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Simplified MUM for Determining Personal Goodwill

By Thomas Gillmore, CPA, CFE, CVA

Editor's note: The author is a valuation expert and forensic accountant in Florida who uses the multiattribute utility model (MUM), but not in its full form. He uses a streamlined version that has been accepted in court and that may reduce the exposure to severe cross-examination. In this article, he gives some background on the relevant legal landscape in Florida and describes his version of MUM based on a recent engagement.

In a number of different contexts, the valuation analyst may need to evaluate the fair market value of a business interest for the purpose of equitable distribution or shareholder settlement. This evaluation may include breaking out goodwill into its two components: personal and enterprise goodwill.

In Florida, the state Supreme Court's instruction in *Thompson v. Thompson* to the business valuation analyst was to seek out and evaluate the various goodwill attributes of a subject business and determine (or opine on) whether each attribute is in the nature of personal or enterprise goodwill:

> We therefore answer the certified question with a qualified affirmative: If a law practice has monetary value over and above its tangible assets and cases in progress which is separate and distinct from the presence and reputation of the individual attorney, then a court should consider the goodwill accumulated during the marriage as a marital asset. *The determination of the existence and value of goodwill is a question of fact and should be made on a case-by-case basis with the assistance of expert testimony.*[1] (emphasis added)

In *Schmidt v. Schmidt*, the 4th District Court of Appeal reversed the trial court's valuation of the subject business and remanded for the trial court to ascertain the personal goodwill remaining in the marital portion of the business, which can be determined by analyzing what the value of the business would be if the business owner did not sign a covenant not to compete (CNC).[2]

The trial court in *Schmidt*, when pressing the valuation expert to quantify the business value with and without a CNC, would have benefited by the expert's reference to *Thompson v. Commissioner,* T.C. Memo 1996-468 (1996), where the Tax Court lists 11 factors to determine the economic reality of a CNC including the following: grantor's business expertise, grantor's intent to compete, grantor's economic resources, potential damage to the grantee, grantor's network, duration and geographic scope of the CNC (limited to seven years in Florida), enforceability by state law, age and health of grantor, payment terms, payment duration, and fairness of negotiations. Having considered these factors, the analyst could opine on the likelihood and degree of moral turpitude of the seller and weight of countervailing actions from the buyer.

The analyst's failures in *Schmidt* are evidenced when the court assigns extraordinarily

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

2 *Schmidt v. Schmidt*, 120 So. 3d 31, 33-34 (Fla. 4th DCA 2013).

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undifferentiated significance to a CNC as if the personal goodwill of a plastic surgeon is similar or even identical to the personal goodwill of an insurance broker or plumber, by stating, "Because the $2,520,562 value requires execution of a non-compete agreement, it is clear that such valuation still includes a personal goodwill component."

The *Schmidt* court appears frustrated by the lack of guidance the expert witness offered then rightly remands the case.

Parity unraveled. It is critical to distinguish between: (1) the requirement or existence of a CNC; and (2) the quantification of personal goodwill.

In *Held v. Held*, the 4th District Court of Appeal found that, "for purposes of separating enterprise goodwill from professional goodwill, there was no distinction between a non-compete agreement and a non-piracy agreement."[3] Similarly, there is no distinction between a CNC between the seller and buyer of: a physician's practice, an insurance broker's book of business, a plumber's geographic operating area, or a Kentucky Fried Chicken location. A plumber with over 100 employees who signs a CNC cannot to himself then be allocated 100% of the enterprise value (as personal goodwill).

Regardless of the type of enterprise, the strength of a noncompete assures the buyer that he or she will acquire and hold unimpeded access to the enterprise cash flows being purchased in good faith. The CNC, although critical to the buyer's future success, does not in any way accurately portray the full spectrum of personal goodwill monetary value, which varies greatly between a plastic surgeon and the skilled plumber as shown in this example. For example, I will actually "wear" the plastic surgeon's goodwill on my face or body part; however, I will not wear the goodwill of a plumber on my face or body. Thus, in my opinion, the plumber's personal goodwill attributes, when

3 *Held v. Held*, 912 So. 2d 637 (Fla 4th DCA 2005).

considered altogether, rise to a value considerably less than the attributes associated with a plastic surgeon's personal goodwill attributes.

Two important points emerge from this:

1. The analyst should take care to not mistakenly focus on the existence of a CNC as if that is the sole determinant of whether personal or enterprise goodwill exists, or the analyst may fail to even consider the CNC as part of the valuation; and

2. Even experienced valuation analysts frequently and mistakenly focus on the personalized name of a subject entity as if that is the sole determinant of whether personal or enterprise goodwill exists.

