assets used in the business or practice.² Long ago, Justice Cardozo observed:

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¹ *In re Marriage of Bradley*, 2004 WL 2137452 (Cal. Ct. App. 2004), *citing In re Marriage of Lopez*, 38 Cal. App. 3d 93, 108 (Cal. Ct. App. 1974).

² *Yoon v. Yoon*, 711 N.E.2d 1265, 1268 (Ind. 1999).

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Men will pay for any privilege that gives a reasonable expectancy of preference in the race of competition. . . . Such expectancy may come from succession in place or name or otherwise to a business that has won the favor of its customers. It is then known as good will.³

Goodwill is typically associated with commercial enterprises. Nevertheless, professional practices such as medical, dental, chiropractic, legal, veterinary, accounting and stockbroker, among others, have also been recognized as possibly possessing goodwill.⁴ Goodwill in these instances is classified as “professional goodwill.”

“Professional goodwill” stated succinctly is “the difference between the total value of the professional association or corporation and the aggregate value of its separable resources and property rights, less liabilities.”⁵ More specifically, it is:

[A] benefit or advantage 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.⁶

An often cited list of factors to consider when attempting to determine the existence of goodwill, and if it is found to exist, the value of it, are:

1. The practitioner’s age and health;
2. The practitioner’s past demonstrated earning power;
3. The practitioner’s professional reputation in the community as to his or her judgment, skill and knowledge;
4. The practitioner’s comparative professional success; and
5. The nature and duration of the practitioner’s business as a sole practitioner or as a member of a partnership or professional corporation to which his or her professional efforts have made a proprietary contribution.⁷

³ *In re Brown*, 150 N.E. 581, 582 (N.Y. 1926).

⁴ *But see In re Marriage of McTiernan and Dubrow*, 133 Cal. App. 4th 1090, 35 Cal. Rptr. 3d 287 (Cal. Ct. App. 2005) (holding that no goodwill arose from a husband’s practice or career as a motion picture director).

⁵ *Hertz v. Hertz*, 657 P.2d 1169, 1173 (N.M. 1983).

⁶ *In re Marriage of Lukens*, 558 P.2d 279, 281 (Wash. Ct. App. 1976).

⁷ *See In re Marriage of Lopez*, 113 Cal. Rptr. 58, 68 (Cal. Ct. App. 1974). *See also Wisner v. Wisner*, 631 P.2d 115 (Ariz. Ct. App. 1981); *In re Marriage of Lowery-Russell*, No. G025965, 2001 WL 1566597 (Cal. Ct. App. 2001); *Poore v. Poore*, 331 S.E.2d 266 (N.C. Ct. App. 1985); *Hertz v. Hertz*, 657 P.2d 1169

The goodwill in a professional practice or business can be personal to the practitioner or attachable to the practice or business itself. Therefore, it is necessary to distinguish between “personal” goodwill and “enterprise” or “business” goodwill. The Indiana Supreme Court cogently explained the difference between the two in the following way:

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 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 transferable to others and has a value to others.

....

In contrast, the goodwill that depends on the continued presence of a particular individual is a personal asset, and any value that attaches to a business as a result of this “personal goodwill” represents nothing more than the future earning capacity of the individual and is not divisible.⁸

Any goodwill, whether enterprise or personal, must be divisible and distributable. This means that the goodwill must be realizable as opposed to unrealizable. Realizable goodwill is that which the owner can convert into cash at any time by selling the business in the open market. Realizable goodwill is almost uniformly held to be a marital asset subject to valuation and distribution.⁹ Since realizable goodwill has an immediate cash value,

(N.M. 1983); *In re Marriage of Goger*, 557 P.2d 46 (Or. Ct. App. 1976); *In re Marriage of Hall*, 692 P.2d 175 (Wash. 1984).

⁸ *Yoon v. Yoon*, 711 N.E.2d 1265, 1268-1269 (Ind. 1999).

⁹ *See, e.g., Wright v. Wright*, 904 P.2d 403 (Alaska 1995); *Nicholson v. Nicholson*, 669 S.W.2d 514 (Ark. Ct. App. 1984); *Malkowski v. Malkowski*, 613 So. 2d 924 (Fla. Dist. Ct. App. 1993); *Olsen v. Olsen*, 873 P.2d 857 (Idaho 1994); *In re Talty*, 652 N.E.2d 330 (Ill. 1995); *Hollander v. Hollander*, 597 A.2d 1012 (Md. Ct. Spec. App. 1991); *Knigge v. Knigge*, 903 S.W.2d 225 (Mo. Ct. App. 1995); *Nastrom v. Nastrom*, 262 N.W.2d 487 (N.D. 1978); *Traczyk v. Traczyk*,

it represents more than mere future potential earnings. Although the valuation may be flawed in the sense that its value can be somewhat speculative, courts generally hold otherwise.

