

# American Journal of **Family Law**

---

VOLUME 18 NUMBER 3

FALL 2004

## ARTICLES

- Michael D. Shepard and Matthew D. Lee **White Collar Crime and the Innocent Spouse**
- Dennis Bingham and William C. Herber  
Laura W. Morgan **Major Issues Associated with the Valuation of a Business in a Divorce**
- Marshall A. Morris **The Economics of Child Support Guidelines: A Short Examination of the "Cost Shares" Model**
- Jill D. Sanders **Elements of a Business Valuation Report: A Primer for Non-Accountants**
- David Wood **Obtaining Useful Parenting Evaluations in Cases Involving Third Parties**
- David Wood **An Allocation Model for Distinguishing Enterprise Goodwill from Personal Goodwill**

## DEPARTMENTS

- Sanford M. Portnoy **The Role of Judges in Keeping Difficult Parties Contained in Court**
- David L. Walther **Ethical Issues in Collaborative Law**

## FEATURES

- Ron Brown **Fairshare Cases: Disclosing Client Confidences; Minority Discount; Gambling Losses; Surviving Spouse; Withdrawal of Counsel . . .**

## INDEX

# An Allocation Model for Distinguishing Enterprise Goodwill from Personal Goodwill

DAVID N. WOOD, CPA/ABV

After reviewing several dozen articles on the subject of goodwill, both personal and enterprise, I discovered one central fact. It was very difficult to take the information from these articles and turn it into a number for my valuations. I was looking for a sound and supportable template, but I was unable to find anything that met my needs. At the suggestion of a colleague, I looked to other scientific disciplines and found something called "Multiattribute Utility Theory." This approach will be of value to matrimonial practitioners who need to retain and communicate with forensic specialists valuing goodwill in divorce cases.

## PERSONAL AND ENTERPRISE GOODWILL—WHY BREAK THEM OUT?

The breakout of personal and enterprise goodwill from total goodwill has become an important concept in some states. I practice in Illinois, so I will use this as my base for analysis, but there are a number of states that are following the attempt (rightly or wrongly) to avoid what the courts perceive as "double counting." The argument goes like this: If personal goodwill is counted as a divisible asset and earnings are used to determine maintenance (and child support), then in the case of the professional, personal goodwill has been counted twice. The idea is that the personal goodwill, in the case of a professional, is a result of the professional's earning potential. Counting both, the courts tell us, is unfair.<sup>1</sup>

Further, the courts have told us that not only professionals can have personal goodwill, but any business, such as an automobile dealership,<sup>2</sup> can have personal goodwill.

These concepts have been around for about a decade and have been ruled on often. Most recently in Illinois, the *Marriage of Schneider*<sup>3</sup> has further established the need for separately identifying personal goodwill in what increasingly looks like an "either/or" strategy set out by the Illinois Supreme Court. Ironically, if the appellate court is correct in *Schneider*, the breakout of personal goodwill would become less important in cases with no maintenance. However, I suspect that divorce attorneys will continue to want to know what the personal goodwill amount is likely to be in order to develop their strategy.

Finally, some states tend to emphasize the point that a "willing seller" is a necessary component of the definition of "fair market value." Using a "willing seller" concept makes it more likely that goodwill is transferable, both personal and enterprise, as it assumes that the seller is willing to assist in the transfer of value of assets.

However, depending on the state, personal goodwill can be computed using a number of different le-

---

*David N. Wood is the principal at Wood Forensic/Valuation Services, Mount Vernon, Illinois. He thanks Darrell D. Dorrell, Financial Forensics (c) Portland, Oregon for his contribution and encouragement in the preparation of this article. ©2003 David N. Wood.*



gal theories. I have heard some refer to “walk away” or liquidation valuations, essentially asking the question, “What would the value of goodwill (both personal and practice) be if the owner died on the valuation date or “walked away” from the business? This “walk away” approach leaves less of an allocation problem between personal and enterprise goodwill, since, under these conditions, very little, if any, goodwill would be available.

On the other hand, some states seem to have gone so far in the other direction that all goodwill is left intact and there is little reason to allocate between enterprise and personal goodwill as it is all counted. This “count it all” concept goes so far in this and other marital valuation applications that it seems the standard of value may have shifted to a “fair value” or “investment value” standard.

