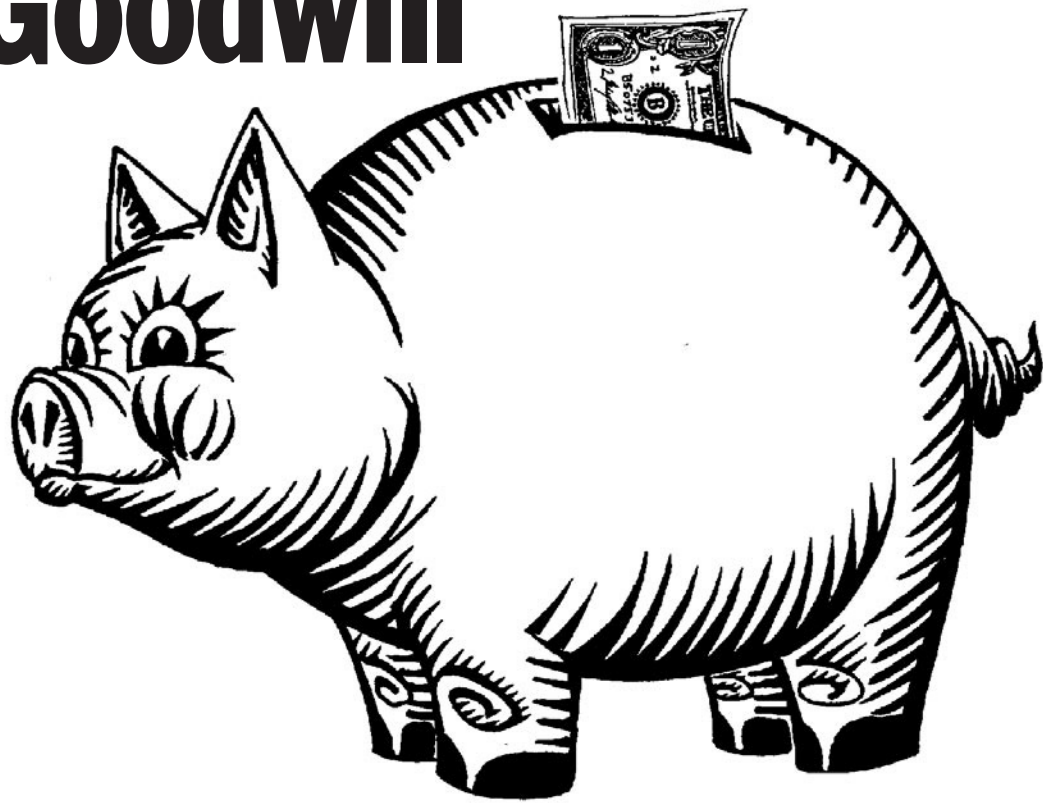


## Family Law

# Valuing Goodwill



By Mitchell A. Jacobs and Robert Burch

The valuation of the goodwill of a community business is one of the key decisions a divorce court can make in dividing assets between spouses. In the past couple years, the appellate courts have weighed in several times on the issue, most recently with *In re Marriage of Ackerman*, 2006 DJDAR 16935 (Dec. 27). The *Ackerman* court approved the use of national compensation surveys to determine the appropriate capitalization amount of a business' earnings to value the business' goodwill.

In *Ackerman*, the husband was a plastic surgeon who ran a sole proprietorship in Newport Beach. On divorce, the parties litigated the value of the business's goodwill. Each party's forensic accountants determined goodwill by capitalizing the difference between the husband's earnings and the reasonable compensation of the husband's peers.

The main difference in the testimony was over the method to use in determining the reasonable compensation of the husband's peers. The trial court used the husband's expert's methodology as a "curbstone," then applied its own "quality control" and "common-sense view." The result was a ruling that was more favorable to the husband than the valuation advanced by the husband's own expert. The wife appealed.

The appellate court noted that no rigid rule applies for determining the value of goodwill. Rather, it may be measured by any legitimate method that measures its present value by taking into account some past result. The court stated that one recognized valuation method was the capitalization-of-excess-earnings method, which was used by both parties' experts in this case.

The basis for the excess-earnings method is a comparison of the earnings of the professional in question with the reasonable compensation of a peer whose performance is average. The court discussed two methods to determine such "reasonable compensation." First, courts can look to the average compensation of a typical salaried employee with similar experience to the spouse in question. Alternatively, courts

may apply the "similarly situated professional" standard, under which reasonable compensation is based on the cost of hiring a nonowner outsider to perform the same average amount that other people are normally compensated for performing similar services.

The court found that professional compensation surveys, although not binding, may be used as guidelines to determine reasonable compensation.

**The focus of a valuation survey should be how the data is related to the business that is being valued.**

In *Ackerman*, each side's expert relied on different surveys and arrived at different figures for the reasonable compensation of similarly situated professionals. The wife's expert used a survey that breaks down statistics by region, specialty and years in practice.

The husband's expert based his opinion on a national study by a different organization, which used the statistical data to calculate the total revenue and professional expenses for self-employed surgeons and the net income of self-employed surgeons, then calculated the net income as a percentage of the total revenue. As "a sanity check," he took the husband's "net income as a percentage of the total revenue" and applied it to the husband's gross revenue in order to calculate what reasonable compensation would be as a percentage of his gross revenue.

At the court's request, the husband's expert also provided a rebuttal to the wife's report and included the results of his own personal survey of plastic surgeons in the Newport Beach area. Although the local survey was admittedly limited, the husband's expert used it to show that the husband generated almost the average amount of revenue of his similarly situated peers.

The trial court found problems with both experts' surveys. For the wife's survey, the court was troubled by what a national survey of surgeons in the western states had to do with a Newport Beach plastic surgeon, because cosmetic surgery uses discretionary income, which varies by region.

The court was also unimpressed with the husband's expert's survey but found it more sound than the wife's because the expert related the statistical data to the hus-

band's practice area by conducting his own survey of Newport Beach surgeons. However, the court used the husband's expert's methodology only as a "curbstone." To reach its conclusion on reasonable compensation, the court applied its "own quality control" and "common-sense view" of the husband's track record.

The appellate court upheld the trial court's unique approach, holding that, in establishing goodwill value, opinion evidence is admissible but is not conclusive and that courts also may consider evidence such as the owner's talent, training, expertise, reputation and the actual business situation. The trial court did just that by using the husband's expert's methodology, then applying to this methodology evidence introduced regarding the husband's specific talents and business situation.

The court addressed the wife's argument that the trial court erred in relying on a national survey to determine reasonable compensation because the court in *Rosen* had disapproved of the use of such surveys. The wife's expert in that case had relied on a national survey of lawyer compensation to determine reasonable compensation for the husband, who was a sole practitioner. The court faulted the use of the survey because there was no showing that the national figures were commensurate with those in Southern California and because the survey did not distinguish among types of law practices.

The *Ackerman* court distinguished the *Rosen* decision by noting that the husband's expert had related the information in the national survey to the husband's business and practice area by supplementing the national survey with his own survey of Newport Beach surgeons.

The *Ackerman* decision is significant because it makes clear that, in determining goodwill, the focus of a family law attorney's analysis should not be whether the survey used to establish reasonable compensation is local, regional or national. Instead, the focus should be how the data in the survey is related to the business that is being valued.

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