

Is Ohio Ready to Join the Majority of States in Bifurcating Goodwill in Divorce Proceedings?

J. Michael Nesser, JD, CPA/ABV, CFE

Introduction

O.R.C. 3105.171 (B) provides that, in divorce proceedings, the court shall determine what constitutes marital property and what constitutes separate property of the parties. In either case, upon making such a determination, the court must then divide the marital and separate property equitably between the spouses.

An ownership interest in a professional practice or other closely-held business is often the most significant asset of the parties to a divorce proceeding. In many cases, goodwill is the most significant component comprising the value of a professional practice or other closely-held business. Goodwill has been defined as “a business’s reputation, patronage, and other intangible assets that are considered when appraising the business, especially for purchase; the ability to earn income in excess of the income that would be expected from the business viewed as a mere collection of assets.”¹ A more elegant definition comes from Lord Eldon, who described goodwill as “the probability that the customers will resort to the old place.”² In the context of a marital dissolution, a classic definition was quoted by the court in the Indiana case of Yonn v. Yonn.³ In that case, the court defined goodwill as the expectation of continued public patronage.

A challenging issue for domestic relations courts and valuation professionals is whether goodwill should be bifurcated between personal and enterprise goodwill, and how any such bifurcation should be computed/quantified. Personal goodwill can be defined as the goodwill associated primarily with

¹ Black’s Law Dictionary, 8th Edition, Thomson West, 2004, page 715.

² Crutwell v. Lye, 3 Eng. Rep. 129, 134 (1810).

³ 687 N.E. 2d 201, 1997 Ind. At LEXIS 1532 (Ind. Ct. App. (October 21, 1997)).

an individual, and in most states it is treated as non-marital, or separate property.⁴ Enterprise goodwill can be defined as the goodwill associated primarily with the enterprise or institution, and in most states it is treated as marital property to be divided between the parties.⁵ As outlined below, the valuation profession has developed various approaches for bifurcating goodwill, and the bifurcation of goodwill between enterprise and personal goodwill is now widely accepted among valuation professionals. Nonetheless, as of the date of this writing, the Supreme Court of Ohio has yet to decide how goodwill should be treated in a divorce proceeding.

The Majority Position in Most States is to Bifurcate Goodwill

As noted in a University of Dayton Law Review article authored by Kelly Schroeder, the treatment of goodwill in divorce proceedings has been debated among the jurisdictions, both within and outside of Ohio, over the past twenty-five years.⁶ Although several Ohio appellate courts have been hesitant to accept the argument for bifurcation of goodwill into enterprise and personal goodwill, some Ohio appellate courts have held that the goodwill of a professional practice or closely held business, attributable to the continued presence of the business owner, should not be subject to equitable distribution pursuant to a divorce proceeding.⁷ Ms. Schroeder's article surveys the law among the states regarding the treatment of goodwill in divorce proceedings, and advocates the majority position which bifurcates goodwill into enterprise and personal goodwill. The Conclusion to the law review article reads as follows:

“The Supreme Court of Ohio may soon face the issue of how to allocate goodwill in a divorce proceeding. When confronted with the issue, the Supreme Court of Ohio should step in line with the majority of states and hold that goodwill should be divided between enterprise and personal goodwill based upon the facts of each

⁴ See “Fair and Equitable Distribution of Goodwill in an Ohio Divorce Proceeding.” University of Dayton Law Review, Vol. 31: 1, pp. 81-100.

⁵ Ibid.

⁶ Ibid.

⁷ Ibid, page 82.

case and upon accepted accounting methodologies. This treatment of goodwill has proven to be a successful approach that delivers equitable results in twenty-five states. Moreover, such Ohio appellate cases as *Flexman*, *Young*, and *Arena* represent the Ohio appellate courts' willingness to adopt the majority position regarding the division of enterprise and personal goodwill in a divorce proceeding. This author sincerely urges the Supreme Court of Ohio to approve of this trend and adopt the majority approach which complies with the statutory requirement that property be distributed in a fair and equitable manner.”⁸

Many professional service businesses and other closely-held businesses are essentially “one or two person operations.” Especially in such cases, the specific facts and circumstances often provide a compelling case for a domestic relations court to bifurcate the goodwill value associated with the business operation between personal and enterprise goodwill.

Bifurcation of Goodwill Between Enterprise and Personal Goodwill is Now Widely Accepted within the Valuation Profession

During the 2008 joint AICPA/ASA National Business Valuation Conference in Las Vegas on November 10, 2008, Jay Fishman, FASA, made a presentation titled “Personal Goodwill v. Enterprise Goodwill.”⁹ Mr. Fishman is among the most well known and accomplished business valuation practitioners in the country. Mr Fishman’s presentation materials include references to various professional literature and case law relating to the bifurcation of goodwill between enterprise and personal goodwill. For example, the Presentation materials contain the following from the Florida case of Williams v. Williams:

“ . . . the goodwill of (a) professional practice can be a marital asset subject to division in a dissolution proceeding, if it exists and was developed during the

⁸ Ibid, page 100.