Whether the controlling state uses a “willing seller” concept, a “walk away” concept, or a “count it all” concept, the issue of how much personal goodwill exists is still a potential issue. Thus, regardless of the state, in divorce litigation it may be necessary to be able to develop a conclusion of value of a business that includes a separate opinion as to the amount of personal goodwill. However, in states with no double counting, “either/or” approaches to divorce valuations, the breakout of personal goodwill can be the largest single financial factor in determining the marital estate. Whatever the view of the state law controlling the valuation, the valuator needs a clear and supportable way to form and communicate this valuation.

## MULTIATTRIBUTE UTILITY MODEL (MUM)

Whether the valuation is under the federal Rules of Evidence or state adopted and/or modified federal rules, or independently established rules of evidence, generally there is a threshold that the expert must climb over (as in *Daubert*<sup>4</sup> hearings) or an ability to show general acceptance of methods (as in states still under *Fyre*,<sup>5</sup> such as Illinois).

MUM can resolve those challenges. Finding an objective and scientific method to making imprecise value judgments is one of our most difficult tasks. MUM provides a step-by-step guide that should offer a reasonable position against evidentiary challenges, allow for a consistent method for the allocations from case to case, and a comprehensive method that objectively addresses this imprecise task. That is the goal of using MUM, to establish the values of personal goodwill and enterprise goodwill. The goal of this article is to allow the valuator to have a tem-

plate for valuations and to allow any reader to recreate this method using a simple spreadsheet.

The Multiattribute Utility Model has been used by many disciplines—economic, political, and scientific—to establish decision support for such things as placement of surplus weapons-grade plutonium, plant and treatment facilities location, and in the restoration of highly radionuclide contaminated aquatic ecosystems in some countries of the former Soviet Union. If it can assist in such lofty, but imprecise, goals, why can’t we use MUM to solve the “goodwill allocation” problem? The answer is that we can, and the key word is “imprecise.” What these goals and ours have in common is that both require the introduction of scientific methodology to bring order to imprecise subjective analysis.<sup>6</sup>

For this use of MUM, I chose the multiplicative model, instead of the additive model. This aspect of the model will become apparent in the description of the methodology. MUM steps are relatively straightforward.

- Define an objective.
- Establish alternatives.
- Define attributes.
- Measure the utility of each attribute.
- Aggregate the results (*i.e.*, do the math).
- Evaluate the alternatives.
- Express an opinion.

## Our Assignment

Determine the value of the two elements of goodwill, personal and enterprise, from the total goodwill, such that a reasonable, well-founded basis can be communicated as the support for our conclusion of value.

## Our Objective

The objective is stated as the resolution of our assignment—form a conclusion of value of the separate elements of total goodwill that represent personal goodwill and enterprise goodwill.

## Establish the Alternatives

The alternatives define the choices in which MUM will result. The alternatives are selected as a



range of percentages. The end result of the MUM analysis will be a range of results or a specific value within the range. I have chosen five alternatives for illustration purposes. The method would easily accommodate broader or narrower ranges. The Exhibit 1, below, demonstrates the alternatives I have chosen.

### Define the Attributes

The model assesses the multiple attributes' multiplicative utility in choosing an alternative result. Thus, it is necessary to define the attributes the valuator is going to use to establish a distinction between personal goodwill and enterprise goodwill.

I divide the attributes into the two categories—personal attributes and enterprise attributes. (See Exhibit 2.) In a sense, most attributes could be described as opposite sides of the same coin. For example, if multiple locations of a business tend to indicate more enterprise goodwill, then fewer or only one location could be said to indicate personal goodwill. However, I believe that most attributes could be primarily defined as characteristic of one or the other.

However, if one valuator placed an attribute into the personal category and another valuator into the enterprise category, the model would cor-

rect for this during the measuring process. Even the same valuator could do this from case to case; however, for consistency reasons I believe the valuator should establish his or her set of rules and stick to them.

I have also used an even number of attributes for each category. The central concept behind my use of this methodology is to establish an arbitrary half and half division between personal and enterprise goodwill. The MUM analysis moves the admittedly arbitrary center in one direction or the other. With equal division of attributes and with the same weight assessment for each attribute, the MUM result is a fifty-fifty split between personal goodwill and enterprise goodwill.

One of the reasons I like this methodology is that it is flexible enough to allow for deviations from this approach to one that is more reasonable or logical to another valuator, or that could be modified for a particularly unusual valuation.

For illustration purposes, Exhibit 2 shows goodwill attributes for a valuation. A discussion of the attributes and how I have applied them is the subject for some discussion, but it is beyond the scope of this article's purpose.