Unrealizable goodwill, and the valuation and divisibility thereof, are much more problematical. It occurs where the business or practice cannot be sold on the open market and understandably causes the most concern and confusion.

Unrealizable goodwill exists mostly in law and other professional practices. It may also be found in certain nonprofessional small businesses where the business is basically marketing the personal skills and reputation of the owner. Its value is to an individual, and that value is essentially the likelihood of future enhanced earnings.¹⁰ As one court observed:

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.¹¹

. . . .

It is thus unrealizable professional goodwill that creates the greatest diversion that exists among the courts of the different states (and sometimes the courts within a state).

II. Categories of States' Approaches to Goodwill

A. *The "Black" Group: Neither Personal Nor Enterprise Goodwill Marital*

In a limited number of states, neither personal nor enterprise goodwill is considered marital property subject to distribu-

891 P.2d 1277 (Okla. 1995); *Butler v. Butler*, 621 A.2d 659 (Pa. Super. Ct. 1993); *Endres v. Endres*, 532 N.W.2d 65 (S.D. 1995); *Finch v. Finch*, 825 S.W.2d 218 (Tex. Ct. App. 1992).

¹⁰ *Holbrook v. Holbrook*, 309 N.W.2d 343 (Wis. Ct. App. 1981).

¹¹ *Id.* at 350.

tion. These states include Kansas, Louisiana, Mississippi, South Carolina, and Tennessee.¹²

Mississippi is the most recent of these states to subscribe to this view. In *Singley v. Singley*,¹³ the Mississippi Supreme Court held that it was “join[ing] the jurisdictions that adhere to the principal that goodwill should not be used in determining the fair market value of a business, subject to equitable division in divorce cases.”¹⁴ The reasoning was:

Goodwill within a business depends on the continued presence of the particular professional individual as a personal asset and any value that may attach to that business as a result of that person’s presence. Thus, it is a value that exceeds the value of the physical building housing the business and the fixtures within the business. It comes increasingly difficult for experts to place a value on goodwill because it is such a nebulous term subject to change on a moment’s notice due to many various factors which may suddenly occur, i.e., a lawsuit filed against the individual or the death and/or serious illness of the individual concerned preventing that person from continuing to participate in the business. It is also difficult to attribute the goodwill of the individual personally to the business. The difficulty is resolved however when we recognize that goodwill is simply not property; thus it cannot be deemed a divisible marital asset in a divorce action.¹⁵

There is good reason why this view constitutes the minority view. It is unfair and inequitable to the non-professional spouse who may get short-changed in these states. The rule is simply the easy way out—courts dodge the difficulty of evaluating input into a career by claiming, in circular fashion, that the valuation process is too difficult.

Indeed, the primary justification for this view is the speculative and difficult nature of valuing goodwill. Valuations of this kind, however, are done all the time in the real world outside of the divorce arena. Moreover, so-called valuation concerns have not precluded other speculative or intangible assets, including

¹² See *Powell v. Powell*, 648 P.2d 218 (Kan. 1982); *Chance v. Chance*, 694 So. 2d 613 (La. Ct. App. 1997); *Singley v. Singley*, 846 So. 2d 1004 (Miss. 2002); *Donahue v. Donahue*, 384 S.E.2d 741 (S.C. 1989); *Smith v. Smith*, 709 S.W.2d 588 (Tenn. Ct. App. 1985).

¹³ 846 So. 2d 1004.

¹⁴ *Id.* at 1010.

¹⁵ *Id.* at 1011.

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nonvested pension interests and contingency fees,¹⁶ from being part of the marital or communal estate subject to division.

