

Personal Goodwill and the Courts: An Analysis

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As valuers and analysts have undertaken to ascertain the value of personal goodwill, their myriad approaches have led that valuing to take on a life of its own. Add to the mix the numerous federal and state courts that handle business dissolutions, bankruptcy, taxation issues, and divorces, and it is no wonder that there is a lack of consistency among the approaches used to value personal goodwill. Unfortunately, the need to determine the value of personal goodwill has become more imperative than ever before, because of both the record numbers of small businesses being sold or acquired and the increasing private equity funding given to new businesses that seek to go public. This article presents an analytical review of court decisions in six states and the federal courts to illustrate the techniques used in ascertaining personal goodwill.

KEY WORDS: Enterprise goodwill; excess earnings method; fair market value; fair value; personal goodwill; professional goodwill.

With burgeoning business sales and acquisitions along with the hot Initial Public Offering (IPO) market, it is crucial to understand and value personal goodwill. There is no conclusive definition of personal goodwill, however, and to add to the uncertainty, there is no one dominant approach in valuing this intangible. Personal goodwill is an intangible asset, which, unlike entity goodwill, most accountants lack knowledge on how to value. All assets, whether tangible or intangible, are valued using standard valuation methodologies; personal goodwill is no exception. However, just like a handyman utilizes various tools depending on the specifics of the job, so, too, a valuator selects the methodology based on the circumstances surrounding the need to value personal goodwill. Because there is no uniform statutory valuation mechanics in determining personal goodwill, different court venues, such as bankruptcy and family courts, might lend themselves to differing methodological preferences, due to statutory and case law precedent.

The field of business valuation is infamous for the multitudes of approaches used to conjure up a value or range of values for particular assets, liabilities, portfolios, or an enterprise as a whole. Therefore, the million-dollar question is: what techniques for personal goodwill valuations

are most often used by the courts? These techniques also have plenty of variants to suit the particular needs of an engagement.

This article first defines the term *personal goodwill* from the valuation, accounting, tax, and legal perspectives. Then it provides a detailed analysis of the commonly used methods for valuing personal goodwill so the reader can gain an understanding of the myriad, accepted approaches utilized in the valuations. Next, the results of the comprehensive study of the court cases are elaborated upon so that some conclusions can be reached. Finally, it offers some parting comments and suggests areas for future research.

DEFINITIONS

When seeking a technical definition of *personal goodwill*, valuation expert David Wood¹ has suggested that there are plenty of definitions, but they all lack a functional foundation upon which to build that a model. After surveying several textbooks, court cases, and articles, Wood synthesized meaningful characteristics of personal goodwill within a family law context; however, he still felt his research fell short of producing a working model. He ultimately defined personal goodwill as “. . . the value of earnings or cash flow attributable to attributes of the individual that results in

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earnings from new consumers who seek out the individual, and in earnings from referrals made to the individual.”

Van Amburgh² sought to distinguish the characteristics of personal goodwill from those of enterprise goodwill via a survey of over 500 users (i.e., customers, clients, patients) of professional practices. He compiled 26 characteristics, or goodwill attributes, into Van Amburgh’s Goodwill Assessment System. According to his system, the dominant traits suggesting the existence of personal goodwill are as follows:

1. Years of practitioner experience;
2. Practitioner licenses and specialties;
3. Peer reputation;
4. Practitioner age;
5. Practitioner individual awards;
6. Level of income referrals from other practitioners; and
7. Personal practitioner advertising.

Using these attributes within a weighting system, a value of personal goodwill can be calculated and distinguished from that of enterprise goodwill.

In addition to the definitions often used by valuation professionals, however, one must also incorporate accounting and legal standards. For instance, authorities such as the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) currently do not bifurcate goodwill into enterprise or personal components. Under FASB Accounting Standard Codification 350, for instance, goodwill occurs only during a purchase and particularly when the total fair value paid exceeds the fair value of identifiable net assets acquired.

Numerous statutes and different court arenas, such as bankruptcy and family court, also have entered into the fray by separately defining and elaborating upon what constitutes personal goodwill.

