CALCULATING PERSONAL GOODWILL IN THE CONTEXT OF DIVORCE

By Edward S. Sachs CPA/ABV

Goodwill is defined by the Internal Revenue Service as "the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor." The more classic definition is the propensity of customers to return for repeat business. It is the ability of a business to earn a rate of return in excess of a normal rate of return on the net assets of the business.

In Florida divorce matters, once goodwill is established, the valuation expert must determine what portion of the goodwill is enterprise goodwill versus personal goodwill. In the 1991 case of Thompson v Thompson the Court stated that if goodwill exists, in order for the goodwill to be a marital asset it must exist separate and apart from the reputation or continued presence of the marital litigant. In 1997 the Court in Walton v Walton established the concept that personal goodwill may be represented by the existence of a non-compete agreement and in 2005 in Held v Held the Court found there to be no distinction between a non-compete agreement and a non-solicitation/non-piracy agreement. The concept of personal goodwill was expanded into non-professional service businesses in Christians v Christians.

With little guidance from the Courts, and no definitive standards or guidance in the valuation industry for determining personal goodwill, the valuation expert must treat each situation based on the facts and circumstances of the case.

The existence of a sole operator or professional or 100% owner of a business does not, in and of itself, mean that personal goodwill exists. One cannot assume that a sole practitioner professional practice automatically has no enterprise goodwill. The expert who does not perform the due diligence necessary to establish the level of personal goodwill is not meeting the standards required by Daubert.

Appelrouth Farah has successfully argued that a sole practitioner dentist had a significant level of enterprise goodwill based on the fact that the practice had a catchy trade name, and garnered much of its business by offering loss leaders ($9.99 first visits with xrays) in local community newspapers and coupon mailers.

In another matter involving a business that recycled auto and truck batteries, the opposing expert testified that all of the goodwill was personal based on the sole owner's connections with the sources from whom he bought the batteries and the customers to whom he sold the batteries. The expert ignored the fact that the company had a catchy trade name and advertised extensively throughout the community. The Appelrouth Farah Litigation Department contacted the companies suppliers and determined that they would sell to "anyone with cash" that wanted to purchase used batteries and many of the institutional buyers that the company sold to claimed to have no allegiance to any one company. The Court agreed and ruled that the company had no personal goodwill.

However, once the expert determines that goodwill does exist, how do you quantify what portion is personal and what portion is enterprise.

There are three different methods that can be reasonably employed to establish the value of personal goodwill.

First, if the expert believes that the value established for the business is predicated on the requirement that the seller execute a non-competition, non-solicitation or non-piracy agreement ("covenant"), the value of that covenant may represent the value of the personal goodwill. Keeping in mind that such a covenant precludes the seller from earning a living in the same or similar business or with the same customers, the seller's discretionary earnings for the period of the agreement could represent the value of the personal goodwill. (Annual earnings of $65,000 with a two year non-compete might suggest a value of the personal goodwill as $130,000.)

Another method available to the appraiser is the lost profits or lost business method. If it can be determined within a reasonable certainty how much business would be lost if the seller did not sign a covenant then the appraiser can utilize the income approach to determine what the value of the company is with and without the agreement. The difference would represent personal goodwill.

The third method is a market approach. The Pratt's Stats transaction database often includes information as to whether or not a covenant was granted, and if so, how much of the sales price was allocated to the covenant. This information can allow the appraiser to determine a reasonable percentage of the market value attributable to the covenant.

No matter which method is utilized, the appraiser should not reach a conclusion without analyzing whether the value ascribed to the covenant is sufficient enough for the seller not to breach the agreement.