B. The “White” Group: Both Personal and Enterprise Goodwill Are Marital

Thirteen states take the position that both enterprise and personal goodwill constitute marital property. Arizona, California, Colorado, Kentucky, Michigan, Montana, Nevada, New Jersey, New York, North Carolina, New Mexico, North Dakota, and Washington are included in this group.¹⁷

The reasoning behind this view was best articulated in *Golden v. Golden*¹⁸:

[I]n a divorce case, the good will of the husband’s professional practice as a sole practitioner should be taken into consideration in determining the award to the wife. . . . [I]n 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.¹⁹

Similarly, a Colorado appellate court reasoned:

A professional, like any entrepreneur who has established a reputation for skill and expertise, can expect his patrons to return to him, to speak well of him, and upon selling his practice, can expect that many

¹⁶ See Christopher A. Tiso, *Are Contingency Fee Cases Part of the Marital or Communal Estate?*, 15 J. AM. ACAD. MATRIM. LAW. 391 (1998). See also *Stageberg v. Stageberg*, 695 N.W.2d 609 (Minn. Ct. App. 2005) (holding that husband’s contingency fees are akin to nonvested, unmaturing pension interests which are not too speculative to be considered marital property).

¹⁷ See, e.g., *Wisner v. Wisner*, 631 P.2d 115 (Ariz. Ct. App. 1981); *In re Foster*, 117 Cal. Rptr. 49 (Cal. 1974); *In re Marriage of Huff*, 834 P.2d 244 (Colo. 1992); *Heller v. Heller*, 672 S.W.2d 945 (Ky. Ct. App. 1984); *Kowalesky v. Kowalesky*, 384 N.W.2d 112 (Mich. Ct. App. 1986); *In re Marriage of Stufft*, 950 P.2d 1373 (Mont. 1997); *Ford v. Ford*, 782 P.2d 1304 (Nev. 1989); *Dugan v. Dugan*, 457 A.2d 1 (N.J. 1983); *Moll v. Moll*, 722 N.Y.S.2d 732 (N.Y. Sup. Ct. 2001); *Poore v. Poore*, 331 S.E.2d 266 (N.C. Ct. App. 1985); *Mitchell v. Mitchell*, 719 P.2d 432 (N.M. Ct. App. 1986); *Sommers v. Sommers*, 660 N.W.2d 586 (N.D. 2003); *In re Marriage of Hall*, 692 P.2d 175 (Wash. 1984).

¹⁸ 75 Cal. Rptr. 735 (Cal. Ct. App. 1969).

¹⁹ *Id.* at 737-738.

will accept the buyer and will utilize his professional expertise. These expectations are a part of goodwill, and they have a pecuniary value.²⁰

This “everything is included” approach can be as unfair and inequitable as those states that exclude both personal and enterprise goodwill. For instance, this group disregards the legitimate double-dipping concerns of counting the goodwill—especially the goodwill attaching personally to the professional—both as a marital asset subject to division and as a source of future earnings to pay alimony and support.

C. The “Gray” Group: Enterprise Goodwill Is Marital, Personal Goodwill Is Not

The majority of the states hold that personal goodwill cannot constitute marital property whereas enterprise goodwill can. The states comprising the majority view consist of Alaska, Arkansas, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, Utah, Virginia, West Virginia, Wisconsin, and Wyoming.²¹

This view is essentially premised upon the concept that personal goodwill is purely a personal asset of the professional. Any value attributable to it amounts to nothing more than future earning capacity which is more equitably considered for support

²⁰ *In re Marriage of Nichols*, 606 P.2d 1314, 1315 (Colo. Ct. App. 1979).

²¹ *See, e.g.*, *Richmond v. Richmond*, 779 P.2d 1211 (Alaska 1989); *Tortorich v. Tortorich*, 902 S.W.2d 247 (Ark. Ct. App. 1995); *Eslami v. Eslami*, 591 A.2d 411 (Conn. 1991); *E.E.C. v. E.J.C.*, 457 A.2d 688 (Del. 1983); *McDiarmid v. McDiarmid*, 649 A.2d 810 (D.C. 1994); *Thompson v. Thompson*, 576 So. 2d 267 (Fla. 1991); *Antolik v. Harvey*, 761 P.2d 305 (Haw. Ct. App. 1988); *In re Marriage of Schneider*, 824 N.E.2d 177 (Ill. 2005); *Yoon v. Yoon*, 711 N.E.2d 1265 (Ind. 1999); *Prahinski v. Prahinski*, 540 A.2d 833 (Md. Ct. Spec. App. 1988); *Goldman v. Goldman*, 554 N.E.2d 860 (Mass. Ct. App. 1990); *Roth v. Roth*, 406 N.W.2d 77 (Minn. Ct. App. 1987); *Hanson v. Hanson*, 738 S.W.2d 429 (Mo. 1987); *Taylor v. Taylor*, 386 N.W.2d 851 (Neb. 1986); *In re Watterworth*, 821 A.2d 1107 (N.H. 2003); *Travis v. Travis*, 795 P.2d 96 (Okla. 1990); *Matter of Marriage of Maxwell*, 876 P.2d 811 (Or. Ct. App. 1994); *Butler v. Butler*, 663 A.2d 148 (Pa. 1995); *Moretti v. Moretti*, 766 A.2d 925 (R.I. 2001); *Guzman v. Guzman*, 827 S.W.2d 445 (Tex. Ct. App. 1992); *Sorenson v. Sorenson*, 839 P.2d 774 (Utah 1992); *Howell v. Howell*, 523 S.E.2d 514 (Va. Ct. App. 2000); *May v. May*, 589 S.E.2d 536 (W. Va. 2003); *Peerenboom v. Peerenboom*, 433 N.W.2d 282 (Wis. Ct. App. 1988); *Root v. Root*, 65 P.3d 41 (Wyo. 2003).

