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## Community Property - Valuation of Professional Goodwill

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COMMUNITY PROPERTY—VALUATION OF PROFESSIONAL  
GOODWILL. *Hurley v. Hurley*, 94 N.M. 641, 615 P.2d 256 (1980).

In *Hurley v. Hurley*,<sup>1</sup> the New Mexico Supreme Court held that the goodwill of a professional practice should be considered in valuing the practice as a community asset upon the dissolution of a marriage. This was an issue of first impression in New Mexico and, as in many New Mexico community property cases, the court adopted the rule established in California.<sup>2</sup> While adopting the position that goodwill in a professional practice should be considered in valuing community assets, the court set no clear guidelines for a method of valuing goodwill. This Note will address two issues: 1) whether goodwill in a professional practice should be considered in valuing community assets upon the dissolution of a marriage; and 2) if so, the problems which arise in valuing goodwill.

I. STATEMENT OF THE CASE

In December, 1977, Dr. Hurley, an orthopedic surgeon<sup>3</sup> in Albuquerque, filed suit for divorce in the District Court of Bernalillo County.<sup>4</sup> One of the issues in the case was the valuation of the community's interest in Schultz & Hurley, P.A., a professional medical association.<sup>5</sup> The Hurleys had married in 1953 while Dr. Hurley was an intern.<sup>6</sup> At the time of divorce, Dr. Hurley owned 1,000 shares of

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1. 94 N.M. 641, 615 P.2d 256 (1980).

2. California was the first state to rule that the goodwill of a professional practice should be considered in valuing the practice for the purpose of dividing community assets upon the dissolution of a marriage. See *Mueller v. Mueller*, 144 Cal. App. 2d 245, 301 P.2d 90 (Dist. Ct. App. 1956). See also *In re Marriage of Slater*, 100 Cal. App. 3d 241, 160 Cal. Rptr. 686 (Ct. App. 1979); *In re Marriage of Foster*, 42 Cal. App. 3d 577, 117 Cal. Rptr. 49 (Ct. App. 1974); *In re Marriage of Lopez*, 38 Cal. App. 3d 93, 113 Cal. Rptr. 58 (Ct. App. (1974)); *In re Marriage of Fortier*, 34 Cal. App. 3d 384, 109 Cal. Rptr. 915 (Ct. App. 1973); *Golden v. Golden*, 270 Cal. App. 2d 401, 75 Cal. Rptr. 735 (Ct. App. 1969); *Todd v. Todd*, 272 Cal. App. 2d 876, 78 Cal. Rptr. 131 (Ct. App. 1969); *Brawman v. Brawman*, 199 Cal. App. 2d 876, 19 Cal. Rptr. 106 (Dist. Ct. App. 1962).

3. Transcript of Record on Appeal, vol. 3, at 692, *Hurley v. Hurley* [hereinafter cited as Record]. The Record is on file at the University of New Mexico Law Library.

4. *Hurley v. Hurley*, 94 N.M. at 643, 615 P.2d at 258.

5. Other issues raised on appeal were: 1) the community's interest in Dr. Hurley's retirement plan; 2) the disposition of property and debt acquired by Dr. Hurley without his wife's knowledge the day before the filing of the petition for divorce; 3) whether forbearance from prosecution of a divorce action can be consideration for a contract; 4) the amount of alimony; and 5) the amount of attorney's fees to be awarded Mrs. Hurley.

6. Record, *supra* note 3, vol. 3, at 694.

Schultz & Hurley, P.A.<sup>7</sup> and was a partner in Encino X-Ray and Therapy.<sup>8</sup>

At trial, each party presented an expert witness who testified to the value of the goodwill in Schultz & Hurley, P.A. Dr. Gary Libecap,<sup>9</sup> an assistant professor of economics at the University of New Mexico, testified on behalf of Dr. Hurley.<sup>10</sup> Dr. Libecap took a market-value approach to the valuation of goodwill. He testified that there was not a saturated market for orthopedic surgeons in Albuquerque and that a doctor could establish a paying orthopedic practice in Albuquerque within one to two years. Based on these facts and on discussions with orthopedic surgeons who had recently moved to Albuquerque, Dr. Libecap concluded that the goodwill of Schultz & Hurley, P.A. was not salable, and thus had no market value.

Raymond Zimmer, a certified public accountant, testified on behalf of Mrs. Hurley.<sup>11</sup> Mr. Zimmer used a "capitalization of excess earnings" approach to determine that the value of the community's interest in the combined practice of Schultz & Hurley, P.A. and Encino X-Ray and Therapy equaled \$190,735.