Furthermore, in the world of taxation, the line between personal goodwill and enterprise goodwill also is quite murky. The tax concept of personal goodwill only started to take hold when the Tax Court began to distinguish between the two types of goodwill. For instance, in *Martin Ice Cream Co. v. Commissioner* (110 T.C. 189 (1998)), the Tax Court ruled that intangible assets embodied in the shareholder’s personal relationships with key suppliers and customers were not assets of the shareholder’s corporation because there was no employment contract or noncompetition agreement between the shareholder and the corporation.³ In *Kennedy v. Commissioner* [100 T.C.M. (CCH) 268 *9 (T.C. 2010)], the Tax Court did not consider Martin Ice Cream as

standing for the broad proposition that any personal goodwill constituted a capital asset that could be sold for tax purposes. Following a series of such issues, the IRS wanted to address goodwill more profoundly and amended Code Section 1060 to strengthen their position regarding corporate goodwill. However, this amendment did not address the problems surrounding personal goodwill. Because neither the Code nor Revenue Rulings address personal goodwill, the current parameters must be gleaned from Tax Court precedents.

And as if these definitions were not complicated enough, numerous statutes and different court arenas, such as bankruptcy and family court, also have entered into the fray by separately defining and elaborating upon what constitutes personal goodwill. For example, in Florida, personal goodwill is not considered a marital asset subject to equitable distribution and, therefore, must be ascertained and excluded from the valuation of a closely held company.⁴

Similarly, bankruptcy cases have demonstrated the difficulty inherent not only in assigning value to personal goodwill in the context of creditor–debtor relationships but also determining what constitutes personal goodwill. For instance, in *In re Prince*, 127 B.R. 187, 188 (N.D. Ill. 1991), Dr. Prince, a married dentist and sole owner of a dental practice, filed a joint individual Chapter 11 petition for bankruptcy relief. Prince was the sole shareholder of the practice, which was incorporated as a professional corporation. The confirmed Chapter 11 plan of reorganization provided that for Prince to retain the practice, he was to pay its value to the bankruptcy estate. Post confirmation, Prince entered into a letter of intent to sell his practice to another dentist for between \$450,000 and \$500,000. The bankruptcy court subsequently held a valuation hearing, to determine the fair market value of the practice. The creditor’s committee contended that the value of the practice, based on a discounted cash flow analysis, was \$650,000. Prince contended that due to him not being subject to a covenant not to compete, the value of the corporate stock must necessarily exclude personal goodwill, resulting in a \$7500 liquidation value. The bankruptcy court concluded that based on the nature of the practice, the practice’s value resided primarily in the personal goodwill of Prince, and thus excluded any value attributed to personal goodwill, to what Dr. Prince would need to contribute to the estate.

With this understanding of the key components used in defining the term personal goodwill, let’s take a look at some of the common methodologies and techniques utilized in ascertaining this value.

METHODOLOGIES AND TECHNIQUES

So what are the *methods* commonly used in calculating personal goodwill? You will have noticed the emphasis on “methods” in the preceding sentence. This is quite

disconcerting for many professionals who seek the value of a particular item. Yet the world of valuation is seen as an art as well as a science. This portion of the article provides the most commonly used approaches in determining personal goodwill. As a side note, even when there are statutes involved, that does not necessarily provide any more clarity than if omitted. These statutes would provide terms such as fair market value, fair value, and so forth, which are simply standards of value and not any particular heuristic approach. For instance, the State of Florida Family Court mandates that the fair market approach be applied in determining personal goodwill (*Thomson v Thomson*, 576 So. 2d 267, Fla 1991; See also: *Young v. Young*, 600 So. 2d 1140, 1992, Fla. App. and *Christians v. Christians*, 732 So.2d 47, 1999). That's fine—but how do we get to fair market value? Many approaches may be used to calculate it.