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purposes (i.e., alimony). As articulated by the Indiana Supreme Court:

[B]efore including the goodwill of a self-employed business or professional practice in a marital estate, a court must determine that the goodwill is attributable to the business as opposed to the owner as an individual. If attributable to the individual, it is not a divisible asset and is properly considered only as future earning capacity that may affect the relative property division.²²

In *Hanson v. Hanson*,²³ the Missouri Supreme Court queried and rationalized:

The common theme in all of [the] definitions is that the goodwill which can be sold, and is therefore property, attaches not to an individual but to a business entity. Goodwill has no separate existence; it has value only as an incident of a continuing business.

...

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.*

...

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.²⁴

Some of the cases encompassing this view adopt the notion that goodwill, if it is to be recognized and divisible at all, must be completely separate and distinct from the presence and reputation of the professional. For example, in *Thompson v. Thompson*, the Florida Supreme Court concluded: “Generally, clients come to an individual professional to receive services from that specific person. Even so, if a party can produce evidence demonstrating goodwill as an asset separate and distinct from the other party’s reputation, it should be considered in distributing marital property.”²⁵

To this end, goodwill will be considered personal and unrealizable if the expert testifying acknowledges that the practice can-

²² *Yoon v. Yoon*, 711 N.E.2d 1265, 1269 (Ind. 1999).

²³ 738 S.W.2d 429 (Mo. 1987)

²⁴ *Id.* at 433-435.

²⁵ *Thompson v. Thompson*, 576 So. 2d 267, 270 (Fla. 1991).

not be valued without either the professional's presence or the existence of a noncompetition or non-solicitation/non-piracy agreement.²⁶ In other words, if there are *any* ties or strings attached to the professional, there can be no goodwill.

D. States Not Yet Definitively Resolving the Goodwill Issue

In *Endres v. Endres*²⁷ and *Carr v. Carr*,²⁸ both courts concluded that enterprise goodwill would be marital or community property but each declined to consider whether personal goodwill would likewise be marital or communal. Neither case involved a professional practice.

In Ohio, one appellate court has held that both enterprise goodwill and personal goodwill can constitute marital property.²⁹ Another more recent appellate court opinion concluded that personal goodwill cannot be a marital asset.³⁰ Given that the former has been subsequently cited³¹ and latter not at all, plus the fact that the former seems to be more in line with dicta found in an Ohio Supreme Court case,³² the former arguably is or will become the rule in Ohio.

²⁶ See *Held v. Held*, 912 So. 2d 637 (Fla. Dist. Ct. App. 2005); *Kricsfeld v. Kricsfeld*, 588 N.W.2d 210 (Neb. Ct. App. 1999); *Walton v. Walton*, 657 So. 2d 1215 (Fla. Dist. Ct. App. 1995).

²⁷ 532 N.W.2d 65 (S.D. 1995).

²⁸ 701 P.2d 304 (Idaho Ct.App. 1985).

²⁹ *Kahn v. Kahn*, 536 N.E.2d 678 (Ohio Ct. App. 1987).

³⁰ *Goswami v. Goswami*, 787 N.E.2d 26 (Ohio Ct. App. 2003).

³¹ See, e.g., *Zerbe v. Zerbe*, Nos. C-040035, C-040036, 2005 WL 627781 (Ohio Ct. App. 2005); *Hamilton v. Hamilton*, Nos. CA2001-01-005, CA2001-01-010, 2002 WL 1009359 (Ohio Ct. App. 2002); *Barone v. Barone*, Nos. L-98-1328, DR 96-0085, 2000 WL 1232391 (Ohio Ct. App. 2000).