The errant analyst may go further with these mistaken thought processes by stripping away *all* enterprise value from cash flows and then assign a "fair market value" to the business consisting of some cumulative variant of cash, other assets, plus accounts receivable minus debts. Some analysts will also mistakenly toss in a 10%-to-20% liquidity/marketability discount against the cumulative resultant value, thus "quantifying" a supposed difficulty in liquidating cash, which of course is a spurious notion. All or any part of this misguided process will expose the errant analyst to tough cross-examination on the stand or at deposition.

The analyst should be familiar with the AICPA reference material[4] in which Robert Cimasi, the author, states, "[The appraiser shall] identify, distinguish, disaggregate, and allocate the relevant portion of existing goodwill to either professional or personal goodwill." Mr. Cimasi goes on to say, "[P]rofessional or personal goodwill results from the charisma, education, knowledge, skill, board certification, and reputation of a specific physician practitioner."

4 Robert James Cimasi, MGA, ASA, AVA, CM&AA, *The Advisor's Guide to Healthcare – Consulting With Professional Practices*, AICPA.

The expert may want to be familiar with the work of David Wood, CPA, ABV, CVA, who developed the multiattribute utility model (MUM),[5] which "recently received ratification" by the court in *Lieberman v. Lieberman.*[6] Many of the goodwill attributes both Cimasi and Wood identified are listed here:

- Ability, skills, and judgement;
- Age and health of the owner;
- Closeness of contact with clients or patients;
- Comparative personal success in the subject industry;
- Marketing and branding associated with the individual;
- Marketing and branding associated with the subject entity;
- Personal in-bound referrals;
- Personal reputation;
- Personal staff;
- Work habits;
- Ancillary services;
- Assets in use;
- Business name;
- Business reputation;
- Repeating revenue streams;

5 For example, see "'MUM's the Word': A Formal Method to Allocate Blue Sky Value in Divorce," *Business Valuation Update,* March 2007.

6 *Lieberman v. Lieberman*, Case No. FD-2008-956 (Tulsa, Okla.), Judge Funderburk presiding. The expert witness in *Lieberman* relied on the Illinois case *In re Marriage of Alexander* (2006 Ill. App. Lexis 836) to defend against a *Daubert*-like challenge.

- Systems and organizational structure;
- Workforce in place;
- Location of business; and
- Barriers to entry.

Simplified MUM. Having reviewed *Daubert* challenges, Florida courts admonished expert analysts who failed to defend their positions with scientific methods and who relied on subjectivity and speculation.[7] Thinking proactively, an analyst may be able to preempt or prevent the *Daubert* challenge altogether by removing entirely the subjective "utility" of each goodwill attribute, e.g., those Wood and Cimasi identified, thus relying solely on the existence of an attribute in binary terms. In other words, the attribute either exists or it does not, which alleviates debate on "just how important is each specific attribute's utility."

True, whether the attribute rises to the level of "making a difference" may be discussed, but this threshold is far less extenuous than the burden of convincing someone that the utility of an attribute rises to a specific level of, for example, "4" on a scale of 1 to 10, an obvious response being "why does the utility of that attribute not rise to a level of 7 or 8, and how does your subjective choice of a level 4 differ from a subjective choice of 7 on your conclusion of fair market?" The experienced counsel or trier of fact could have a field day with a utility level of 3, or 2, or 8, finally proclaiming that your method is too subjective to be reliable.

Case example. The following workflow analysis is an excerpt of the author's valuation report narrative developed in contemplation of relevant Wood/Cimasi goodwill attributes on a startup clinical laboratory (clinic) offering on-site collections. To generate a level playing field/fairness in the analysis, the author uses an equal row count of personal attributes to enterprise attributes as shown in Exhibit 1.

The subject business is 3.5 years old as of August 2015, owned by three shareholders with a 40/40/20 voting rights, and employs 1,099 contractors who perform the phlebotomy work on-site at nursing homes, residences, and the like. Gross revenues are approaching $800,000 and are scheduled to reach $2 million in the coming years.

A discussion of each attribute related to enterprise and personal goodwill follows. Those attributes marked with a "-" do not exist, so value allocation is not appropriate. Attributes marked with a "+" are those that do exist, so value allocation is appropriate.

Enterprise goodwill. A total of 10 attributes were considered related to enterprise goodwill in the case.

1. *Assemblage of assets* (-). The analyst considered the following premises of value when contemplating whether the assemblage of assets can be differentiated from the mere fact that certain assets exist.

> Premise 1: Value in continued use as part of a going-concern business enterprise;
>
> Premise 2: Value in place, but not in current use in the production of income;
>
> Premise 3: Value in exchange, as part of an orderly disposition;
>
> Premise 4: Value in exchange as part of a voluntary liquidation; and
>
> Premise 5: Value in exchange, as part of an involuntary liquidation.