### Measure the Attribute's Utility as to Importance and to Existence

This is a two-step process. The first is to measure how important an attribute is to a particular valuation. Depending on the type of business, its location, the period of time the business has been established or any number of other factors, the valuator will focus on and decide that some attributes are simply more important than others.

The key to the weighing of the "Importance Utility" is that the weight is relative to other attributes. Thus, it is a presumption that an attribute listed in this part of the analysis has some merit and, thus, must be given some weight by the valuator. Attributes are not ranked in an individually unique ascending or descending order of importance (such as one to eight), but are weighed against each other (see Exhibit 3). To attempt to do otherwise, even as an attempt to introduce greater objectivity, is to introduce too much precision to our imprecise task. While a valuator might adjust the weights (such as 1, 2, 3 or 1, 5, 10) to suit a particular need, all attributes defined must have a weight assigned, in contrast to the "Existence Utility" (see Exhibit 4.) The weights I assigned are shown in Exhibit 3.

The "Existence Utility" is a measure of assessment of how strong is the presence of the specific attribute.

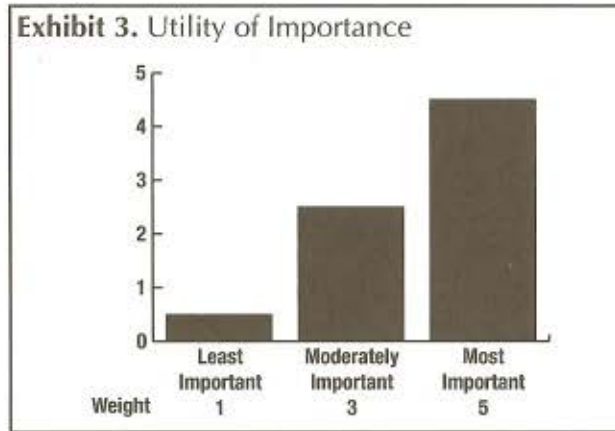
**Exhibit 1.** Alternatives 1 through 5—Personal and Enterprise Goodwill

Alternative	Goodwill (Percent)	
	Personal	Enterprise
1	0–20	80–100
2	20–40	60–80
3	40–60	40–60
4	60–80	20–40
5	80–100	0–20

**Exhibit 2.** Personal and Enterprise Goodwill Attributes

Personal	Enterprise
Lacks transferability	Number of offices
Specialized knowledge	Business location
Personalized name	Multiple service providers
In-bound referrals	Enterprise staff
Personal reputation	Systems
Personal staff	Years in business
Age, health, and work habits	Out-bound referrals
Knowledge of end user	Marketing





(See Exhibit 4.) This utility is both absolute and relative. The attribute, in the mind of the valuator, may not exist at all, in which case the absolute value would be zero. Thus, the utility measure provides for the possibility of zero presence. An attribute could be perceived as having a presence roughly double that of another attribute. The scale of zero to four is a matter of personal choice. However, the utility must be great enough to cause real differences in the attributes' utility and not so large as to permit one particular attribute to overly impact or exaggerate the results. The weights I assigned are shown in Exhibit 4.

#### Aggregate the Results—Do the Math

The math is relatively straightforward. Below are the mathematical formulas. However, it is most easily visualized by examining the following spreadsheet in Exhibit 5.

**Exhibit 5.**

$$\text{TMU PGA} = \sum [\text{IU}^{\text{PGA for 1 to N}} \times \text{EU}^{\text{PGA for 1 to N}}]$$

$$\text{TMU PGU} = \sum [\text{IU}^{\text{EGA for 1 to N}} \times \text{EU}^{\text{PGA for 1 to N}}]$$

$$\text{TMU} = \text{TMU PGA} + \text{TMU EGA}$$

TMU PGA = Total Multiplicative Utility for Personal Goodwill  
 TMU EGA = Total Multiplicative Utility for Enterprise Goodwill  
 TMU = Total Multiplicative Utility

$$\text{Personal Goodwill} = \frac{\text{TMU PGA}}{\text{TMU}} \times \text{Total Goodwill}$$

$$\text{Enterprise Goodwill} = \frac{\text{TMU EGA}}{\text{TMU}} \times \text{Total Goodwill}$$