The trial court stated in its Findings of Fact that there was no goodwill in Schultz & Hurley, P.A.<sup>12</sup> On appeal, the supreme court reversed, ruling that the fact that the goodwill is not salable is not dispositive and that "capitalization of excess earning" is a legitimate, although not the exclusive, method of valuing goodwill in a professional association.<sup>13</sup>

## II. SHOULD GOODWILL IN A PROFESSIONAL PRACTICE BE CONSIDERED A COMMUNITY ASSET UPON DISSOLUTION OF A MARRIAGE?

New Mexico defines community property as all property acquired during marriage by either or both spouses, except: a) property acquired by either spouse by gift, bequest, devise, or descent; b) property designated as separate property by written agreement between the spouses; c) each spouse's undivided interest in property held by the spouses as cotenants; and d) property declared separate by judicial decree.<sup>14</sup> Upon divorce, community property is to be divided

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7. Record, *supra* note 3, vol. 3, at 693.

8. Record, *supra* note 3, vol. 3, at 697.

9. Dr. Libecap's name is misspelled "Lybecap" in the court opinion and in the Record.

10. This testimony is contained in the Record, *supra* note 3, vol. 3, at 924-966.

11. Record, *supra* note 3, vol. 3, at 967-997.

12. Record, *supra* note 3, vol. 3, at 334.

13. 94 N.M. at 644, 615 P.2d at 259.

14. N.M. Stat. Ann. § 40-3-8 (1978).

equally between the parties<sup>15</sup> without consideration of potential or continuing income.<sup>16</sup>

The issue of whether goodwill in a professional practice should be considered in the division of assets upon the dissolution of a marriage presents both legal and policy questions. Legal questions arise because some definitions of goodwill necessarily implicate potential or future income. In addition, it is difficult to determine a method of valuing goodwill, and different methods lead to widely disparate results. Policy questions arise because goodwill is a non-liquid asset in the professional practice. If goodwill is considered a community asset, the award of goodwill to the professional must be offset by an award of liquid assets to the spouse. This may result in stripping the professional of all liquid assets. However, if the goodwill of the professional practice is not considered, the division of community property may seem inequitable to the professional's spouse since a professional practice may have little value if only its tangible assets are considered. For these reasons, it is important that the courts develop a carefully reasoned definition of goodwill in a professional practice and narrowly define the appropriate methods of valuing that goodwill.

#### A. What is Goodwill?

The court in *Hurley* did not define goodwill. It relied on the case of *Durio v. Johnson*<sup>17</sup> for the proposition that goodwill can exist in a professional practice. *Durio*, however, discusses goodwill only in the context of a sale. It does not address the problem confronted in *Hurley* of whether goodwill in a professional practice exists and has value in the absence of its being salable.

The concept of goodwill arose in the context of commercial businesses to account for the value of a business which exceeds the combined value of its tangible assets. In accounting, there are two basic theories of goodwill. The first defines "goodwill" as a means of measuring the overall value of undervalued or unrecorded assets. Under this theory, goodwill arises from the difference between the accounting value of an asset and its economic value. Such intangible factors as a favorable line of credit, dependable suppliers, loyal customers,

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15. *Sands v. Sands*, 48 N.M. 458, 152 P.2d 399 (1944).

16. 94 N.M. at 644, 615 P.2d at 259.

17. 68 N.M. 82, 358 P.2d 703 (1961). In *Durio* the court held that goodwill was adequate consideration for the purchase price in the sale of a veterinary practice. The sale was accompanied by a covenant not to compete. The court did not equate the covenant not to compete with goodwill but its existence is a factor to consider. Compare *Durio* with *Lucas v. Lucas*, 95 N.M. 282, 621 P.2d 500 (1980), in which the court held that proceeds from the sale of a covenant not to compete were not community property (distinguishing *Hurley*).

etc., which do not show up on the balance sheet, are subsumed under goodwill.<sup>18</sup> The second accounting theory of goodwill is the going-value theory. This is basically a synergic concept, recognizing the value of organization. Under this theory, goodwill represents the value of the assets working together in excess of the aggregate value of the separate assets.<sup>19</sup>

The early legal concept of goodwill adopted the unrecorded-undervalued asset theory. Lord Eldon defined "goodwill" as "the probability that old customers will resort to the old place of business."<sup>20</sup> Justice Story, in his treatise on partnerships, defined goodwill as:

the advantage or benefit which is acquired by an establishment beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.<sup>21</sup>

In a commercial business, goodwill is marketable under either theory. A purchaser of a going concern will acquire the undervalued-unrecorded assets in the business as of the time of purchase. Because of the retention of the name associated with the business, a purchaser will acquire the benefit of previous advertising and the benefit of the reputation established by his predecessor. As long as the business remains in the same location, the purchaser will acquire customers who are accustomed to returning to that location. The purchaser of a going concern also acquires the organization that has been established by his predecessor. That organization may be reflected in the layout of the business, in specialized methods established for handling inventory, in the existence of suppliers for the business, etc. Because the assets subsumed under the label "goodwill" will continue to produce income without interruption in the future, the purchaser is willing to pay for goodwill, and the value of goodwill is often calculated by considering the future income which will be produced by either the unrecorded, undervalued assets or by the organization of the assets in a going concern.<sup>22</sup>

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18. Bedford and Burton, *Goodwill*, in *Handbook of Modern Accounting* 21-2 (S. Davidson and R. Weil, eds., 2d ed. 1977).

