

Kentucky Supreme Court Excludes “Personal Goodwill” from Marital Estate

Prior to the Supreme Court of Kentucky’s recent decision in *Gaskill v. Robbins*, Kentucky was one of the few states that still allowed “personal goodwill” to be included as a marital asset for distribution during a divorce proceeding. In many cases, this meant that the value of a divorcing party’s business included what is generally referred to as “personal goodwill” – or the value of the divorcing party’s personal value to the business.

In what is sure to be a heavily scrutinized decision within the family law legal community, the Supreme Court of Kentucky recently established that the law of Kentucky recognizes “personal goodwill” as a non-marital asset and, thus, the value of any business to be included in the marital estate in a Kentucky divorce case will no longer include the “personal goodwill” of the divorcing party.

This new and important law arose from a divorce action involving the valuation of an oral and maxillofacial surgery practice that was operated solely by one of the divorcing parties. At trial, the valuation expert retained by the wife who owned and operated the surgery practice placed a value of zero on the business’ goodwill. By contrast, the husband’s valuation expert opined that goodwill, including Wife’s nontransferable personal goodwill, should be included in determining the value of the surgery practice.

There was no dispute that the surgery practice was a marital asset, so the primary issue addressed by the Supreme Court of Kentucky was whether the value of the surgery practice should include amounts relating to the wife’s “personal goodwill”. The Court, “[r]ecognizing that this Opinion is a departure from previous law,” held that “personal

goodwill” must be distinguished from “enterprise goodwill,” the latter representing the value of a business above and beyond its underlying tangible assets such as reputation in the community, established business relationships and the like, to the extent that it inheres in the business, independent of any single individual’s personal efforts and will outlast any person’s involvement in the business.

In its holding, the Court stated that:

The distinction between enterprise and personal goodwill has a rational basis that accepts the reality of specific business situations.

In a case such as this one, there can be little argument that the skill, personality, work ethic, reputation and relationships developed by Gaskill are hers alone and cannot be sold to a subsequent practitioner. In this manner, these attributes constitute nonmarital property that will continue with her regardless of the presence of any spouse.

To consider this highly personal value as marital would effectively attach her future earnings, to which Robbins has no claim. Further, if he or someone similarly situated were then awarded maintenance, this would amount to “double dipping” and cause a dual inequity to Gaskill...

Additionally, this type of distinction is as susceptible to expert valuation as goodwill on the whole is. If the value of goodwill can be reasonably determined at all, the amount of enterprise goodwill, which is all that can be considered as marital property, can be determined.

The question on most family law practitioners’ and business valuers’ minds is exactly what methodology is to be used to allocate personal goodwill and enterprise goodwill from the whole goodwill value, a value that already is intangible and subjective. Knowing that Kentucky is following the modern trend of not including personal goodwill in the divisible marital estate would lead one to believe that there is precedent from other states for the methodology to be applied in allocating personal and enterprise goodwill. However, despite

the length of time that other states have had to develop such an acceptable methodology, no particular methodology has prevailed.

The valuation of personal goodwill and enterprise goodwill is also not well-settled in the professional valuation community. This is due, in part, to the fact that the distinction between personal goodwill and enterprise goodwill primarily arises in divorce cases. As such, the underlying applicability of the concept varies greatly depending on the jurisdiction. As the *Gaskill* court noted, there remain a minority of states that make no distinction between personal and enterprise goodwill. For example, the Supreme Court of Mississippi found personal and enterprise goodwill so intertwined as to be indivisible, thus further prompting that Court to exclude the entirety of goodwill from business valuations. Furthermore, the standard of value can vary depending on the law of the state in which the divorce action has been filed (*e.g.*, fair value versus fair market value; unwilling seller versus willing seller, etc.) Suffice it to say that family law, by its very nature, constitutes a unique forum in which valuation methodologies are applied, making universally accepted valuation approaches for determining personal versus enterprise goodwill more difficult to achieve. Moreover, it is not surprising that a dominant standard has yet to develop, as the very concept of goodwill is so intangible that its valuation, including a valuation of its parts, is necessarily somewhat dependent on the perspective of the valuator.

There is one common thread running through the opinions of those states that do distinguish between enterprise and personal goodwill and exclude the latter from the valuation: no matter how difficult it may be to determine the value of enterprise goodwill, the valuation must be done, even if the resulting value is zero.

Some states, while not promoting any one approach as correct, have still determined that there is a high burden of proof attached to establishing the value of personal and enterprise goodwill. In Arkansas, the proponent of finding enterprise goodwill in the practice must prove its salability as a business asset of a professional practice, and must provide convincing proof delineating between personal and enterprise goodwill. It remains to be seen whether Kentucky will develop such a high standard of proof for allocation of goodwill in valuations, but if that is where we are headed, how can such a standard be accomplished?

There are certain aspects relating to this issue that are susceptible to description and relative agreement, such as identification of characteristics that help to differentiate personal goodwill from enterprise goodwill. The following represent some of the more common business characteristics that valuation experts consider when addressing this issue:

Personal Goodwill

Lacks transferability
Specialized knowledge
Personalized name
In-bound referrals
Personal reputation
Personal staff
Age, heal, and work habits
Knowledge of end user

Enterprise Goodwill

Number of offices
Business location
Multiple service providers
Enterprise staff
Systems
Years in business
Out-bound referrals
Marketing

Distinguishing personal goodwill from enterprise goodwill is dependent on the nature of the entity being valued and the characteristics thereof, some of which are identified above.

As stated by Mr. Jay Fishman, FASA, CBA in *Business Valuation Resource's Guide to Personal v. Enterprise Goodwill* (2009):

Determining the existence of goodwill and distinguishing within that goodwill between personal and enterprise goodwill is fact sensitive. Ultimately, the

allocation of goodwill between personal and enterprise is driven by the degree to which the success or failure of the business depends upon the individual's personal services.

At the intersection of “fact-sensitive” and “subjective,” it would appear that a uniform methodology for these valuations might be impossible. But what if a valuator were able to use a mathematical formula to break down his subjective opinion of personal goodwill value? In 2006, an Illinois court approved of such a methodology wherein the valuator used the multiattribute utility model (“MUM”) to allocate between personal and business goodwill. In 2003, Mr. David N. Wood, CPA/ABV, developed MUM for use in valuing personal/enterprise goodwill by essentially adapting a method that had been applied in other disciplines such as economics, political science and scientific inquiry. Mr. Wood employed this approach in order to make a “precise decision from imprecise and subjective criteria.” This approach enables the valuator to allocate goodwill into enterprise and personal goodwill by incorporating subjectively determined factors into a mathematical formula. After using the suggested formula, the valuator must then review the result to make sure that certain factors are not “driving the results,” another subjective determination. When applied correctly and consistently, the MUM method offers the dual attractiveness of an understandable and repeatable approach. There is no implication that the approach will make the valuation completely objective. However, it does provide a way to break down and explain the allocation of personal goodwill and enterprise goodwill in a way that will provide some credibility to the valuation for the court. In that way, the MUM method appears to stand alone. Regardless of whether Kentucky adopts the MUM method or some other method of allocating personal and enterprise goodwill, an approved uniform method will assist family

law practitioners and their clients and business valuers by providing a foundation for the business valuers opinions, in a way that can be explained and understood.

In conclusion, the *Gaskill* decision will require counsel and valuation experts to develop acceptable methods for identifying and quantifying the personal and enterprise goodwill value of entities at issue in Kentucky divorce actions. While the valuation and accounting issues involved are not resolved at this point in time, the valuation community will continue to develop methodologies to address this challenge.

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