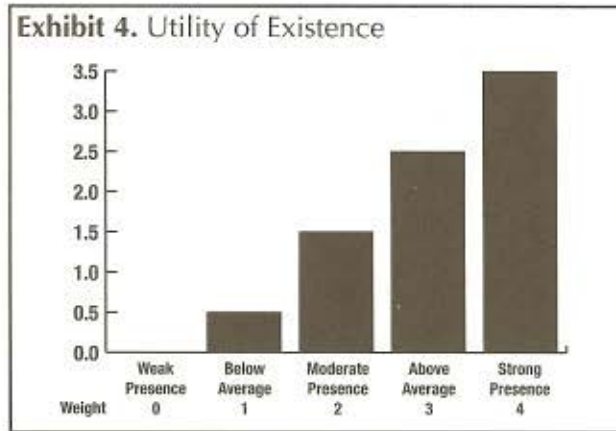


Exhibit 6 shows the computations associated with the arbitrary baseline of a fifty-fifty split. Exhibit 7 illustrates sample data for a professional valuation with significant enterprise goodwill, such as in the case of a multiple office, multiple practitioner with weak in-bound referrals.

#### Fit the Results to the Range of Alternatives and Analyze the Results

In Exhibit 8, the total multiplicative utility for the enterprise goodwill attribute (TMU EGA) is 78 percent. This fits into Alternative Four (60 to 80 percent). Before determining a conclusion of value, the valuator must individually identify the attributes and their respective contribution to the total utility for each the personal and enterprise goodwill attributes. This is done by simply computing the percentage of each attribute's utility to the total attribute utility for the particular category. Exhibit 8 shows the computations and the Exhibit 9 demonstrates the significance of the personal reputation attribute.

What the valuator needs to ask is whether, in light of all the facts and circumstances, this particular attribute should be driving the results in this manner? Does the model give the expected result? If not, was the valuator's expectation inaccurate or have the utilities been incorrectly presented? Ultimately, that judgment must be made in light of the NACVA Professional Standards requiring objectivity.

The valuator also needs to apply sensitivity analysis by changing the Importance Utility and the Existence Utility. These should be done independently, and, as necessary, in conjunction with each other. It is not necessary to test every possible variance, but sufficient testing should be done to see the impact on the resulting indication of alternatives.

**Exhibit 6. Personal Goodwill Attribute Ability****Multiattribute Utility Model for Goodwill Allocation**

Personal Goodwill Attributes (EGA)		Importance Utility(IU)	Existence Utility(EU)	Multiplicative Utility	Percent
Lacks Transferability	1	3	2	6	12.5%
Specialized Knowledge	2	3	2	6	12.5%
Personalized Name	3	3	2	6	12.5%
In-bound Referrals	4	3	2	6	12.5%
Personal Reputation	5	3	2	6	12.5%
Personal Staff	6	3	2	6	12.5%
Age, Health and Work Habits	7	3	2	6	12.5%
Knowledge of End User	8	3	2	6	12.5%
<b>Total Utilities</b>		<b>24</b>	<b>16</b>		
<b>Total Multiplicative (PGA) Utility</b>				<b>48</b>	<b>50%</b>

**Exhibit 7. Enterprise Goodwill Attribute Ability**

Enterprise Goodwill Attributes (EGA)		Importance Utility(IU)	Existence Utility(EU)	Multiplicative Utility	Percent
Number of Offices	1	3	2	6	12.5%
Business Location	2	3	2	6	12.5%
Multiple Service Providers	3	3	2	6	12.5%
Enterprise Staff	4	3	2	6	12.5%
Systems	5	3	2	6	12.5%
Years in Business	6	3	2	6	12.5%
Out-bound Referrals	7	3	2	6	12.5%
Marketing	8	3	2	6	12.5%
<b>Total Utilities</b>		<b>24</b>	<b>16</b>		
<b>Total Multiplicative EGA Utility</b>				<b>48</b>	<b>50%</b>
<b>Total Multiplicative Utility (TMU)</b>				<b>96</b>	<b>100%</b>

In Exhibit 8, the TMU EGA is 78 percent and fits into Alternative Four. Moving only a few of the Importance Utility weights and/or Existence Utility weights could push the result into Alternative Five. Depending on how the valuator forms the conclusion of value, such a change could be significant.

**Reaching an Opinion**

After all of the analyses is completed, an alternative (range of value) has been identified. If the valuator is making an Opinion of Value, as opposed to an Estimate of Value (see following section on communicating your opinion), then the valuator must make a determination as to the specific value to be assigned to the respective assets. While it would be tempting to simply use the TMU EGA (78 percent in Exhibit 8), I believe it is more effective and more proper to select the midpoint of the range, or, in this case, 70 percent.

