ILLINOIS STATE BAR ASSOCIATION

APRIL 2018 VOL 61 NO. 10

Family Law

The newsletter of the Illinois State Bar Association's Section on Family Law

Personal goodwill: Can we limit the subjectivity?

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Goodwill is a catch-all term. It is an expression used by professionals and academics to recognize a company's value above its tangible assets. In accounting, it is only recognized after a transaction occurs. In finance, it recognizes the premium paid for potential future earnings. In family law matters, goodwill is a potential marital asset.

Illinois courts have recognized that personal goodwill is a non-marital asset. The opinion from *Marriage of Zells*[1] recognized a professional's goodwill is inseparable from one's income potential and thus personal goodwill is accounted for in maintenance. The *Zells* court stated, "If good will is that aspect of a business which maintains the clientele, then the good will in a professional business is the skill, the expertise, and the reputation of the professional… To figure good will in both facets of the practice would be to double count and reach an erroneous valuation."[2] The *Zells* court recognized the existence of personal goodwill in professional practices is not divisible as marital property.

In the opinion of *Marriage of Talty,*[3] the court recognized personal goodwill can exist in non-professional business. Furthermore, in *Marriage of Schneider,*[4] the court determined that personal goodwill is a marital asset when the parties waive maintenance.

By 2006, the court expressed concerns regarding how appraisers determined personal and enterprise goodwill. From *Marriage of Alexander*,[5] the court adopted a model to remove some of the subjectivity from separating personal and enterprise goodwill. Prior to *Marriage of Alexander,* Illinois courts relied on subjective reasoning in determining personal goodwill. *Alexander* introduced the Multi-Attribute Utility Model (MUM) which allows appraisers to demonstrate reasoning behind their allocation between personal and enterprise goodwill.

We would like you to consider other methodologies to arrive at a less subjective calculation for the value of a company's personal goodwill. Because goodwill is a catch-all asset, it is our opinion that identifiable intangible assets can be identified, valued, and classified as personal or enterprise assets. The following methods are typically used in financial reporting but can be adopted for family law engagements.

Top-Down Analysis

As the name suggests, appraisers start by determining the *fair market value* of the company. Then, the appraiser identifies and values the intangible assets associated with personal goodwill: Family name, owners' reputation, employment contracts, etc. Finally, the value of identified intangible assets associated with personal goodwill is deducted from the company's top-level value and the residual value is considered divisible within the marital property.

For example: A home renovation company that specializes in restoring prairie-style homes with traditional materials and techniques (Wright Restoration). Wright Restoration is co-owned by Brother/Sister team. Mr. Wright has recently entered into a divorce proceeding and requires an appraisal of his 50 percent interests in the company. He has an active role in the company by handling the bid process and other day-to-day operations. The sister has a smaller role in the company. The company is named after their family and has a superior reputation in their community. The company's assets are appraised at $2 million including $750,000 of tangible assets. The company also has $500,000 of long-term debt. This yields a $1,500,000 of total equity value.

Of the $1.25 million of goodwill value we determined that it is partially made up of intangible assets classified as personal goodwill and therefore not included in the marital property. We identified the hypothetical non-compete agreement and the company's name as the personal goodwill intangible assets which are excluded from marital property. Although there was no non-competition agreement in existence, we assume the willing buyer would require a covenant to proceed with the hypothetical transaction. Therefore, we assert that the hypothetical non-compete agreement is personal goodwill because it hinders Mr. Wright's expected future income, which thus would be a double dip into maintenance.

We valued the non-compete agreement based on a Before and After Discounted Cash Flow analysis, which falls under the Income Approach. We assumed that cash flows would be reduced by about 50 percent for three years without a non-compete agreement. The resulting value of the non-compete is $312,000.

