
American Journal of Family Law

VOLUME 16 NUMBER 2

SUMMER 2002

ARTICLES

- Bobby Marzine Harges **The Reliability of the Social Science Testimony of Custody Evaluators after *Daubert* and *Kumho***
- Darrell D. Dorrell **The Valuation Report Card©**
- Anju D. Jessani **A Step-by-Step Approach to the Divorce Mediation Process: From Soup to Nuts**
- John E. Barrett, Jr. **Bifurcating Enterprise and Personal Goodwill**

DEPARTMENTS

- Kalman A. Barson **Are Company Retained Earnings Marital Savings?**
- David L. Walther **Ethics 2000 Commission Update for Family Lawyers**

COMMENTARY

- Stephen J. E. Sprague **Protecting Family Autonomy**

FEATURES

- Ira Lurvey **California: 2001 Developments—Diamond “Gifts,” Lottery Win as Loss, Custody Fighting**
- Ron Brown **Fairshare Cases: QDRO Rights vs. IRS Lien on Pension, Fifth Amendment Inference, Disqualification for Support of Judge’s Reelection, Parental Cybersex, Savings Alimony**

INDEX



Aspen Law & Business

American Journal of Family Law

VOLUME 16 NUMBER 2

SUMMER 2002

CONTENTS

Articles

- The Reliability of the Social Science Testimony of Custody Evaluators after *Daubert* and *Kumho*** 93

Bobby Marzine Harges

After reviewing the US Supreme Court decisions in *Daubert* and *Kumho*, the author (a professor of law) focuses on their applicability to custody evaluators. The article also offers guidance to matrimonial attorneys and judges in a variety of possible scenarios (e.g., in jurisdictions in which *Daubert* and *Kumho* have and have not been adopted).

- The Valuation Report Card©** 109

Darrell D. Dorrell, CPA, MBA, ASA, CVA, CMA, DABFA, CMC

The Valuation Report Card© permits matrimonial attorneys to assess rapidly and objectively the opponents valuation work product. It can also be provided to your client, the other party's counsel, other experts, and the judge to encourage them to agree with your viewpoint. This useful tool is described and illustrated.

- A Step-by-Step Approach to the Divorce Mediation Process:
From Soup to Nuts** 118

Anju D. Jessani, MBA, APM

This is a guide to divorce mediation. It explains mediation and then takes readers from the beginning of the process (initial contact and scheduling of the first mediation session) through each subsequent session outlining the goals to be accomplished at each stage leading to the final Memorandum of Understanding.

- Bifurcating Enterprise and Personal Goodwill** 129

John E. Barrett, Jr., CPA, ABV, CVA, MST, MBA

A valuation expert takes matrimonial practitioners through the various issues that arise when valuing goodwill in a closely held business or a professional practice. Among the subjects discussed are transferability and the hypothetical noncompete agreement (in the context of the hypothetical sale in a divorce case).

Departments

- Are Company Retained Earnings Marital Savings?** 81

Kalman A. Barson, CPA

Bifurcating Enterprise and Personal Goodwill

JOHN E. BARRETT, JR., CPA, ABV, CVA, MST, MBA

Family courts are increasingly looking to bifurcate the intangible value of a closely held business, for marital dissolution purposes. To facilitate this result, the courts are requiring the business appraiser to distinguish between enterprise goodwill (or more appropriately enterprise intangible value) and personal goodwill.¹ In each of these cases, a state appellate court remanded the cases back to the lower court to differentiate the established intangible value, which had previously been determined, between enterprise intangible value and personal goodwill. Many jurisdictions consider only the enterprise intangible value as part of the marital estate, with the personal goodwill treated as a nonmarital asset. Often states indicate that personal goodwill is an entrepreneurial skill to be considered for spousal maintenance and child support purposes, but not a property right subject to division. Of course, this determination varies on a state-by-state basis.

SOME BASIC DEFINITIONS

The process of bifurcating the intangible value of a business or professional practice between enterprise intangible value and personal goodwill can be a difficult task. Perhaps a good starting point toward completing this task is to review some definitions of intangible assets and good-

will. *The International Glossary of Business Valuation Terms* defines "intangible assets" as "non-physical assets (such as franchises, trademarks, copyrights, goodwill, equities, mineral rights, securities, and contracts as distinguished from physical assets) that grant rights, privileges, and have economic benefits for the owner."² We can determine from this definition that goodwill is only one possible component of intangible assets that might exist in a specific business. Other intangible assets that often exist in a business, based on a going concern premise, include name recognition, customer loyalty or retention, location, a trained workforce in place, and operating systems. *The International Glossary of Business Valuation Terms* defines "goodwill" as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."³ This would indicate that goodwill is often used as a catchall when intangible assets are not separately identified and valued.