This may appear to understate the enterprise goodwill in Exhibit 8, but I believe that an attempt to put too fine a point on the value runs afoul of another scientific concept—"significant digits." Neither this methodology nor any other that I have seen can make the case that our imprecise assignment can result in a precise answer.

It is possible that during the analysis stage, the valuator could see ahead to the indicated result and redefine the alternatives. For example, using ten alternatives would place the illustrated result in Alternative Seven (70 to 80 percent). This would give a 75 percent midpoint. However, I caution users of this method, that what may be gained reaching a "desired result" or in the "comfort level" of the valuation may be lost in the integrity of the argument, especially if the value is likely to be challenged as in the case of marital litigation.

If the valuator intends to alter the alternatives on a case-by-case basis, I believe and recommend that the valuator would be best served by develop-



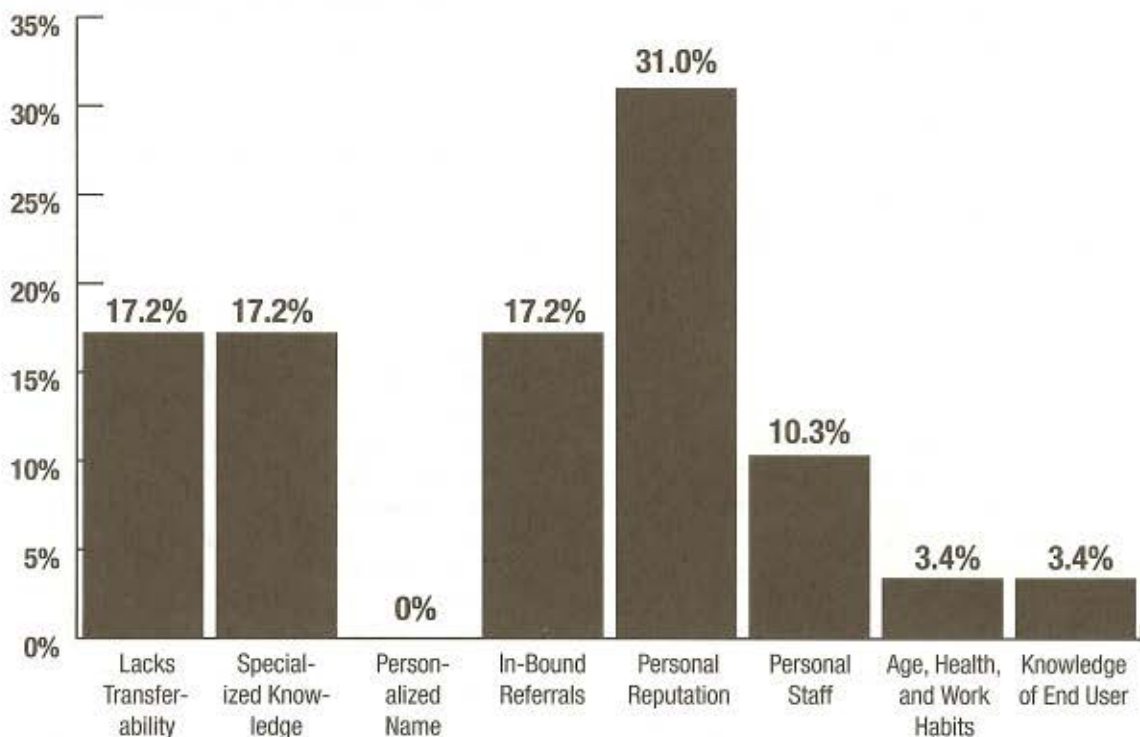
**Exhibit 8. MUM Goodwill Allocation Illustrated**

<b>Personal Goodwill Attributes (PGA)</b>		<b>Importance Utility(IU)</b>	<b>Existence Utility(EU)</b>	<b>Multiplicative Utility</b>	<b>Percent</b>
Lacks Transferability	1	5	1	5	17.2%
Specialized Knowledge	2	5	1	5	17.2%
Personalized Name	3	3	0	0	0.0%
In-bound Referrals	4	5	1	5	17.2%
Personal Reputation	5	3	3	9	31.0%
Personal Staff	6	3	1	3	10.3%
Age, Health and Work Habits	7	1	1	1	3.4%
Knowledge of End User	8	1	1	1	3.4%
<b>Total Utilities</b>		<b>26</b>	<b>9</b>		
<b>Total Multiplicative (PGA) Utility</b>				<b>29</b>	<b>22%</b>