Exhibit 1

Valuation of a Hypothetical Non-Compete Agreement under the Before and After DCF				
		2018	2019	2020
Cash Flow w/ Restrictive Covenant		$250,000	$258,750	$267,806
Cash Flow w/o Restrictive Covenant	50%	$125,000	$129,375	$133,903
Reduction in Cash Flow		$125,000	$129,375	$133,903
Present Value Factor	16%	0.9285	0.8004	0.6900
		$116,060	$103,533	$92,394
Fair Market Value of Non-Compete Agreement (Round)		$312,000		

The company is named after the family and has a positive reputation within the community it serves. We utilized the Relief from Royalty Method under the Income Approach to value the trade name. Based on market data we determined the royalty rate for a trade name in the industry is 3 percent of net sales. After accounting for taxes and the time value of money, we determine the fair market value of the trade name is $194,000.

Therefore, we can determine the value of the tangible assets and enterprise goodwill in arriving at the value of the Divisible Marital Assets.

Exhibit II

Valuation of a Trade Name under the Relief from Royalty Method					
		2018	2019	2020	Terminal
Net sales		$1,000,000	$1,035,000	$1,071,225	$1108,718
Pre Tax Royalty Rate	3.0%	$30,000	$31,050	$32,137	$33,262
Less: Taxes	25%	($7,500)	($7,763)	($8,034)	($8,315)
After Tax Royalty Receipt		$22,500	$23,288	$24,103	$24,946
Capitalization Multiple					8.00
Terminal Value of Royalty Receipt					$199,569
Present Value Factor	16%	0.9285	0.8004	0.6900	0.6900
Present Value of Royalty Receipts		$20,891	$18,640	$16,631	$137,705
Fair Market Value of Trade Name (Round)		$194,000			

Exhibit III

Valuation of Personal Goodwill Based on Top-Down Analysis		
	The Company	Subject Interest
Ownership %	100%	50%
Fair Market Value of the Company's Equity	$1,500,000	
Less: Tangible Assets	750,000	
Value of Intangible Assets	$750,000	
Less: Personal Goodwill Intangible Asset, Non-Compete Agreement	$312,000	
Less: Personal Goodwill Intangible Asset, Trade Name	$194,000	
Enterprise Goodwill	$244,000	
Tangible Assets	$750,000	$375,000
Enterprise Goodwill	$244,000	$122,000
Personal Goodwill	$506,000	$506,000
Fair Market Value of the Subject Interest	$1,500,000	$1,003,000
Divisible Marital Property (Tangible Assets + Enterprise Goodwill)		$497,000

Bottom-Up Analysis

This approach is most often utilized when appraising intangible assets for financial reporting requirements; however, it is quite useful in the context of separating personal and enterprise goodwill. This approach begins at the most basic level of valuation by appraising the company's tangible assets. Next, the appraiser values the company's enterprise intangible assets. Any residual value is determined to be personal goodwill.

Identifiable intangible assets include: software, assembled workforce, trade names and marks, patents, non-compete agreements, customer relationships, etc. Based on the qualities of the underlying intangible asset, we would use the appropriate valuation methodology. For example, artistic- and marketing-related intangible assets are typically valued by utilizing comparable royalty rates found in market datasets and determining the time value of licensing out the intangible. The Multiperiod Excess Earnings Method ("MPEE Method") under the Income Approach is utilized for the intangible assets with the largest driver of revenue, typically customer relationships. This method values an asset based on its potential future earnings while taking into the account the economic rent charged by the company's other assets.

For example: A temporary staffing agency with annual revenue of $5 million and a net profit margin of 5.5% after its third year of operation. We determined the business value of $2.36 million. The owner has 20 years of industry experience and a network of referrals. The firm has a manager/owner, a vice president of operations, three recruiters, three business development specialists, and one office staffer.

In determining the personal goodwill of the company, we identified and valued the company's assembled workforce and customer relationships as intangible assets. We valued the company's assembled workforce at $290,000 using the Cost to Recreate Analysis under the Asset Approach. We determined the replacement cost of each position based on cost of recruiting, hiring and training a replacement employee for each position. See Exhibit IV below for our calculation.

