Does My Business Have "Goodwill" For Divorce Purposes?

January 30, 2014 | by Cimmerian Morgan

I am the sole proprietor of a business which provides services. If I were to leave the business, the business would undoubtedly die because it is entirely dependent on me. Does this mean that my business has no goodwill? How is “goodwill” determined?

By way of preface, remember from my prior Ask the Attorney column that in the context of a divorce, the object of business valuations is not to determine the “fair market value” of the company. Rather, the object is to determine the “fair value.” To refresh your memory, “Fair market value” can be defined as the amount at which property would be sold between a willing buyer and a willing seller, each having reasonable knowledge of the relevant facts, and neither being under any compulsion to buy or sell. The “fair market value” method permits discounting of value for lack of marketability (inability to attract potential buyers) and lack of control (inability to dictate the operations or decisions of the company), otherwise known as minority discounting.

The critical difference between the “fair market value” method and the “fair value” method is that the latter does not discount for lack of marketability or lack of control when valuing a closely held business.

In other words, the value that your closely held business may or may not command on the open market is not the ultimate consideration in determining its value in the context of a divorce.   The relevant value of your business is its value to the marriage, not to a hypothetical third party buyer.

When determining the value of a service business to the marriage, forensic accountants seek to quantify the business’ goodwill, which is a component of a valuation method known as the Capitalization of Earnings Method. This method capitalizes a stabilized economic benefit stream at an appropriate rate of return.

In general terms, the goodwill of a business is the difference between the actual economic benefit derived by the owner of the business and the cost of replacing that owner with someone to perform the owner's identical job functions (otherwise known as "replacement compensation"). For example, if the economic benefit derived by the owner is $500,000 per year, and it would cost $300,000 per year to hire someone to replace the job duties of the owner, then the goodwill is $200,000 per year. After "normalizing" other economic benefits to determine the actual economic benefit stream of the business, a forensic accountant then determines the value of the company by multiplying the economic benefit stream by a capitalization rate, which takes into consideration various risk factors.

To apply the foregoing explanations to your specific questions, the fact that your business may not survive without you is irrelevant to the question of whether your business has a value which would be subject to equitable distribution with your spouse. Again, the focus is not whether you could sell your business to a hypothetical third-party value. The focus is the economic benefit of your business to the marriage, and implicit in that focus is the assumption that you will continue to own and operate your business.

As to the amount of goodwill associated with your business, you should consider the amount it would cost to hire someone to replace your job functions and the extent to which that cost is less (or perhaps more) than the totality of the economic benefit which you derive from your business.

It is critical for any business owner, or any spouse of a business owner, who intends to seek a divorce to develop an understanding of these concepts and the relevant valuation approaches and methodologies. To develop such an understanding, it is important to retain an attorney who is both familiar with the extensive body of case law related to equitable distribution of business interests and experienced in litigating cases where business valuations are at issue.