Interestingly, in one divorce case (*In Marriage of Hall*, 692 P.2d 175 (Wash. 1984)), the State of Washington Supreme Court concluded that personal goodwill can be determined using five different approaches. These approaches, as elaborated upon by the Court and with our slight definitional modifications for purposes of this paper, are as follows:

1. **Straight capitalization:** Under this method, the average net profits of the business are determined, and then this figure is capitalized by some discount rate. This calculation represents the total value of the business, including both tangible and intangible assets. To determine the value of goodwill, the book value of the business's assets is subtracted from the total value figure.
2. **Excess earnings method:** This approach determines the business value by computing the company's value based on the adjusted value of tangible assets plus an additional amount for intangible assets. A company's tangible assets should provide a reasonable return to the owner. Therefore, it is common for organizations to use prevailing industry rates for the return on assets. Any returns produced in excess by the company above this chosen rate on tangible assets will be deemed intangible assets. These "excess earnings" are then capitalized to estimate the value of the intangible assets.
3. **IRS Variation of Capitalized Excess Earnings:** This method takes the average net income of the business for the last five years and subtracts a reasonable rate of return based on the business's average net tangible assets. From this amount, a comparable net salary is subtracted. Finally, the remaining amount is capitalized at a definite rate, resulting in the goodwill figure.
4. **Market value method:** Professional goodwill is established by determining what fair price would be obtained in the current open market if the practice were sold. This method requires that the professional practice has been recently sold, or is in the process of being sold, or is the subject of a recent offer to purchase.
5. **Buy/sell agreement method:** This technique values goodwill by reliance on a recent actual sale or an unexercised existing option or contractual formula set forth in a partnership agreement or corporate agreement. Because the contracting individuals may have been influenced by many factors other than fair market value in negotiating the terms of the agreement, courts relying on this method should inquire into the presence of such factors, as well as the arm's-length nature of the transaction.

The Washington Supreme Court also made clear that these five methods are not the only ones available and that the particular method chosen should not be used in isolation. Because of the sheer number of variants, this article limits discussion of the various approaches to those most commonly used in practice based on the authors' experiences.

In practice, for both personal and institutional (sometimes labeled "business" or "enterprise") goodwill, the income approach is the most commonly used, because goodwill often is conceptualized based on future earnings. Although the Washington Supreme Court discussed the straight capitalization technique under the income approach, they duly noted the many modifications that can exist under straight capitalization. For example, income approaches alone can include such techniques as: (1) residual from business value; (2) capitalized excess earnings; and (3) present value of future income.⁵ In each of these methods of valuation, goodwill is calculated as the present value of the future income not associated with the business's identifiable intangible or tangible assets. The straight capitalization technique that the Court described falls under the residual from business value approach. However, even within each of these categories, many gradations exist.

Residual from Business Value

The residual from business value technique is based on the notion that the value of an entity's total assets value (i.e., the left side of the balance sheet) will equal the sum total of the entity's liabilities and retained earnings (i.e., the right side of the balance sheet). Under this technique, a discounted cash flow method first is used to establish the total business value. Then, total goodwill is calculated as the total business value minus the fair market value of all identified business assets, including working capital, tangible assets, and identifiable intangible assets. A distinction still is needed, however, to bifurcate the enterprise goodwill from the personal goodwill. The multi-attribute utility method (MUM) is one means of making this division. MUM is conceptually similar to Van Amburgh's Goodwill Assessment System, mentioned earlier, in that both begin by determining the critical characteristics that are more akin to personal versus business goodwill. The goal of MUM is to impose some objectivity upon the subjective

matter of differentiating between business goodwill and personal goodwill. The methodology begins by having the valuator determine the various attributes of personal and business goodwill present in the enterprise. For instance, personal goodwill often includes the owner's specialized knowledge, strong personal reputation, and personalized business name, whereas business goodwill includes such things as the existence of an enterprise-wide business system, a high-caliber staff, and an excellent business location. After defining the various personal and business goodwill attributes, the valuator weights each attribute based on relative importance. After this, percentages can be divided between personal and business goodwill.

This method seems to be gaining traction and acceptance in the courts. Most recently, this method was accepted by the Illinois Second District Court of Appeals case (*In re Marriage of Preston, No. 2-17-0656, Ill. App., Aug. 1, 2018*). In *Preston*, the husband was the sole shareholder in a manufacturing company that had almost \$3.1 million of goodwill. His expert applied a MUM with 10 personal and business goodwill attributes. He assigned each attribute a value of either 1, if it had a "significant presence," or 0, if it was weak or not present. Based on the score of 6 for personal goodwill and 3 for business goodwill, the expert attributed two-thirds of the total goodwill to personal goodwill—almost twice the amount the wife's expert allocated to personal goodwill. This method, although it reduces the level of subjectivity involved, is still not perfect.