Exhibit IV

Valuation of Assembled Workforce Under Cost to Recreate Analysis		
Job Title	**Annual Compensation**	**Replacement Cost**
CEO	$281,250	$68,603
VP of Operations	218,750	53,447
Talent Recruiter	100,000	24,650
Talent Recruiter	100,000	24,650
Talent Recruiter	75,000	15,294
Business Development Specialist	118,750	44,936
Business Development Specialist	100,000	24,650
Business Development Specialist	81,250	16,552
Office Staffer	68,750	14,036
Fair Market Value of an Assembled Workforce (Round)		$290,000

Next, we can determine the value of the company's current customer relationships using the MPEE Method. We assume a 3 percent long-term growth with straight line deterioration of revenue attributed to the existing customer over five years. Then we subtract the economic rent of 5 percent for net working capital, 7 percent for fixed assets, and 17 percent for the assembled work force. Finally, we summed the present value of earnings attributable to current customers to determine the fair market value of the customer relationship of $490,000.

After completing our analysis, the value of personal goodwill is determined by calculating the company's residual value by deducting its tangible and identifiable intangible assets.

Exhibit V

Valuation of the Customer Relationship under MPEE Method						
		2018	**2019**	**2020**	**2021**	**2022**
Revenue from Current Customers	3.0%	$5,000,000	$5,150,000	$5,304,500	$5,463,635	$627,544
After-Tax Margin	5.5%	$275,000	$283,250	$291,748	$300,500	$309,515
Retention Factor		100%	80.0%	60.0%	40.0%	20.0%
Expected Income		$275,000	$226,600	$175,049	$120,200	$61,903
Less: Required Return on:						
Net Working Capital	5.0%	$18,750	$15,450	$11,935	$8,195	$4,221
Fixed Assets	7.0%	$7,000	$5,600	$4,200	$2,800	$1,400
Assembled Workforce	17.0%	$49,300	$40,623	$31,381	$21,549	$11,098
Total Contributory Asset Charge		$75,050	$61,673	$47,517	$32,544	$16,718
Earnings Attributed to Customer Relationship		$199,950	$164,927	$127,532	$87,656	$45,185
Present Value Factor	15.0%	*0.933*	*0.811*	*0.705*	*0.613*	*0.533*
PV of Earning attributed to Customer Relationship		$186,454	$133,735	$89,924	$53,745	$24,091
Fair Market Value of a Customer Relationship (Round)		$490,000				

Exhibit VI

Fair Market Value of Personal Goodwill with Bottom-Up Analysis	
Fair Market Value of Company	$2,360,000
Less:	
Tangible Assets	$475,000
Assembled Workforce	$290,000
Customer Relationship	$490,000
Fair Market Value of Personal Goodwill	$1,105,000

Draw Backs

It is important to consider all three approaches presented in this article when faced with the challenge of appraising and allocating the goodwill of a company. The MUM factors analysis is the most common among the three approaches and is a subjective approach to allocating between personal and enterprise goodwill; this approach uses certain attributes of a company which are unique to its existence and splits them between personal and enterprise, then a weight is added to the more pertinent attributes.

Top-down analysis begins by appraising the entire company. After arriving at the top line value, personal goodwill is deducted, and the residual is part of the marital property. Bottom-up analysis begins with tangible assets added to enterprise goodwill to make up the marital asset.

Both the top-down and bottom-up analyses provide a less-subjective solution to allocating personal and professional goodwill than subjective allocation or MUM factors analysis; however, they have their draw-backs. They are more analytically complicated and are harder to explain to triers-of-facts than the subjective models like the MUM factors. Also, they require greater time and information to execute than the subjective models. Yet they provide a handy solution to the issues surrounding subjectivity within the MUM Factor Model. ■

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1. *In re Marriage of Zells,* 155 Ill. App. 3d at 58-59, 107 Ill. Dec. 738, 507 N.E.2d 891.
2. *Id.*
3. *In re Marriage of Talty*, 623 N.E.2d 1041, 252 Ill. App. 3d 80 (2nd Dist 1993) rev'd, 166 Ill. 2d 232, 652 N.E.2d 330, 191 Ill.Dec. 451 (1995).
4. *In re Marriage of Schneider*, 343 Ill. App. 3d 636.
5. *In re Marriage of Alexander,* 857 N.E.2d 766 (2006).