Guest Article

Valuing Goodwill and the Danger of the Double Dip

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How do you value something you cannot see?

That is exactly the problem of valuing goodwill. Many businesses, particularly service businesses, are worth more than their hard assets and cash reserves. They have a significant intangible value associated with the business's reputation and related ability to generate substantial income into the future for its owners. Valuing these kinds of companies is really about figuring out what this "invisible" asset is worth.

In a nutshell, goodwill is generally valued by looking at the income of the company, comparing it to similar companies, and figuring out how much better (or worse) this company does than its competitors. In other words, goodwill is the measure by which one business stands out in its field and is able to generate more money than competitors. Then, that incremental benefit is capitalized into the future using multiples built up by very smart accountants to generate a present value for the business' goodwill.

What is important about this analysis is that the valuation process derives its foundation from the income of the owner and business. That income is then converted into recognition of the value to the owner in having that income stream. Of course, by converting income into value a divorcing business owner is set up for potential catastrophe and a dangerous double (or even triple) dip: That same income is going to be used to create a value for division of an asset, and then to pay alimony and (if the couple have children) child support. A business owner could be called upon to share in the same dollar of income three times due to the valuation process.

Admittedly, this is an esoteric concept that makes a lot more sense in the context of an example. In 1988, John Smith graduated from law school. He set out to hang his own shingle and began building a general law practice, with some emphasis on criminal defense work. One day, a client with a particularly novel 4th Amendment issue walked through John's door as a pro bono referral. Because he was interested in the issues in the case, John took it for free. He ended up successfully arguing the issue before the United States Supreme Court in 1997.

As a result of this particular, unique decision to take an interesting pro bono case, John built a national reputation as a criminal defense attorney and became highly sought out in his home state for complex criminal cases involving 4th Amendment violations by the state. His practice boomed and eventually grew to five partners, 20 additional lawyers, and 50 total employees.

In 1991, just a few years after beginning his practice, while he was still a solo practitioner, John met and fell in love with Jane. They were married in 1993. During the course of their marriage, Jane and John had three children, and Jane stayed at home to care for the family and support John's career.

The rigors of John's professional life took a toll on the marriage, however, and in 2014, Jane filed for divorce. The couple had lived a relatively lavish lifestyle, enjoying all the fruits of John's large income. They also owned a million dollar country club home with no mortgage, several luxury automobiles, $250,000 in a brokerage account, and John's $500,000 401(k) retirement account.

In any state in the country, and in any domestic relations court trying to sort out the dissolution of John and Jane's marriage, John's interest in his law firm would need to be valued.

So what is the value of the law firm, anyway? If one were to merely add up the sum of the "stuff" in the law firm — computers, cubicles, office supplies, the art on the walls, and the copy machines — there is unlikely to be significant value. For one, the firm has likely been depreciating these assets (legitimately) over several years, reducing their value. For another, pens and paper, and even computers and other office machines, are just not worth that much money. Maybe, at best, the entire law firm is worth $250,000 or so in tangible assets, rendering John's 20% interest worth $50,000.

Does that make sense, really?

Of course not. Let's assume that John makes $2 million per year, representing his share of firm profits (and let's ignore the idea, for the moment that, John is paid by any compensation formula more complicated than that he draws 20% of the profits and all of the partners of the firm are equally paid). That means that the firm's <u>profits</u> alone (after reasonable and necessary business expenses that will survive IRS scrutiny) are $10 million. Maybe the firm's revenues are closer to $20 million.

It sounds conceptually impossible for a firm generating net income of $10 million per year to be worth $250,000. Some of the most valuable publically traded companies (such as Facebook) typically run at a loss, in fact.

The magic value in John's law firm is in goodwill — the intangible assets of the company, such as its reputation, that allow it to produce more income than other similarly situated businesses.

The law firm described thus far is the classic service-driven business that owns, as its primary asset most likely, "goodwill." At least some part of the value of John's interest in his law firm is its reputation as a top law firm, and some of that value is related to John's own personal reputation and accomplishments as a criminal defense attorney that successfully argued an appeal before the United States Supreme Court.

Back to divorce court for John and Jane. As previously mentioned, this couple enjoyed a fairly lavish lifestyle. Jane didn't work and doesn't have much income earning potential. Consequently, on top of seeking a fair division of the marital/community estate, she is also seeking spousal support/alimony from John out of his $2 million in income.

This is where the dangerous double dip in valuing personal goodwill comes. Jane is seeking to share in the value of John's share of his law firm that is derived almost entirely from John's income, but she is also seeking a second share of the same income in the form of alimony. John could be double charged to share the same dollars of his income with Jane.

The parties' also have children who are still legally minors. Thus, child support is an issue as well, and Jane, as the historical primary stay-at-home parent, will have the children the majority of the time even after the divorce. Even if she doesn't, given the parties' disparity in income, she is likely entitled to some amount of child support. John's income will again be considered to determine how much additional child support he pays Jane.

