A legal note from Marshal Willick about how it may be time for Nevada to distinguish enterprise from personal goodwill in business valuations

I. THE ROLE OF GOODWILL IN DIVORCES INVOLVING BUSINESSES

In divorce cases involving a business owned or operated by a spouse, the value of that business is usually a central concern. And often the largest component of the valuation is the "goodwill" value of the business – defined by the Nevada Supreme Court in *Ford v. Ford*, 105 Nev. 672, 782 P.2d 1304 (1989), as "a reputation that will probably generate future business."

The *Ford* case maintained that a professional practice – even a solo business – has goodwill divisible upon divorce, even if the business is not salable. In that case, the expert proposed, and the Nevada Supreme Court approved, a valuation methodology based upon "three months gross receipts."

Some lawyers over-reacted to that holding, and claimed that particular valuation methodology was the only acceptable one in Nevada. A fair reading of the case supports no such conclusion, because it also includes the specific holding that goodwill can be measured by "any legitimate method of valuation which measures the present value of goodwill by taking into account past earnings."

The Court has said little about the subject in the past 20 years, merely re-affirming its *Ford* holding in *Malmquist v. Malmquist*, 106 Nev. 231, 792 P.2d 372 (1990), where it repeated the holding stated above.

II. DEVELOPMENTS ELSEWHERE – "ENTERPRISE" VS. "PERSONAL" GOODWILL

In the meantime, courts elsewhere have been giving the matter some thought, and a distinction thus far unseen in Nevada appears to be gaining a majority consensus. Specifically, the distinction between "enterprise" and "personal" goodwill – the former of which is considered divisible marital property, and the latter of which is not.

Representative of the wave of similar cases across the country was *Gaskill v. Robbins*, 282 S.W.3d 306 (Ky. 2009), in which an oral surgeon set up a solo practice during the marriage, and earned roughly 90% of the income the couple received during that time. The doctor's husband had assisted with setting up the office, but made little income thereafter.

The case facts recited in the opinion indicated that the doctor was hard working and managed her practice with frugality, and was solely responsible for patient acquisition.

During the divorce, both sides presented experts. The doctor's accountant collected data from the business records and investigated the practice on-site, and prepared a detailed report laying out all of the financial information, a discussion of various accounting methods, and definitions of frequently used accounting terms.

At trial, after testifying about why various valuation methods were not applicable due to the unique nature of this sole proprietorship, the accountant settled on an asset-based analysis. He chose this approach because the business was not actually to be liquidated, no similar sales of a reasonably similar business were available, and there was no previous transaction in this business with which to compare. He testified at trial that the practice had a value of $221,610, which he later adjusted downward to make the valuation more current.

Relevant to this discussion is that the accountant assigned a value of zero to goodwill based on his opinion that the doctor's role in the business amounted to a "non-marketable controlling interest." To illustrate, he asked, "Why would a purchaser pay more than fair market value of the tangibles if Dr. Gaskill can take her patients, go down the hall, and set up a practice?"

The husband's expert used the accountant's detailed data, against which he applied four different methodologies to evaluate the business: capitalized earnings, excess earnings, adjusted balance sheet, and the market approach. He calculated a value for the business under each method, then averaged the four numbers to arrive at a value of $669,075, and quibbled about various other assumptions used by the accountant.

The trial court accepted the husband's expert's view, primarily because, under established Kentucky law, there was no legal authority for a distinction between personal and enterprise goodwill.

The appellate court reversed. The court began with the assertion of how "complicated, often speculative or assumptive, and at best subjective" the valuation of a business is, "particularly in a divorce case where the business is a professional practice with only one practitioner, clients or patients come to the business to receive that particular person's direct services, the business is not actually being sold, and the success of the business depends upon the personal skill, work ethic, reputation, and habits of the practitioner."

In balance, the court acknowledged the obvious fact that "at times," a business can be sold for more than just the value of its assets, which statement it based on findings very much like the Nevada Supreme Court's reasoning in *Ford* – that the reputation of the business will draw customers, get them to return, and thus contribute to future profitability. But the Kentucky court found that its line of cases focused on professional practices, and assumed that there was a potential buyer.

The court found a basis for distinguishing personal and enterprise goodwill in its existing law (identical to that of Nevada) that an advanced professional degree is not marital property because it is personal to the holder and cannot be transferred to another, citing *Lovett v. Lovett*, 688 S.W.2d 329 (Ky. 1985). Examining the rationale for that conclusion, the court recited that a professional degree:

> does not have an exchange value or any objective transferable value on an open market. It is personal to the holder. It terminates on the death of the holder and is not inheritable. It cannot be assigned, sold, transferred, conveyed or pledged. An advanced degree is a cumulative product of many years of previous education, combined with diligence and hard work. It may not be acquired by the mere expenditure of money. It is simply an intellectual achievement that may potentially assist in the future acquisition of property ....

