Personal Goodwill

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In a divorce situation, the key question with respect to goodwill in a business setting is, how much of the goodwill is personal to the individual and how much is the goodwill of the business enterprise? This is not a simple question to answer. In some situations, such as a professional practice (doctors and lawyers, for example), it is clear that much of the goodwill value is personal to the individual because the value of the practice is dependent upon that individual's skills. A leading California case, In re Marriage of Lopez, 38 Cal.App.3d 93, 113 Cal.Rptr. 58 (1974), sets forth certain criteria which the Court of Appeals for the Third District determined were significant in valuing the goodwill of a professional practice. Those criteria include: the age and health of the individual; the individual's demonstrated earning power; the individual's reputation in the community for judgment, skill, and knowledge; the individual's comparative professional success; and the nature and duration of the professional's practice either as a sole proprietor or as a contributing member of a partnership or professional corporation.

The Lopez Court talked in general about how the goodwill value of a professional practice might be determined, but did not answer the question of whether that goodwill should be included in the marital estate, or to what degree. Instead, the Court simply stated that "professional goodwill may be separate or community property or varying degrees of both depending on the particular circumstances." Thus, the Lopez Court defined the issue but failed to provide a solution.

Other courts have attempted to refine the Lopez ruling just a little. The Illinois Supreme Court, in In re Marriage of Zells, 143 Ill.2d 251, 572 N.E.2d 944 (1991), held that "professional goodwill as an aspect of economic potential is reflected in maintenance and support awards in dissolution proceedings but is not divisible marital asset." The professional practice at issue in Zells was the husband's law practice, a classic example of a situation where personal goodwill exists. The Court stated that "consideration of goodwill as a divisible marital asset results in gross inequity." This was based on the Court's analysis of the relevant factors of the Illinois equitable distribution statute: the relevant economic circumstance of each spouse when the division of property is to become effective; the occupation, amount and sources of income, vocation skills, and employability of … of each of the parties; and the reasonable opportunity of each spouse for future acquisition of capital assets and income. In Illinois practice, this is known as the "double dip" argument: it is not fair to consider a spouse's ability to earn future income as an asset subject to a present distribution in a dissolution of marriage case because the same dollars are being considered as both an asset and as a stream of income.

Illinois followed the Zells decision with In re Marriage of Talty, 166 Ill.2d 232, 652 N.E.2d 330 (1995). In Talty, the business at issue was a car dealership. The husband argued that much of the value of his dealership was personal to him. Talty is a departure from the "professional practice" paradigm. One might say that car salesmen are not ordinarily held in the same professional esteem as lawyers or doctors. More importantly, a car dealership has hard assets, notably inventory, which can be valued and sold. Although a car dealership may have an element of goodwill in its value, that goodwill may not be solely attributable to the efforts of the individual owners of the business. However, the Talty Court ruled that a distinction between personal and enterprise goodwill may be appropriate in certain situations. The Court further went on to state that "to the extent that goodwill inheres in the business, existing independently of [husband's] personal efforts, and will outlast his involvement in the enterprise, it should be considered an asset of the business and hence of the marriage. In contrast, to the extent that goodwill of the business is personal to [husband], depends on his efforts, and will cease when his involvement with the dealership ends, it should not be considered property."

There's the rub, of course. Talty acknowledged that a business may have both elements of personal and enterprise goodwill.

The Court, however, offered no guidance as to how that distinction should be made. In fact, although other courts have adopted the logic of Talty, see, e.g., Yoon v. Yoon, 711 N.E.2d 1265 (Ind. 1999), there appear to be no reported dissolution of marriage cases that actually distinguish between the personal goodwill value and the enterprise goodwill value of a business. Litigants file appeals, claiming that trial courts erred by including personal goodwill in the value of an asset subject to distribution. Appellate courts agree that and remand with instructions to the trial courts to determine the personal vs. enterprise goodwill values. But there appear to be no reported dissolution of marriage cases containing specific instructions on how that distinction should be made. It seems that the family law courts have asked the question, but have not answered it.

Obviously, the courts are struggling with a difficult issue in an attempt to achieve fair results. With respect to this goodwill issue, it seems that two basic concepts of divorce law are in conflict. On one hand, courts try to ensure that non-business owner spouses are compensated for their contributions during the marriage. On the other hand, the business owner's post-decree income and earnings should not be included in an award of marital property.

B. Other Courts' Approaches

Maybe divorce courts are simply avoiding the issue. It seems likely that these kinds of cases settle on remand because the valuation questions are tough. However, the issue has not been completely ignored by all courts. There are tax court cases dealing with corporate liquidations that address the question, and those cases seem to hinge on whether the goodwill in question is "vendible." See. E.g., Watson, 35 TC 203 (1960). The Watson Court stated that goodwill, "from a transferee's standpoint, is an opportunity to succeed to the advantageous position of his predecessor. Generally, attitudes of customers or others may be transferred from one proprietor to another (1) by furnishing the transferee with all the symbols and other transferable attractions which invoke a favorable response in the customers, and 2) by removing the transferor as an alternative attraction."

The Watson approach seems to invite a valuation of personal goodwill based on the existence of a non-compete agreement. In another recent tax court case, Norwalk, TCM 1998-279, the Court ruled that a lack of non-compete agreements between an accounting firm (which was being liquidated) and the accountants who worked at the firm rendered <u>all</u> of the goodwill value in the practice to be personal to the individual accountants. The firm itself had no goodwill. In a similar tax case, Martin Ice Cream, 110 TC 189 (1998), the Court ruled that, because the ice cream business had not executed any employment agreement or non-compete agreement with a former shareholder who sold his distribution rights to another ice cream company, the business did not own those intangible assets. Thus, the goodwill associated with those assets was personal to the individual former shareholder.