Let's say that John's interest in his law firm is valued at $2.5 million. Given that it is the largest asset of the marriage, Jane will need to somehow receive close to $1.25 million from John. These parties have $1.75 million in other assets — the home, investment account, and John's retirement account. Jane will likely get the lion's share of those assets to offset John's receipt of his law firm interest, the value of which is mostly made up of his ability to earn income through that firm (i.e., goodwill). It is not hard to see how John could easily feel like Jane got "real" assets in the form of all of the family's real estate, and most of its investments and retirement savings, while he got an asset that was primarily the "right to keep working."

And because John has just "bought" the right to keep working at his law firm, he could be on the hook for tens of thousands of dollars of spousal support per month, plus child support. His only way to fund these additional obligations is to share with Jane the income from the asset that he already effectively shared through the goodwill valuation process. It might be difficult to quantify how much, but Jane is getting to make a claim on some of the same dollars <u>three times</u>.

There are four general approaches that state family law courts use to deal with the intangible goodwill issues addressed in this article.

1 **The Majority Approach:** The states that follow the majority approach deal with this issue by trying to separate goodwill into two categories: enterprise goodwill and personal goodwill.[1]

Enterprise goodwill is defined as the intangible value associated with the business as a unit itself, say, of John's law firm as a whole, and is tied to the existence of the particular business as a going concern.[2] On the other hand, personal goodwill is tied to the personality and individual excess value brought to the table by the individual owner, including through an excess earnings analysis.[3]

By separating the goodwill income personal to the divorcing spouse from the goodwill income that is related solely to the fact that there is a business with a good general reputation (and, thus, entirely associated with the existence of an asset), the majority rule attempts to minimize or mitigate the double dip by setting aside the personal component of the spouse's income from the business value and, thus, sparing that portion of income from being turned into an asset and divided twice with the imposition of alimony.

In our hypothetical scenario, an expert trying to separate out what portion of the law firm's value represents personal versus enterprise goodwill might attempt to quantify how much of the income John enjoys as a partner is due to his personal reputation and attributes, versus how much is simply firm profit. Perhaps the expert would consider how many of the income-generating firm clients are personal referrals to John versus referrals to the firm as a whole. The personal goodwill component could be the excess income John has created out of his own personal reputation in his Supreme Court victory (which is being conveyed as a benefit to the entire firm), whereas John's share of the profits from the civil side of the firm's practice might be enterprise goodwill.

2 **Minority Approach:** The minority approach adopted by the 17 states not otherwise specifically addressed herein is to value intangible goodwill as marital/community property without distinguishing between enterprise and personal components. Obviously the risk of a double dip is greatest in this context as even the personal-income-generating potential of the business owner is also an asset subject to division. These states explicitly ignore the double dip problem altogether.

3 **Ignoring Goodwill:** A few additional states exclude goodwill of any variety from the value of a business asset.[4] Obviously, under this stark approach, there is no risk of double dipping. On the other hand, as discussed above, the non-business-owner spouse is going to lose out on an awful lot of the true value of the business to be divided.

4 **Unique Approaches:** A few other states have adopted truly unique approaches. For example, Iowa ties the existence of goodwill to the business continuing as a going concern (which sounds like enterprise goodwill) but also considers it as a factor bearing on the spouse's earning potential in the future (more like personal goodwill).[5] South Dakota has refused to address whether personal goodwill in a business constitutes a marital asset, but does treat enterprise goodwill as marital.[6]

So what is the solution for John? How does he fairly share the fruits of his long-term marriage to Jane, without being charged twice on the same dollars? And how does Jane make sure she gets her fair share of the accumulated wealth of the marriage as well as providing for her future support?

Jane has a problem if she lives in one of the four states that decline to include goodwill entirely. However, it is not a futile exercise for her to quantify it. Perhaps the courts in those four states won't consider the goodwill of John's practice as an asset, but she could argue that this economic circumstance justifies a more favorable division of other property, or, perhaps that she should receive a larger share of John's ongoing income since he's getting an asset for pennies on the dollar.

On the other hand, John has a problem if he lives in one of the states that treat all goodwill as marital/community property. But, again, it is not a waste of time for John to analyze the separate personal and enterprise components of goodwill. He may be able to make counterarguments about different property divisions, or reductions to his alimony to account for and mitigate the double dip. Creative legal arguments — and good accounting — still matter, even in states with rules that ignore the fundamental and endemic problem of double dipping in the goodwill valuation context.

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[1] Alaska, Arkansas, Connecticut, Delaware, the District of Columbia, Florida (which goes a step farther and severely limits enterprise goodwill, treating it mostly as personal), Hawaii, Illinois, Indiana, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, Utah, Vermont, West Virginia, Wisconsin and Wyoming all take this approach.

[2] *See, e.g.,* In re Marriage of Bookout, 833 P.2d 800 (Colo. App. 1991)(describing "enterprise goodwill," even though Colorado has declined to date to distinguish between enterprise and personal goodwill).

[3] Shannon Pratt, The Lawyer's Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony, 174-187 (2000).

[4] Kansas, Mississippi, South Carolina and Tennessee take this approach.

[5] *See, e.g.*, In re Marriage of Hogeland, 448 N.W.2d 678 (Iowa App. 1989).

[6] *Endres v. Endres*, 532 N.W.2d 65 (S.D. 1995).

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