

Valuing Professional Goodwill In re Marriage of Ackerman

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An ongoing debate in the valuation community is how to identify and value professional goodwill. These debates stem from and lead to significant court cases where the issue is placed before a judge to decide. In January, 2007 a significant case was decided by the California Court of Appeals and the results of the case have attracted national attention. It has become known as "The Ackerman Decision." (California Court of Appeal, 4 Civil G034582, G034259, 146 Cal.App.4th 191, 52 Cal.Rptr.3d 744) Contrary to previous court decisions in California, and other states, the courts did not question whether professional goodwill existed. By virtue of that alone, this was an important case establishing – or reaffirming – that professional goodwill is a factor in the valuation of professional practices.

Beyond that, the relevance of this case is the method the court used to value the goodwill. Boris (plastic surgeon) and Ann Ackerman were married in 1991. Before they were married a prenuptial agreement was signed placing a value on Boris' medical practice of \$162,000. The agreement stated that any increase in value would be community property and that, in the event of divorce, a forensic accountant would be hired to place a value on the business. The couple separated in 2001. Among the issues litigated as a result of the divorce was the valuation of the practice.

When valuing a professional practice there are two key elements. The first is profit as in any other business. The second is goodwill. This factor is unique in family court since there are parallel calculations being done: income for the purpose of establishing support and income for the purpose of establishing the value of an asset. The greatest concern is that the same income is not used for both purposes – double dipping. In Ackerman, the court adopted the capitalization of excess earnings method. In simple terms, this method requires that the earnings from a business are capitalized only to the extent that the earnings exceed the earning power of the professional. For example, if the medical practice for a doctor generates \$350,000 annual income and the earning power of the doctor in another place of employment is \$275,000, then only \$75,000 is capitalized to determine the value of a business.

This scenario, then, makes the analysis of earning power and/or reasonable compensation a central issue. The wife's expert opined that reasonable compensation was from \$291,000 to \$355,000. The husband's expert opined that reasonable compensation was \$551,000. In effect, the wife's expert was saying that more of the income was due to the goodwill value of the practice and the husband's expert was saying that the income was due more to the personal efforts of the husband.

The court decided that the reasonable compensation amount was \$544,000. The final result was in the husband's favor – there was minimal value to the practice outside the personal goodwill of Mr. Ackerman.

Several other issues were decided by the court in the Ackerman case but from a valuation standpoint several points were reinforced as it relates to valuation of professional practices:

- One of the experts based reasonable compensation conclusions on "regional" studies. The court was astute enough to identify that a survey of the western states will produce

a low result when analyzing the income of a doctor in a high-income wealthy area such as where Dr. Ackerman practiced.

- One of the experts based his reasonable compensation opinion on, among other sources, personal interviews with plastic surgeons in the immediate geographical area. While this seems to be a reasonable approach, the court disregarded it.
- Once again a court has established that value is based on historical earnings not projected earnings. While this is contrary to how business is valued in virtually every other venue, it seems to be the law of the land in family courts around the country.
- The value of the professional goodwill continues to be linked to the earning power (reasonable compensation) of the individual doctor. The remaining income generated by the business is then relevant to determine the goodwill value of the business.
- The value of a well written prenuptial agreement is highlighted once again. Establishing, in advance, the method and procedure of valuation in the pre-nuptial could have saved both sides a lot of legal fees.

Involving valuation professionals “up-front” in pre-nuptial or buy-sell agreements is a smart way to reduce conflict, uncertainty, and expense at the “back end” when everyone is already unhappy.

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