In his book *Valuing a Business*, Shannon Pratt states, "The criterion as to whether goodwill exists usually is the ability to earn a rate of return in excess of a normal rate of return on the net assets

John E. Barrett, Jr., CPA, ABV, CVA, MST, MBA, is the principal at Barrett Valuation Services, Inc., Cranston, RI. John is Chair of the RI Society of CPAs Business Valuation Committee.

of a business, after reasonable compensation to operating personnel."⁴ This definition could probably be expanded to include all the intangible assets of the business. Mr. Pratt also states, "[P]ersonal goodwill may be described as the intangible value attributable solely to the efforts of or reputation of an owner spouse of the business."⁵ He further states that institutional or practice goodwill (enterprise intangible value) "may be described as the intangible value that would continue to inure to the business without the presence of that specific owner spouse."⁶ In other words, enterprise intangible value focuses on the intangible value of the business that would continue should the current owner spouse be replaced with either a replacement employee or a new owner employee.

Enterprise intangible value focuses on value that would continue should the owner spouse be replaced.

TRANSFERABILITY OF GOODWILL

Enterprise intangible value is generally transferable subject to the usual difficulties embedded in selling or transferring an interest in a closely held business. Therefore, the market approach to valuation can be a strong indicator as to the enterprise intangible value of the business. This is commonly demonstrated when a business is sold to a financial buyer. New ownership may or may not be interested in retaining the current owner/employee. It is quite common for a buyer of a closely held business to intend to directly manage the newly acquired business. If the continued services of the owner are not needed, this would indicate there is little or no personal goodwill. Any intangible value would be attributable to the business and represent enterprise intangible value. In a marital dissolution case, an actual sale is usually not contemplated. If it is reasonable to assume that a hypothetical buyer either could or would replace the owner spouse with comparable management, however, then little or no intangible value should be allocated to personal goodwill.

Personal goodwill also has some degree of limited transferability with proper effort and cooperation by both a willing buyer and a willing seller of a business. In this context, often what is actually transferable is not personal goodwill.

Rather, what is transferred is the opportunity offered by the seller to the buyer to forge similar relationships with the business' existing customer base. The transferability of intangible value would be a strong indicator that the intangible value is more likely to inure to the business itself and represent enterprise intangible value rather than be attributable to a specific individual. Once a sales transaction has been consummated and possibly a transitional phase completed, the services of the seller may not be required or desired. If the seller does remain with the business, his or her role is often dramatically altered.

BIFURCATION FACTORS

In attempting to bifurcate the overall intangible value of a closely held business or professional practice between enterprise intangible value and personal goodwill, there are a number of factors that should be addressed. These factors should be considered on a case-by-case basis and will vary based on the applicable fact pattern. Factors that would be indicative of enterprise intangible value would include, but not be limited to, such elements as: (1) name recognition; (2) location; (3) computer systems; (4) operating procedures; (5) a trained and assembled workforce; and (6) an existing customer base.⁷ Factors to review in considering personal goodwill would include the business spouse's: (1) age; (2) health; (3) past earning power; (4) reputation and business skills; (5) technical skills; and (6) past success.

Standard of Value

The next step in completing the process of allocating intangible value between enterprise intangible value and personal goodwill is to review the applicable standard of value utilized. The majority of family courts apply a fair market value standard or some variation of that standard, depending on state law. Revenue Ruling 59-60 defines fair market value as, "[T]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

Premise of Value

In addition to the standard of value, the appraiser must also consider the premise of value.

The going concern premise of value is the value of a business in continued use. This is often the appropriate premise of value in a marital dissolution case. The appraiser will frequently base valuation assumptions on existing management continuing in the business. This is often the case, even when a sale is contemplated and the potential new owner plans to replace the existing owner in managing the business. There is frequently either a stated or an implied assumption that replacement management of equal or similar capabilities could be substituted for the existing management. This assumption would tend to be correct in situations in which many potential buyers of the business would have the needed skills to operate the business successfully on an on-going basis.

Unique Factors

Normally, many of the unique factors that might indicate the presence of personal goodwill should be accounted for in determining an estimate of fair market value. For instance, qualitative factors dealing with such issues as thinness of management, concentration of sales, or other factors that might tend to indicate that the business is overly reliant on one or a few individuals must be taken into account in developing an estimate of value. An income based approach would consider such factors through normalization adjustments to the earnings stream (owner's compensation) and the increased measure of risk through development of an appropriate discount rate or capitalization rate. A market based approach would consider such factors through adjustments to the multiples applied. An asset based approach would consider such factors through actually identifying and valuing specific intangible assets.