The court mused that "goodwill" generally gives a businesses "value beyond fixtures and accounts receivable," as when what is being sold is "any . . . reputational thing a buyer could reasonably be expected to pay for." But the court found that analysis alone inadequate, because ***sometimes*** "part of goodwill . . . is personal and nontransferable, much like the professional degree. . . ."

Finally reaching the crux of the matter, the court adopted the view developed elsewhere that "personal" and "enterprise" goodwill are properly distinguished upon divorce, on the basis of whether any "goodwill could reasonably be marketable as continuing with the business absent the presence of a particular person." The court adopted the holding and reasoning of *May v. May*, 589 S.E.2d 536 (W. Va. 2003).

That court had defined "goodwill" as the value of a business or practice that exceeds the combined value of the net assets used in the business. And it specifically contemplated that the goodwill in a professional practice ***might*** be attributable to the business enterprise itself by virtue of its existing arrangements with suppliers, customers or others, and its anticipated future customer base due to factors attributable to the business. However, the *May* court also found that such goodwill ***might*** be attributable to the individual owner's personal skill, training or reputation.

Factors going to enterprise goodwill are a business's location, name recognition, business reputation, "or a variety of other factors depending on the business" that "contribute to the anticipated future profitability of the business" and therefore constitute an asset of the business divisible in a dissolution. The *May* court acknowledged that enterprise goodwill is "not necessarily marketable" in the sense that there is a ready and easily priced market for it, but it is "in general transferrable to others and has a value to others."

By way of contrast, the *May* court defined "personal goodwill" as that which depends on the continued presence of a particular individual, holding that any value that attaches to a business as a result of such "personal goodwill" represents nothing more than the future earning capacity of the individual and is therefore not divisible.

The *Gaskill* court therefore concluded that, to the extent a business or profession has goodwill (or has a value in excess of its net assets) it is a factual issue to what extent, if any, that goodwill is personal to the owner or employee and to what extent it is enterprise goodwill and therefore divisible property.

The trial court was directed to consider as "personal" the skill, personality, work ethic, reputation, and relationships developed by Dr. Gaskill, which were to be hers alone because such things cannot be sold to a subsequent practitioner. The court found that any consideration of these factors in a case where alimony was at issue also created a risk of "double dipping," because the same qualities were involved in setting such support.

On the other hand, the court held that if a doctor, even a solo practitioner, was willing to leave her name on the practice, even though she herself did not continue to practice, there arguably could be some reputational reliance that she would stand behind the quality of the practice which could have some pecuniary value.

Finally, the Kentucky court found the potential value of a hypothetical non-compete agreement to be too speculative to value.

III. APPLICATION OF THE DISTINCTION IN NEVADA DIVORCE LAW

In States like Kentucky where earning capacity is a factor for disproportionate property division, such future earning capacity could go into the property division.

In a State such as Nevada, with a presumptively equal property split, it would become a potential ***alimony*** factor, but perhaps factors such as "skill, personality, work ethic, reputation, and relationships" most properly belong in that analysis anyway. It isn't much of a jump from those things to the "career asset" or "business acumen" that the Nevada Supreme Court has already directed courts to evaluate in making alimony awards.

And considering as part of the business only the "enterprise good will" that is actually transferable to a hypothetical buyer goes some distance toward valuing the business as a business without blurring the lines between business valuation and an alimony analysis. This would largely eliminate the "double dip" angst occasionally seen – as in the debate at the recent Advanced Family Law Seminar on whether a goodwill component to a business valuation necessarily created a double dip when alimony was in issue.

According to a survey of jurisdictions in the *May* decision, as recounted by the *Gaskill* court, 13 courts made no distinction between personal and enterprise goodwill, 5 courts held that goodwill is not a part of marital property, and 24 states differentiated between personal and enterprise goodwill. This would appear to be an emerging consensus.

Perhaps it is time for the issue to be squarely presented by counsel in an appropriate Nevada divorce case involving valuation of a business.

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This legal note is from Marshal S. Willick, Esq., 3591 E. Bonanza Road, Ste 200, Las Vegas, NV 89110. If you are receiving these legal notes, and do not wish to do so, let me know by emailing this back to me with "Leave Me Alone" in the subject line. Please identify the email address at which you got the email. Your State would be helpful too. In the mean time, you could add this to your email blocked list. And, of course, if you want to tell me anything else, you can put anything you want to in the subject line. Thanks.