Capitalized Excess Earnings Technique

The capitalized excess earnings technique encompasses the quantification and capitalization of a business's excess earned income. Under this approach, the first step usually is calculating the fair market value of all identified business assets. The valuator then determines a fair rate of return on these assets. However, this determination can be quite subjective, which is deemed one of the weaknesses of this method. Then, this amount is subtracted from total business earnings, with the difference considered excess earnings. Finally, subjectivity comes into play again when the valuator assigns a capitalization rate to distinguish business goodwill from personal. Once again, MUM can be utilized as a tool under this technique to lessen the subjective nature of this decision.

Comparative Business Value Method

The last of the commonly used methods is the "with-and-without method" (also called the "comparative business value method"). This method is more commonly used to measure personal goodwill than enterprise goodwill. Under this technique, personal goodwill is determined by valuing a business under two scenarios: (1) *with* the particular individual continuing to work in the business; and (2) *without* the individual's continuing involvement.

Thus, an estimate is made of the value of the business entity with and without goodwill. The with and without method uses discounted cash flow models to project the revenues, expenses, and net cash flows that a particular business would expect to realize over a specified period under each scenario.

The "with" scenario projections usually reflect the overall assumptions and cash flow forecasts for the business "as is." As a result, this scenario includes the value attributable to the personal goodwill of the subject key individual. As one would expect, the "without" scenario is based on the premise that a loss of revenue would be directly related to that individual leaving the firm. It is assumed that, unless unusual circumstances are at play, any new hire would take years to accomplish the revenue replacement of the individual who left, if at all. The million-dollar question for valuers, therefore, is how to consider the implications of an immediate new hire replacement in the modeling. The difference between the "with" and the "without" is deemed personal goodwill.

RESEARCH METHODOLOGY

Now that we have gained an appreciation of both the personal goodwill definitions and practitioner-based methodologies, what does the courts have to say on the matter? The courts have to follow statutes, unless those subsequently are ruled unconstitutional. Assuming the statutes are deemed valid, where does this leave us? Most legislative statutes require one of the standards of value—fair value, fair market value, investment value, and so forth. These do not spell out in any format the exact methodologies to use.

The lack of definitive procedures in state statutes is vividly illustrated in an example of the State of Florida definition of fair value: 'According to §607.1301(4), which was recently amended to define "fair value" as the value of the corporation's shares determined: . . . (b) Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable to the corporation and its remaining shareholders. (c) For a corporation with 10 or fewer shareholders, without discounting for lack of marketability or minority status.' So as one can see, there is plenty of wiggle room for valuator discretion. The only concrete rule with this statute governs the use of discounts and premiums.

In terms of the analysis made for the identification of the methods used for personal goodwill, valuation by the courts was based on the observation of the state materials available in the Westlaw database (www.westlaw.com). Overall, 10,000 cases where goodwill was discussed were found among the federal and state cases. However, when searching for the particular terms of personal or

Table 1. The Number of Federal and State Cases Discussing Personal and/or Professional Goodwill

Cases and Locations	Total No. Cases	Cases Discussing Personal and/or Professional Goodwill	
		No	All the Goodwill Cases Discussing the Valuation of the Goodwill (%)
All federal and state cases	10,000	507	5.07
State materials (i.e., caselaw and legal publications)			
California	1297	27	2.08
Delaware	351	6	1.71
Florida	332	20	6.02
Illinois	428	39	9.11
New York	671	8	1.19
Texas	643	26	4.04
Total for all six states	3722	126	3.39

professional goodwill, 507 federal and state cases had those terms—a number that equated to 5.07%. The analysis considered cases from courts of original jurisdiction to the appellate level and from specialty federal courts such as Tax Court and bankruptcy courts.

The cases were grouped into clusters based on the states where the cases were heard. The following analysis includes judicial cases from these six determined states: Florida, Illinois, New York, Delaware, Texas, and Pennsylvania. Overall, these six states generated 3722 cases that discussed goodwill, representing 37.22% of the total population of 10,000 cases. Only 126 cases out of 3722 actually discussed personal/professional goodwill—that is, about 3.39% of the state cases, and if one adds the federal cases, it would increase by only 2.49% (Table 1).