³² In *Spayd v. Turner, Granzow & Hollenkamp*, 482 N.E.2d 1232 (Ohio 1985), the Ohio Supreme Court observed it was "in agreement with" the following statements by the New Jersey Supreme Court in *Dugan v. Dugan*, 457 A.2d 1 (N.J. 1983):

Though other elements may contribute to goodwill in the context of a professional service, such as locality and specialization, reputation is at the core. . . . 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 must exist and have value.

In Iowa, the appellate court in *In re Marriage of Hogeland*,³³ indicated that any goodwill of a professional corporation would be a factor bearing upon the future earning potential of the professional spouse. However, in *In re Marriage of Ceilley*,³⁴ the wife specifically requested the appellate court to acknowledge that “equity good will” was distinct from personal goodwill and could be considered “a marital asset subject to property division.”³⁵ Unfortunately, because there was no factual or evidentiary basis in the record to do so, the appellate court declined the invitation.

Similarly, in *Klein v. Klein*,³⁶ neither party offered any evidence of the value of the husband’s law practice. Accordingly, the Vermont Supreme Court concluded “[b]ecause of the procedural posture, we need not choose among the various rules [including that of goodwill] for valuing a professional practice in this case.”³⁷

In Alabama, Georgia, and Maine,³⁸ there are currently no cases specifically addressing the issue of the divisibility of professional goodwill upon divorce.

III. Valuing Goodwill

Once the threshold determination is made that recognizable or distributable goodwill exists, it must be valued. Although courts have employed innumerable methods in computing goodwill, the five most predominantly accepted are:

- (1) The capitalization of excess earnings approach;
- (2) The straight capitalization approach;

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

³³ 448 N.W.2d 678 (Iowa Ct. App. 1989). See also *In re Marriage of Bethke*, 484 N.W.2d 604 (Iowa Ct. App. 1992).

³⁴ 662 N.W.2d 374 (Iowa Ct. App. 2003), available at 2003 WL 555607.

³⁵ *Id.* at * 2.

³⁶ 555 A.2d 382 (Vt. 1988).

³⁷ *Id.* at 385.

³⁸ In *Sweeney v. Sweeney*, 534 A.2d 1290 (Me. 1987), the Maine Supreme Court almost addressed the issue. However, because the husband had a binding stock redemption agreement concerning his interest in a cardiology practice which excluded goodwill, the court did not reach the issue.

- (3) The formula approach (which is the Internal Revenue Service’s (“IRS’s”) variation of the capitalization of excess earnings method);
- (4) The market value approach; and
- (5) The buy/sell agreement approach.³⁹

A. Capitalization of Excess Earnings

This is perhaps the most commonly relied upon approach for valuing professional practices.⁴⁰ Simply stated, under this method the average net income is determined, from which an annual salary of an average employee practitioner with like experience is subtracted. The resulting amount is multiplied by a fixed capitalization rate to ascertain the goodwill.⁴¹ An example of this method is:

Average net earnings	\$ 60,000
Less comparable net salary	(40,000)
Average earnings on intangible assets	20,000
Capitalize at 20%	x 5
Goodwill	\$100,000

A small number of states reject this method of valuing goodwill.⁴² The primary argument is that it measures future earnings, thereby double counting earning capacity as both a marital asset

³⁹ Cases discussing the five approaches include *Moffit v. Moffit*, 749 P.2d 343, 348 (Alaska 1988); *Hanson v. Hanson*, 738 S.W.2d 429, 435-436 (Mo. 1987); *In re Marriage of Hall*, 692 P.2d 175, 178-180 (Wash. 1984); *May v. May*, 589 S.E.2d 536, 548 (W. Va. 2003).

⁴⁰ See *May v. May*, 589 S.E.2d 536, 548 (W. Va. 2003), citing Alicia Brokars Kelly, *Sharing a Piece of the Future Post-Divorce: Toward a More Equitable Distribution of Professional Goodwill*, 51 RUTGERS L. REV. 569, 610 (1999). See also *In re Marriage of McTiernan and Dubrow*, 133 Cal. App. 4th 1090, 35 Cal. Rptr. 3d 287 (Cal. Ct. App. 2005) (“It has been noted that the ‘excess earnings’ method is commonly used to determine the value of the goodwill in a professional practice”).

⁴¹ The capitalization rate is variable and the specific rate used in a given case will differ depending upon many factors including the type of practice involved, the location, the particular expert’s judgment, and obviously on which party’s behalf the expert is opining.