<b>Enterprise Goodwill Attributes (EGA)</b>		<b>Importance Utility(IU)</b>	<b>Existence Utility(EU)</b>	<b>Multiplicative Utility</b>	<b>Percent</b>
Number of Offices	1	5	3	15	15.0%
Business Location	2	5	4	20	20.0%
Multiple Service Providers	3	5	3	15	15.0%
Enterprise Staff	4	3	3	9	9.0%
Systems	5	3	3	9	9.0%
Years in Business	6	1	3	3	3.0%
Out-bound Referrals	7	5	4	20	20.0%
Marketing	8	3	3	9	9.0%
<b>Total Utilities</b>		<b>30</b>	<b>26</b>		
<b>Total Multiplicative EGA Utility</b>				<b>100</b>	<b>78%</b>
<b>Total Multiplicative Utility (TMU)</b>				<b>129</b>	<b>100%</b>

**Exhibit 9. Personal Goodwill Attributes**



ing a set of rules for such changes. Otherwise, I think that consistent application of this method requires consistent use of all of the aspects of the methodology, at least after the development and testing stage for the valuator.

## COMMUNICATING YOUR VALUE OPINION ON GOODWILL

NACVA Professional Standard Number 3.2 requires the terminology for a specific value to be "Opinion of Value." Further, the standards require the use of "Estimate of Value" to describe a range of values.

The standard should only apply to the expression of a conclusion of value on one or both of the components of goodwill if a separate opinion as to their value is being stated. In Illinois and similar states using the no double counting concept, it is often asked of the valuator to express a separate opinion on the individual components. In this case, the valuator should use the Opinion of Value terminology to describe the conclusion. However, if a range of value is all that is required (or all the valuator believes is possible), then the Estimate of Value terminology is appropriate.

It should be remembered that the Opinion of Value using MUM for purposes of determining personal and enterprise goodwill components of total goodwill does not change the total opinion value of the business or practice that is the subject of the valuation.

If no separate conclusion of value as to the goodwill components is required in the conclusion of value, then the valuator should be unencumbered by the profession's standards as to terminology in the analysis of the report. The conclusion of value about the components simply becomes a part of the overall conclusion of value for the entire business or professional interests being valued.

Finally, NACVA Professional Standard Number 4.3a requires that ". . . the report should effectively communicate important thoughts, methods and reasoning . . . in a simple and concise manner, so that the user of the report can replicate the process followed by the member." Thus, the report should include, regardless of whether a separate conclusion of value is set out in the report, enough of the analysis and methodology to satisfy this standard.

I believe the following should be included to meet this requirement:

- A brief discussion of the (multiplicative) Multiattribute Utility Model, including a discussion of the Importance and Existence Utilities and how they are determined;
- A description of the attributes used and what was done to determine their importance and existence;
- A description of the alternatives, including a reference to their midpoint;
- How the utilities are computed; and
- The additional analysis for individual attribute impact and utility sensitivity.

I believe that if the valuator performs a thorough investigation of the business, gives sufficient thought to the application of MUM, applies this method consistently, and writes a report that meets the standard requirements, the conclusion of value of the business or practice and (if separately stated) of the personal and enterprise components of goodwill should withstand evidentiary challenges and provide a clear and convincing conclusion of value that is supportable and defensible.

## ENDNOTES

1. *Marriage of Zells*, 143 Ill. 2d 251, 255-256, 572 N.E.2d 944, 946 (1991).
2. *Marriage of Talty*, 652 N.E. 2d 330, 209 Ill. Dec. 790, 166 Ill. 2d 232, (1995).
3. *Marriage of Schneider*, Opinion not released publication, Appellate Court of Illinois—Second District, October 24, 2003.
4. *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993).
5. *Frye v. U.S.*, 293 Fed. 1013 (D.C. Cir. 1923).
6. For an excellent discussion on the subject see "A Decision Support System for Multiattribute Utility Evaluation Based on Imprecise Assignments," by Antonio Jiménez, Sixto Rios-Insua, and Alfonso Mateos, Department of Artificial Intelligence, School of Computer Science, Madrid Technical University, Madrid, Spain, July 3, 2002.