The assemblage of assets of the clinic is in place and is used to generate revenue as described in Premise 1. However, the assets are easily replicated, i.e., tables, chairs. Therefore, *value allocation is not appropriate.*

7 See *The Value Examiner*, May/June, 2015 referencing these cases: *Hedges v. Klaus Doup, PA*, *Perez v. Bell South Telecommunications, Inc*., and *Giamo v. Florida Autosport, Inc.*

2. *Barriers to entry* (-). Depending on the specialty and location, it can be difficult and or may take considerable time for new entrants in this industry to establish a referral base and other relationships with other physicians, hospitals, and the local community.

However, the clinic, only 3.5 years in existence, has developed insufficient differentiating factors such as size, presence, long-term relationships, and cost differentiators in this industry and in its geographic operating area to create difficulties (or barriers) to competitors entering the marketplace. Therefore, *value allocation is not appropriate.*

3. *Business location* (-). A business that is easily accessible and ideally located may have more enterprise goodwill. Convenience and recognition may be important factors to a particular business. Alternatively, a hard-to-find location may indicate that consumers are returning for other reasons, such as personal attention, price, or customer support.

The clinic's physical location is not relevant to the homebound patient base, which comprises approximately 98% of revenues. Therefore, *value allocation is not appropriate.*

4. *Business locations—multiple (+).* If a business has multiple locations, it may mean that goodwill is more associated with the enterprise and less with the individual, i.e., an individual cannot be in all locations at the same time and consumers' satisfaction is more likely to be associated with factors other than personal.

The clinic's revenues are derived from on-site visitation to the patient's location. Therefore, *value allocation is appropriate.*

5. *Business name* (-). If the name of the business carries the name of the individual, a greater level of personal goodwill may be present, which may be more difficult to transfer.

The clinic has roughly 3.5 years of activity to assess, meaning it is still in the development phase and is not yet well established in the marketplace. The clinic is still reliant on the personal efforts of the owners to gain new business, i.e., the business name itself is not recognized well enough to entice new business activity. Therefore, *value allocation is not appropriate.*

6. *Business reputation* (-). Business reputation is frequently a factor in determining the attraction of new business and a consumer's likelihood to return for future business. If the reputation is more directly related to the business in general, as opposed to the individual providing the service, then the goodwill is more likely enterprise goodwill.

The clinic has roughly 3.5 years of activity to assess, meaning it is still in the development phase. The clinic is still reliant on the personal efforts of the owners to gain new business, i.e., the business name itself is not recognized well enough to entice new business activity. Therefore, *value allocation is not appropriate*.

7. *Patient base* (+). Where a practice has a large, established patient base that requires recurring care, a greater business value is likely to exist. The patient base can be examined by reviewing the following data:

- Direct contracting customer lists;
- HMO enrollment lists; and
- Patient lists.

The clinic patients do not as a rule require recurring care similar to that which brought them in first place. The clinic interacts with a transient patient base. However, those patients are likely to need annual or more frequent recurring care. Therefore, *value allocation is appropriate.*

8. *Repeating revenue stream* (-). The nature of some businesses is that the consumer finds a need for the service on a regular or even scheduled basis. Vaccinations of pets, routine dental cleanings, and annual physicals are examples of

specific services that generate repeat business. A consumer relationship that generates revenues through the year or years, although not necessarily on a scheduled basis, could also generate repeat business.

Although the clinic interacts with a transient patient base, there is a continued relationship with the nursing homes. However, the clinic is still reliant on the personal efforts of the owners to retain current business, i.e., the business itself is not yet well established in the marketplace. Therefore, *value allocation is not appropriate.*

9. *Systems and organization* (+). The systems and organization attribute refers to all of the decisions management makes that create the structure of the business. It is broader than computer systems and encompasses policies, manuals, procedures, methodology, and forms and documents developed to support the operations.

Systems and organization attributes include but are not limited to:

- Treatment plan/care mapping;
- Procedures and manuals;
- Laboratory notebooks;
- Computer and software integration; and
- Maintenance and support relationships.

The transferrable value of necessary systems and organization exists with the clinic, with the fulcrum being an established patient base. Therefore, *value allocation is appropriate.*

10. *Workforce in place* (+). Based on the economic principle of substitution, i.e., the cost to create a substitute workforce. The following aspects of workforce cost should be considered:

- Replacement cost new—the cost to create the ideal workforce;
- Reproduction cost new—the cost to re-create the actual current workforce;
- Four cost components:
  - Direct costs—recruitment/relocation fees;
  - Indirect costs—interview/hiring/training time;
  - Developer's profit—return on direct and indirect costs;
  - Entrepreneurial incentive—lost income during the workforce assemblage period (i.e., an opportunity cost).

The clinic has a workforce in place that would be transferrable to a buyer. Therefore, *value allocation is appropriate.*

Personal goodwill. Professional (or personal) goodwill is not transferrable. Even with long transition periods of introduction for a new acquiring physician owner, the charisma, skills, reputation, and personal attributes of the seller cannot, by definition, be transferred. Personal goodwill is that which would make a doctor's patients follow him or her even if he or she changed location, staff, and phone number.