⁴² See, e.g., *Mitchell v. Mitchell*, 732 P.2d 208 (Ariz. 1987); *E.E.C. v. E.J.C.*, 457 A.2d 688 (Del. 1983); *Thompson v. Thompson*, 576 So. 2d 367 (Fla. 1991); *Hanson v. Hanson*, 738 So. 2d 429 (Mo. 1987); *Mocnik v. Mocnik*, 838 P.2d 500 (Okla. 1992); *Becker v. Perkins-Becker*, 669 A.2d 524 (R.I. 1996).

subject to equitable distribution and income from which alimony can be paid.⁴³ One commentator has noted:

This criticism is entirely unjustified. By capitalizing only the *excess* earnings of the owning spouse, the excess earnings method actually excludes most future earnings from consideration. The fundamental assumption of the method is that by looking only at earnings above the average salary of similar persons in the same field, the court can focus narrowly upon that segment of future earnings which is actually attributable to previously existing good will. A court which uses the excess earnings method is therefore no more dividing future earnings than is a court which divides a pension. In both instances, the court is treating future benefits as marital property because they were earned during the marriage.⁴⁴

In fact most states have approved and many experts use the capitalization of excess earnings approach as a method of valuing goodwill.⁴⁵

B. Straight Capitalization

This method, also known as capitalization of net profits, requires that the average net profits of the practitioner be determined, then capitalized at a particular rate. That number is considered to be the total value of the practice, both tangible and intangible assets. The book value of the practice assets are subtracted from that number to determine the goodwill. An example of this calculation is:

Average net earnings	\$ 60,000
Capitalize at 20%	x 5
Total business tangible and intangible assets	300,000
Less current net tangible assets	<u>(50,000)</u>
Goodwill	\$250,000

While a number of cases indicate this accounting method is an acceptable formula,⁴⁶ at least with regard to professional

⁴³ See *Skrabak v. Skrabak*, 673 A.2d 732, 737 n.5 (Md. Ct. Spec. App. 1996).

⁴⁴ BRETT R. TURNER, *EQUITABLE DISTRIBUTION OF PROPERTY* § 7.07, at 534 (2nd ed. 1994).

⁴⁵ See *supra* note 41 and authorities cited there.

⁴⁶ See, e.g., *May v. May*, 589 S.E.2d 536 (W. Va. 2003); *Herrman v. Herrman*, Nos. CA99-01-006, CA99-01-011, 2000 WL 1671045 (Ohio Ct. App. 2000); *In re Marriage of Crosetto*, 1 P.3d 1180 (Wash. Ct. App. 2000).

goodwill, there is a dearth of cases in which it was actually utilized, much less accepted.⁴⁷

C. Formula Approach

The “IRS” or formula approach, found in Revenue Ruling 68-609 (1968), essentially involves taking the average net income of the practice for the past five years, subtracting a reasonable rate of return based on the practice’ average net tangible assets. A comparable net salary is then subtracted from the resulting amount which is then capitalized at a particular rate to arrive at the goodwill.⁴⁸ A calculation utilizing this method would be:

Average net earnings	\$ 60,000
Less rate of return on average tangible assets	(2,500)
Subtotal	57,500
Less comparable net salary	(40,000)
Average earnings on intangible assets	17,500
Capitalization at 20%	x 5
Goodwill	\$ 87,500

The IRS approach to valuation is an appropriate method since it is used regularly by accountants in recommending to their clients prices at which they should buy or sell a business or practice. One writer observes:

Since future earnings and individual reputation are not subject to taxation, the IRS would not use a method which included these benefits in valuing a business. The IRS’s decision to use excess earnings is there-

⁴⁷ In *Tatum v. Tatum*, No. 2001-CA-002140-MR, 2004 WL 1488307 (Ky. Ct. App. 2004), the court accepted the expert’s use of straight capitalization but the case involved a machinery company with specialized products, not a professional practice.

⁴⁸ As observed in *May v. May*, 589 S.E.2d 536, 548 (W. Va. 2003), Revenue Ruling 68-609 (1968) provides:

A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say, 15 to 20 percent, is the value of the intangible assets of the business determined under the “formula” approach.

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fore another indication that the method reaches fair results for valuing property upon divorce.