The fair market value standard, based on a going concern premise, would indicate a transferable value of the subject business. This would represent the price that a willing buyer would pay a willing seller, with full knowledge of any reliance that the business would have on the seller. In terms of marital dissolution, any risk associated with the business' reliance on a specific individual should be factored into the overall estimate of value of the business. The development of an estimate of fair market value essentially adjusts for any such defect.

As previously mentioned, enterprise intangible value focuses on the intangible value of the business that would continue should the current

owner spouse exit the business. This assumes, of course, that competent or at least similar management is brought in to replace the existing owner spouse. Whether the services of the current owner spouse would be desired would be part of the negotiating process, but separate and apart from the value of the business. Such negotiations would result in an employment contract. Therefore, the fair market value standard, based on a going concern premise, would primarily represent enterprise intangible value, except for any amount allocated to a noncompete agreement.

HYPOTHETICAL NONCOMPETE AGREEMENT

The business valuation process, in marital dissolution cases, also may require the business appraiser to value not only a hypothetical sales transaction but also a hypothetical noncompete agreement, as if a sale were to take place. The noncompete agreement is not a value in addition to the value of the business, but rather an allocable portion of the overall value of the business. That is to say, if the business were valued at \$500,000, a buyer would not pay \$500,000 plus the value assigned to the noncompete agreement. Rather, the value assigned to the noncompete agreement would be included in the \$500,000. To determine the value of a noncompete agreement, the appraiser must first value the business. Then the appraiser must estimate future cash flows that would be lost to the seller should the seller compete. Next, the appraiser must consider the probability that the seller would compete. This analysis would be applied over the estimated life of the hypothetical noncompete agreement and present valued to today's dollars.⁸

Various states have formed differing opinions as to whether a noncompete agreement should be considered a marital asset. Several take the position that the noncompete agreement is not a marital asset because it restricts the postmarital activity of the owner spouse. A few states have ruled that the noncompete agreement is a marital asset. This is based, in part, on the conclusion that the noncompete agreement is signed in conjunction with the sale of a business and represents the goodwill of the business.

Noncompete agreements are usually time specific and geographic specific. Normally, a prudent business advisor would not advise that a prospective buyer complete a purchase transaction with-

out a noncompete agreement in place. This is to ensure that the buyer gets what the buyer sees. Basically, the noncompete agreement is an implied warranty that would have no value but for the sale of the business. This would tend to support the conclusion that the noncompete agreement simply represents a portion of the enterprise intangible value.

To determine the value of a hypothetical noncompete agreement, the appraiser must first value the business.

The definition of intangible value was discussed previously in this article. Intangible value was defined, in part, as having economic benefits for the owner. Therefore, to exist, intangible value must have some foundation in terms of economic benefits. A noncompete agreement, in and of itself, does not provide an economic benefit. Rather it functions as a form of protection to the prospective buyer. A noncompete agreement would not be sold or transferred independent of a sale of a business. It has relevance only in terms of a sales transaction. As such, any value assigned to a noncompete agreement would represent an allocable portion of the overall enterprise intangible value. Certainly the noncompete agreement places restrictions on the seller. These restrictions, however, apply only in a limited geographic and a limited time specific manner. The seller can generally apply his or her specific abilities outside of that limited scope.

SUMMARY

Family courts are increasingly looking to the business appraiser to distinguish the components of intangible value in a closely held business or professional practice. The appraiser should keep this in mind and review applicable state law with attorneys before beginning an engagement. The business appraiser may also be called on to value a hypothetical noncompete agreement in a marital dissolution case. The appraiser should be prepared to meet these tasks.

END NOTES

1. See *Frazier v. Frazier*, 737 N.E.2d 1220 (Ind. App. 2000); and *Moretti vs. Moretti*, 766 A.2d 925 (R.I. 2001).
2. Shannon P. Pratt, Robert F. Reilly, Robert P. Schweih, *Valuing a Business, the Analysis and Appraisal of Closely Held Companies*, 4th Edition, Appendix, A.1
3. *Id.*
4. Shannon P. Pratt, Robert F. Reilly, Robert P. Schweih, *Valuing a Business, the Analysis and Appraisal of Closely Held Companies*, 4th Edition, p. 820.
5. *Id.*
6. *Id.*
7. See Shannon P. Pratt, Robert F. Reilly, Robert P. Schweih, *Valuing Small Businesses and Professional Practices*, 3d Edition, p.585.
8. For a detailed analysis of valuing noncompete agreements, see Mark O. Dietrich, "Valuing Covenants Not to Compete in a Professional Practice," *AICPA's CPA Expert*, Summer 2002.