⁹ AICPA is the American Institute of Certified Public Accountants, which issues a business valuation certification known as an ABV (Accredited in Business Valuation). The ASA is the American Society of Appraisers.

marriage . . . However, **for goodwill to be a marital asset, it must exist separate and apart from the reputation and continued presence of the marital litigant.**¹⁰
(Emphasis supplied).

With respect to the identification and quantification of personal and enterprise goodwill, Mr. Fishman's presentation materials include a discussion of the California case of In re Marriage of Lopez, in which the court suggested several factors to be considered in quantifying personal goodwill.¹¹ The court in Lopez noted that common attributes associated with personal goodwill include skill, knowledge, reputation, personality, and business relationships. Mr. Fishman expresses his view that the issue ultimately revolves around the institutionalization of the individual's reputation and relationships. He states:

“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.”¹²

The Multiattribute Utility Model (“MUM”) is Recognized in the Valuation Profession as a Useful Methodology for Bifurcating Goodwill Between Enterprise and Personal Goodwill and Has Been Accepted in Court

Although a full discussion of the methods and analyses the courts have accepted for bifurcating goodwill is beyond the scope of this article, one of the methodologies now being widely discussed by valuation professionals is known as the Multiattribute Utility Model (“MUM”). Mr. Fishman describes the history of the use of the MUM for this purpose:

¹⁰ Williams v. Williams, 667 So. 2d 915, 1996 Fla., App. Lexis 864 (FLA Ct. App.).

¹¹ In re Marriage of Lopez, 113 Cal. Rptr. 58, 38 Cal. App. 3d 1044 (1974).

¹² Fishman presentation materials, page 13-18.

“In 2003 David Wood, CPA/ABV took a method that was developed to aid in the restoration in highly contaminated aquatic ecosystems in some countries of the former Soviet Union and applied it to separating personal from enterprise goodwill. MUM or the Multiattribute Utility Theory is a form of decision analysis concerned with multiple conflicting objectives for complex, real world decision-making problems. In this method “professional judgments are used to quantify the likelihoods of a range of consequences while utility theory is used to quantify preferences.”¹³

The MUM methodology for bifurcating goodwill in a divorce proceeding has been accepted by the Fifth District Appellate Court in Illinois.¹⁴

Finally, Mr. Fishman’s presentation materials include a state-by-state summary of “the leading U.S. court cases deciding the disposition of goodwill in marital dissolutions.”¹⁵ **The summary indicates that in the majority of the states, the “leading cases” hold that personal goodwill is not marital property.** Interestingly, the summary lists Kahn v. Kahn as the “leading case” in Ohio, and states that it stands for the position that both personal and enterprise goodwill in a professional practice are marital property.¹⁶

A Brief Discussion of Ohio Case Law Regarding Goodwill

Kahn is a 1987 decision from the 2nd District Court of Appeals for Montgomery County. It is important to note that **the specific issue of bifurcation of personal vs. enterprise goodwill was not before the court in Kahn.** The goodwill issue in that case was a more basic question: whether or not goodwill could be a component of value in a professional practice. The Kahn court noted:

¹³ Fishman presentation materials, page 13-22.

¹⁴ In re Marriage of Alexander 2006 Ill. App. LEXIS 836 (September 7, 2006).

¹⁵ Fishman presentation materials, pages 13-25 to 13-30.

¹⁶ Kahn v. Kahn, 536 N.E. 2d 678 (Ohio App. 2d. Dist.1987).

“The Ohio Supreme Court has not addressed the issue of goodwill in valuing professional practices in divorce proceedings. However, the Ohio Supreme Court addressed the goodwill issue with regard to the dissolution of professional practices when it overturned this appellate court in *Spayd v. Turner, Granzow & Hollenkamp* (1985), 19 Ohio St. 3d 55, 19 OBR 54, 482 N.E.2d 1232. **The new Spayd decision brings Ohio in line with the majority of states which recognize goodwill in valuing professional practices.**” (Emphasis supplied).

When the issue comes before the Supreme Court of Ohio, **a finding by the court that personal goodwill is a non-marital asset would be in line with the majority of the states which recognize that goodwill may be bifurcated, based upon the specific facts and circumstances of each case, and that personal goodwill is not marital property.**

Furthermore, as mentioned above, some Ohio appellate courts have held that the goodwill of a professional practice or closely held business which is attributable to the continued presence of the owner-spouse, should not be subject to equitable distribution pursuant to a divorce proceeding.¹⁷ The University of Dayton Law Review article cites, for example, *Arena v. Arena*, a 1995 decision from the Ohio Appellate 10th District (appeal from the Franklin County Court of Common Pleas, Division of Domestic Relations) as one of those cases.¹⁸

The *Arena* decision notes that O.R.C. “3105.171, which authorizes the court to divide the marital property equitably between the parties ‘prescribes no specific method of valuation for the court to follow’,” and concludes “there was credible testimony upon which the trial court could have determined that defendant’s produce business had no goodwill value apart from defendant’s continued presence.”¹⁹ Accordingly, the precedent in the 10th Appellate District appears to recognize

¹⁷ See “Fair and Equitable Distribution of Goodwill in an Ohio Divorce Proceeding.” University of Dayton Law Review, Vol. 31: 1, page 82.