In light of these other uses, capitalization of excess earnings is simply not a method invented by biased experts for the purposes of dividing future earnings and giving larger values to businesses. It is, instead, a generally accepted accounting method which is used for many purposes other than dividing property at divorce. Decisions which are skeptical of retained earnings have often displayed no awareness of this fact. . . . Attorneys relying on the excess earnings method would therefore do well to stress to the court its wide level of acceptance among accountants for purposes other than valuing property upon divorce.⁴⁹

D. *Market Value Approach*

This methodology requires a determination of what a fair price would be in the current open market if the practice were sold. For the market value approach to be viable, it is generally considered necessary that a similar professional practice has been recently sold (or at least the subject of a recent offer to purchase) preferably in the same or similar community.

In *Hanson v. Hanson*,⁵⁰ after analyzing the five predominant valuation methods, the Supreme Court of Missouri adopted the fair market value method. It reasoned:

First, the fair market value approach does not take explicitly into consideration the future earning capacity of the professional goodwill or the post-dissolution efforts of the professional spouse. . . .

Second, fair market value evidence appears to us to be the most equitable and accurate measure of both the existence and true value of the goodwill of an enterprise. Evidence of a recent actual sale of a similarly situated practice, an offer to purchase the subject or a similar practice, or expert testimony and testimony of members of the subject profession as to the present value goodwill of a similar practice in the open, relevant, geographical and professional market is the best evidence of value.

Third, the fair market value method is most likely to avoid the “disturbing inequity in compelling a professional practitioner to pay a spouse a share of intangible assets at a judicially determined value that

⁴⁹ TURNER, *supra* note 46, § 7.07, at 534-535, n.217.

⁵⁰ 738 S.W.2d 429 (Mo. 1987).

could not be realized by a sale or another method of liquidated value.”⁵¹

In fact, the Missouri Supreme Court in *Hanson* went so far as to “reject the use of capitalization formulae as a substitute for fair market value evidence of the value of goodwill in a professional practice.”⁵²

In Florida, this method is also judicially preferred. The Florida Supreme Court in *Thompson v. Thompson* defined the fair market value approach as “what would a willing buyer pay, and what would a willing seller accept, neither acting under duress for a sale of the business. The excess over assets would represent goodwill.”⁵³ It adopted this as the exclusive method of goodwill valuation, noting that “[a]ctual comparable sales are not required, so long as a reliable and reasonable basis exists for an expert to form an opinion.”⁵⁴

However, many states treat this valuation approach as one of several possible approaches.⁵⁵

It is arguable that complete reliance on the market value approach to establish the existence of goodwill hinders, if not outright precludes, any consideration to whether legal or ethical constraints are present. For instance, in those states where a sole law practice cannot be sold, there can never be goodwill.⁵⁶

⁵¹ *Hanson v. Hanson*, 738 S.W.2d 429, 436 (Mo. 1987). *But see In re Marriage of Brooks*, 742 S.W.2d 585 (Mo. Ct. App. 1987) (limiting the *Hanson* preference to professional practices).

⁵² *Hanson v. Hanson*, 738 S.W.2d at 436. The Court in *Hanson* did at least acknowledge that under certain circumstances, the buy-sell agreement method may be appropriate.

⁵³ 576 So. 2d 267, 270 (Fla. 1991).

⁵⁴ *Id.*

⁵⁵ *See, e.g., Eslami v. Eslami*, 591 A.2d 411 (Conn. 1991) (stating that while evidence of comparable sales would ordinarily be more persuasive, capitalization of excess earnings approach is a permissible method); *McLean v. McLean*, 374 S.E.2d 376 (N.C. 1988); *Wilson v. Wilson*, 741 S.W.2d 640 (Ark. 1987).

⁵⁶ *See, e.g., Richmond v. Richmond*, 779 P.2d 1211 (Alaska 1989); *Prahinski v. Prahinski*, 540 A.2d 833 (Md. Ct. Spec. App. 1988); *Beasley v. Beasley*, 518 A.2d 545 (Pa. Super. Ct. 1986). *But see In re Marriage of Watts*, 217 Cal. Rptr. 301 (Cal. Ct. App. 1985) (determining that the mere fact that a medical practice has no market and could not be sold, standing alone, will not justify a finding that the practice has no goodwill or that the community goodwill has no value).