A total of 10 attributes were considered related to personal goodwill in the case.

1. *Ability, skills, and knowledge* (-). There are insufficient factors in this category to distinguish the owners from their competition in this industry. Therefore, *value allocation is not appropriate.*

2. *Age and health* (-). There is likely less personal goodwill in the case of an older or unhealthy practitioner, since expected future earnings are not expected to continue for a long period of time. The age and health of the individual is considered when weighing the likely longevity of the continuing goodwill. This could be particularly important if the individual's health is poor and/or the age is advanced.

There are insufficient differentiating factors in this category to distinguish the owners from their competition in this industry. Therefore, *value allocation is not appropriate.*

3. *Closeness of contact* (-). When the individual performs a service or offers a product, the closeness of contact generally increases the likelihood that the goodwill generated will be personal. For example, an anesthesiologist may have little or no personal contact, while an ophthalmologist can have substantial personal contact.

The clinic is still reliant on the personal efforts of the owners to gain new business, i.e., the business name itself is not recognized well enough to entice new business activity. However, the owners themselves do not generally perform the on-site work.

There are insufficient factors in this category to distinguish the owners from their competition in this industry. Therefore, *value allocation is not appropriate.*

4. *Comparative professional success* (-). There are insufficient factors in this category to distinguish the owners from their competition in this industry. Therefore, *value allocation is not appropriate.*

5. *Marketing and branding* (+). Name recognition for the individual, as opposed to the product or service that is established through marketing efforts to tie the individual's name to the business, may indicate a higher level of personal goodwill. This might involve the individual's direct involvement in media advertisements and other marketing efforts.

The clinic is still reliant on the personal efforts of the owners to gain new business, i.e., the business name itself is not recognized well enough to entice new business activity. Therefore, *value allocation is appropriate.*

6. *Personal referrals* (+). A personal in-bound referral is defined as a referral from an outside source, such as a patient or a referring physician that has been made to a *particular individual.* The person making the referral is aware of some trait that makes the individual an appropriate referral. Typically, referrals are made because an individual has a specialized skill, talent, or reputation and has inspired confidence in the referral source.

The clinic is still reliant on the personal efforts of the owners to gain new business, i.e., the business name itself is not recognized well enough to entice new business activity. Therefore, *value allocation is appropriate.*

7. *Personal reputation* (+). If the reputation of the individual whose personal goodwill is being assessed is positive and strong, then the likelihood increases that the resulting goodwill is personal. For example, the best plastic surgeons are internationally renowned in their field and can attract patients from around the world. On a smaller scale, word-of-mouth recommendations from satisfied clients go a long way toward drawing new business.

The clinic is still reliant on the personal efforts of the owners to gain new business, i.e., the business name itself is not recognized well enough to entice new business activity. Therefore, *value allocation is appropriate*.

8. *Personal staff* (-). Personal staff employees work for the business because of the personal reputation or knowledge of the individual whose personal goodwill is being assessed. If employees of a business chose to work for the business specifically to have the opportunity of working with and learning from this individual, they are more inclined to leave if this individual is no longer associated with the business.

There are insufficient factors in this category to distinguish the owners from their competition in this industry. Therefore, *value allocation is not appropriate.*

9. *Personalized business name* (-). If the name of the business carries the name of the individual, a greater level of personal goodwill may be present.

The goodwill may be more difficult to transfer, particularly if a name change is anticipated. Therefore, *value allocation is not appropriate.*

10. *Work habits* (-). When comparing two business owners working the same amount of hours in the same specialty, for example, the physician that works more efficiently is likely to have more personal goodwill. Increased time spent per patient is also likely an indicator of personal goodwill.

There are insufficient factors in this category to distinguish the owners from their competition in this industry. Therefore, *value allocation is not appropriate.*

Conclusion of value. The clinic sought to buy out or push out a 40% shareholder who had allegedly misappropriated funds, which caused EBITDA to be unreliable. In summary, the author compared the clinic's gross profits and net sales to known market transaction of similar companies, applied the goodwill ratio, and then added in discounts and premiums for a conclusion of value (see Exhibit 2).

In family law and commercial litigation settings, the author has found many physician-owners, business owners, spouses, attorneys, and judges to be accepting of the goodwill ratio approach, commonly referred to by the author as a simplified MUM. I have used this method for firms with enterprise gross revenues ranging up to $2.5 million.

Tom Gillmore, *CPA, CFE, CVA, is a self-employed forensic accountant serving the Central Florida legal community, business owners, and individuals from his office in Winter Park, Fla., since January 2009. He can be reached at www.FloridaValuationCPA.com.* ◆