¹⁸ Ibid.

¹⁹ *Arena v. Arena*, 1995 Ohio App. LEXIS 4261(Ohio App. 10th Dist. Sept. 29, 1995).

the existence of personal goodwill, and further holds that, based on the facts and circumstances in the Arena case, such personal goodwill did not constitute marital property.

Bunkers v. Bunkers, a February, 2007 decision of the 6th District Court of Appeals of Ohio, Wood County, takes a contrary position. As reported in an April, 2007 Business Valuation Update article titled “Ohio Considers Joining the Majority View,” the majority of U.S. jurisdictions now distinguish enterprise from personal goodwill in divorce actions.²⁰ The article states, however “the Ohio Court of Appeals declined, relying on ‘thorough’ precedent that determined that all goodwill of a solo practitioner was subject to equitable division in divorce - and rejected the argument that ‘goodwill is synonymous with future earnings’ (where the court also awards spousal support); or that by valuing it, a court is improperly valuing a medical degree.”²¹

The court in Bunkers noted that “the parties do agree that the Supreme Court of Ohio has not, in relation to the division of marital assets upon divorce, determined whether personal goodwill is a divisible asset.” The “precedent” discussed by the Bunkers court however, appears to consist only of a prior decision by that same court, and the 1987 Kahn case, which, as noted above, **was not presented with the issue of bifurcation of goodwill between personal and enterprise goodwill.**

A Brief Discussion of Certain Factors Which May Support a Bifurcation of Goodwill Between Personal and Enterprise Goodwill, Based Upon the Facts and Circumstances of Each Case

There can be a number of competing factors at play when considering a bifurcation of goodwill between personal and enterprise goodwill. On one hand, many professional practices and closely-held businesses have a reputation, book of business, customer following, or other intangible assets that have been developed wholly, or in-part, during the course of a marriage. On the other hand, in a number of cases, many, or even most, of the business enterprise’s customers, and in some cases even its employees, would leave the business if one or more of its key owner/operators simply left the business and started a competing business elsewhere. As described above, the MUM approach

²⁰ Business Valuation Update is a monthly periodical widely used in the valuation profession.

²¹ Business Valuation Update, April, 2007, Delux BVUpdate, www.BVLibrary.com.

to bifurcating goodwill is one of the methodologies that has been accepted in the valuation profession and in court. Other methods can also be useful. For example, some valuation professionals have approached the personal/enterprise goodwill issue by analogy to the majority view that the value of a non-compete agreement of the owner/operator of a business is personal, and thus is not a marital asset.²²

Summary

There can be compelling reasons for domestic relations courts to find that the goodwill of a personal services business or other closely-held business should be bifurcated between personal and enterprise goodwill. Although the Supreme Court of Ohio has not yet addressed the issue of bifurcation of goodwill, **the majority of the states recognize that goodwill may be bifurcated, based upon the specific facts and circumstances of each case, and that personal goodwill is not marital property.** Among the methodologies for bifurcating goodwill between personal and enterprise goodwill, the MUM approach has been accepted in the valuation profession and in court.

J. Michael Nesser, JD, CPA/ABV, CFE is the Managing Director of Nesser Consulting Group, Ltd, a Columbus CPA firm that provides primarily litigation consulting, business valuation, and expert testimony services.

²² In Valuing A Business: The Analysis and Appraisal of Closely-Held Companies, Fifth Edition, McGraw Hill (2008), a treatise authored by Shannon P. Pratt., CFA, FASA, MCBA, MCBC. CM & AA, the author notes that several of the states have held that noncompete agreements represent a part of personal Goodwill, since a covenant not-to-compete is attributable to the personal reputation of the seller/spouse and not to the enterprise goodwill of the business. As noted on page 990 of the text, most, but not all, states that have addressed the issue conclude that a noncompete covenant is separate property, not a marital asset, since it restricts the future activities of the spouse. Footnote 123 on page 991 of the text includes a reference to Ohio law: “*Hoelt v. Hoelt*, 74 Ohio App. 3d 809, 600 N.E. 2d 746 (Ohio Ct. App. 1991) (court determined that while proceeds received from the sale of the husband’s dental practice were marital property, monies received from a covenant not to compete were nonmarital).”