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Moreover, in those states such as Florida where any goodwill has to be separate and distinct from the professional, it is often difficult, if not impossible, to find true comparables. In *Weinstock v. Weinstock*,⁵⁷ for example, the husband's dental practice was valued by the wife's expert using comparables where the selling dentists continued to practice at the location for some time after the sale. There were no comparables in which the presence of the selling dentist was discontinued. The appellate court determined that "[t]he inclusion of the goodwill as a marital asset was improper because the evidence failed to establish a value for this goodwill apart from the husband's continued presence."⁵⁸

Another Florida appellate court expressed the difficult nature of finding "true" comparables, noting "that the attempt to determine the goodwill value of the business of a sole professional practitioner, absent consideration of his reputation, presence and tangible assets, is somewhat akin to a metaphysical quest for the sound of one hand clapping."⁵⁹

E. *Buy/Sell Agreement*

This method values goodwill by relying upon a recent *actual* sale or on an unexercised existing option or contractual formula set forth in a partnership or corporate agreement. The flaws in this valuation approach are evident. Most notably, the professional spouse could have been influenced by innumerable factors other than fair market value when negotiating or executing the agreement. Thus, inquiry must be made as to any such influences including the arm's length nature of the transaction. As one court aptly observed: "[B]uy-sell agreements in a closely held corporation can be manipulated by the shareholders to reflect an artificially low value. This is why caution should be exercised in accepting their value for equitable distribution purposes."⁶⁰

Two cases from New Mexico perfectly portray this problem and how to deal with it. Essentially, it turns on the credibility of the agreement and how it has been implemented and reviewed or updated.

⁵⁷ 634 So. 2d 775 (Fla. Dist. Ct. App. 1994).

⁵⁸ *Weinstock v. Weinstock*, 634 So. 2d at 778.

⁵⁹ *Young v. Young*, 600 So. 2d 1140, 1143 n.2 (Fla. Dist. Ct. App. 1992).

⁶⁰ *Bettinger v. Bettinger*, 396 S.E.2d 709, 715 (W.Va. 1990).

In *Hertz v. Hertz*,⁶¹ the court held that the wife was bound to her husband's law firm's buy/sell agreement which provided for one dollar of goodwill value because there had been over 150 purchases and sales of stock in each of which the firm had adhered to the agreement.⁶² In *Cox v. Cox*,⁶³ the court reached a different result. The husband's shareholders' agreement which valued goodwill at zero was rejected since it was executed twenty-nine days after the wife filed for divorce and there was no history of any compliance with or adherence to it.⁶⁴

Simply put, where a buy/sell agreement exists, the logical approach (and really the only fair approach) is to treat it as merely being a factor to consider but not controlling. Most courts subscribe to this view.⁶⁵

IV. Conclusion

The vast majority of the states with cases addressing the issue of professional goodwill hold that "enterprise" goodwill is recognizable and can constitute a part of the marital or community property. A majority also concludes that "personal" goodwill is not marital property.

This is fortunate since dissolution of marriage actions are in equity. It would be inequitable to deprive a nonprofessional spouse the entitlement to share in the value of goodwill in an enterprise or business which (assuming the facts so indicate)

⁶¹ 657 P.2d 1169 (N.M. 1983).

⁶² See also *Sweeney v. Sweeney*, 534 A.2d 1290 (Me. 1987), where the Maine Supreme Court did not address the issue of goodwill concerning the husband's interest in a cardiology practice because the stock redemption agreement expressly excluded goodwill as a factor. Significantly, the court noted that the agreement was entered into prior to the divorce proceedings and nothing in the record indicated it was entered into for the purpose of limiting the value of the stock as a marital asset.

⁶³ 775 P.2d 1315 (N.M. Ct. App. 1989).

⁶⁴ The fact that the shareholders "began discussing [the] shareholders' agreement containing all of the provisions that eventually became part of the agreement at issue" approximately one year prior to its execution did not change the result. *Id.* at 1316.

⁶⁵ See, e.g., *Molloy v. Molloy*, 761 P.2d 138 (Ariz. Ct. App. 1988); *In re Marriage of Fenton*, 184 Cal. Rptr. 736 (Cal. Ct. App. 1982); *In re Marriage of Huff*, 834 P.2d 244 (Colo. 1992); *Stolowitz v. Stolowitz*, 435 N.Y.S.2d 882 (N.Y. Sup. Ct. 1980); *Poore v. Poore*, 331 S.E.2d 266 (N.C. Ct. App. 1985).

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truly does exist. It would be equally inequitable to “charge” the professional spouse with phantom goodwill or goodwill that is solely and personally attributable to the professional and amounts to nothing more than an ability to earn in the future. The latter is certainly more fairly and best utilized for support purposes.

Valuing professional goodwill in a divorce is just as risky as in the real world. It is and always will be speculative in nature. Mistakes in this regard are routinely made in real life business and there is no reason why the divorce arena should be any different. Of course, caution should be the norm to protect against overzealous experts overvaluing professional goodwill. But if it does exist, a value should be placed on it.