After the analysis of the federal court cases, including Tax Court and bankruptcy court, it was determined that although there were no particular rules for the use of specific methods in the valuation of personal goodwill, the excess earnings method and the fair market value standard were most commonly used.

Based on the analysis of 39 cases heard in Illinois, 26 cases heard in Texas, and 8 cases heard in New York state, one can conclude that the excess earning method is the preferred method for the valuation of personal goodwill (assuming the valuation method was discussed). For example, in the case *In re Prince* heard in the district of Illinois, the value of Prince's goodwill represents future cash flows from return on an intangible capital asset that could be sold and transferred with the sale of the practice (*In re Prince*, 127 B.R. 187 (N.D. Ill. 1991), *aff'd sub nom. Matter of Prince*, 85 F.3d 314 (7th Cir. 1996)).

Additionally, the case heard in the New York state (*In re Norman Schultz*, 250 B.R. 22 (6/20/2000)) provides the details of the use of the excess earning approach in the

personal goodwill valuation. First, the average annual salary of a CPA doing business in the location as a sole practitioner was subtracted from the practice's actual earnings. Then the result was multiplied by a factor of 1.25, taking into account the estate's property interest in the goodwill and going concern value of the accounting practice. Interestingly, the court practice in New York state used the term "professional goodwill" differently from the other states. Professional goodwill is an element other than personal attributes of a professional person, such as continuity of location of a professional office, and is a saleable asset. In Illinois, Pennsylvania, and Texas, the term "professional goodwill" is synonymous with "personal goodwill" and represents personal attributes of a professional person.

Based on the analysis of 20 cases heard in the state of Florida, a fair market method of the valuation of personal goodwill is the most appropriate when there is uncertainty as to whether the corporation would be an ongoing entity. The elements of personal goodwill may be evaluated by comparing the profit margins of similar businesses, where no such unusual personal elements of goodwill exist, to obtain a value for the portion of the goodwill attributable to such personal factors.

A review of applicable case law indicates that personal or professional goodwill is not limited to specific professions.

Interestingly, under Pennsylvania law, professional or personal goodwill is "intrinsicly tied to the attributes and skills of certain individuals" (*In re Thomas*, 246 B.R. 500, 506 (E.D. Pa. 2000)). Because professional goodwill is

inextricably intertwined with an individual's skill and attributes, professional goodwill cannot be valued and cannot survive if that individual is disassociated from the business (*In re Thomas*, 246 B.R. 500, 506 (E.D. Pa. 2000)).

A review of applicable case law indicates that personal or professional goodwill is not limited to specific professions. Nonprofessionals can create professional goodwill if they have established a reputation for specialized skill, experience, and judgment (*In re Thomas*, 246 B.R. 500, 507 (E.D. Pa. 2000)). Therefore, the valuation of professional goodwill is not tied to specific professions.

The challenge found after making the case analysis was in the separation of personal goodwill from institutional or business goodwill. Based on the observations made during the analysis of the cases, professional goodwill is seen by many professionals as the result of the charisma, knowledge, skill, and reputation of a specific practitioner. Therefore, it is challenging to transfer personal goodwill to the corporation. If not transferable to the corporation, personal goodwill has no economic value (*Derby v. Comm'r*, 95 T.C.M. (CCH) 1177 (T.C. 2008)). The personal goodwill can be transferred to the corporation by entering in a covenant not to compete or other agreements so that personal goodwill becomes the property of the corporation.

In the several Tax Court cases, it was discussed that the personal goodwill differs from the covenant not to compete agreement for the terms of tax law. However, it is still unclear how one can distinguish between personal goodwill and the covenant not to compete agreement.

CONCLUSION

After reviewing the federal cases and those from the selected states, it became apparent that the excess earnings approach was the dominant approach in determining personal goodwill. The courts also have cited fair market value, but as addressed in this article, this term does not represent any particular methodology. Fair market value is simply a standard of value, not any particular methodology. We also determined that it made no difference whether federal or state courts ruled on personal goodwill, and the type of business did not matter either. In other words, the excess earnings approach would be used whether the business under discussion were a CPA practice or an architectural practice. ■■

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