19. *Id.*

20. *Crutwell v. Lye*, 34 Eng. Rep. 129, 134 (Ch. 1810).

21. J. Story, *Commentaries on the Law of Partnership* § 99, at 157 (7th ed. 1881).

22. G. Catlett and N. Olson, *Accounting for Goodwill* at 13 (1968).

*B. The Problem of Recognizing Goodwill in the Professional Practice.*

Goodwill in a professional practice usually inheres in the individual and cannot be transferred. The likelihood that a patient will return to a doctor, for example, is based upon the doctor's "bedside manner," his skill, his relationship with the patient, and other personal attributes. Professional codes of ethics may prohibit the professional from operating under a corporate name other than one which includes the names of at least the senior practitioner.<sup>23</sup> Thus, the benefit of the reputation acquired by a professional, or the benefit of any advertising which the professional has done, frequently is not transferable to someone taking over his practice.<sup>24</sup> In the event of the practitioner's death, retirement, disability, or even his relocation to a new community, the goodwill will evaporate. The personal nature of a professional's goodwill prevents it from having more than a contingent value.<sup>25</sup> If the professional remains in practice, goodwill may help him realize higher profits, but if he leaves practice, there is no way to realize any value for the goodwill. If professional goodwill has value at all, it is only the likelihood that the individual will have higher future earnings. Such a division of community property cannot take future earnings into account,<sup>26</sup> the inclusion of goodwill in valuing community assets may transgress community property principles.

In general, courts do not recognize the value of attributes which are purely personal in making a division of property in a divorce proceeding, even if these attributes will result in increased future earnings. The New Mexico Supreme Court has refused to consider personal attributes in the division of community property. In *Muckleroy v. Muckleroy*,<sup>27</sup> the court refused to recognize a medical license as community property because it was not subject to joint ownership.

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23. See, e.g. A.B.A. Code of Professional Responsibility, DR 2-102(B).

24. It may be partially transferrable to someone joining the practice. By joining a practice which carries the name of a reputable professional, the person joining will acquire, to some degree, the patients or clients which come because of the firm name.

25. The contingent nature of professional goodwill is apparent if one considers the factors which courts have identified as relevant in determining the value of such goodwill. The court in *Hurley* stated that "[s]ome of the factors to be considered in arriving at the value of good will are: the length of time the professional has been practicing, his comparative success, his age and health, and any past profits of the practice." 94 N.M. at 644, 615 P.2d at 259. The use of age and health as factors suggests that the goodwill will disappear after the individual ceases practice. In valuing goodwill, other courts have considered such personal factors as the imminence of retirement, *In re Marriage of Fleege*, 91 Wash. 2d 324, 588 P.2d 1136 (1979), and the "personality of the parties engaged in the business." *In re Marriage of Foster*, 42 Cal. App. 3d 577, 583, 117 Cal. Rptr. 49, 53 (Ct. App. 1979).

26. *Hurley v. Hurley*, 94 N.M. at 644, 615 P.2d at 259.

27. 84 N.M. 14, 498 P.2d 1357 (1972).

Although the court in *Hurley* distinguished *Muckleroy*,<sup>28</sup> if the joint ownership test survived, goodwill in a professional practice could not be recognized as community property since the goodwill in a professional practice inheres in the individual and is not subject to joint ownership.

Analogous to the goodwill in a professional practice is the increased earning capacity of a professor who has acquired tenure and full-professor rank during marriage,<sup>29</sup> or the businessman who has developed entrepreneurial skills during his marriage,<sup>30</sup> or the student who, because of his increased knowledge, has increased his earning capacity during his marriage.<sup>31</sup> Courts have repeatedly refused to consider the individual's increased earning capacity in these situations when making a division of community assets.<sup>32</sup>

The Texas Supreme Court, recognizing that professional goodwill is personal, has adopted the view that goodwill is not "an earned or vested property right at the time of divorce" because it does not possess a value outside the individual's ability to practice his profession, and would be extinguished in the event of the practitioner's death, retirement, or disablement.<sup>33</sup> Because including goodwill among

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28. The court in *Hurley* identified the issue in *Muckleroy* as whether the right to practice medicine was community property and the issue in *Hurley* as whether the value of the practice was community property. A reading of *Muckleroy*, however, indicates this distinction is spurious.

29. See *Wilcox v. Wilcox*, 365 N.E.2d 792 (Ind. App. 1977) (holding that the increased earning capacity developed by a professor during marriage is not a marital asset subject to division upon divorce).

30. See *Nastrom v. Nastrom*, 262 N.W.2d 487 (N.D. 1978) (the increased earning capacity a businessman developed during the marriage was not a material asset subject to division).

31. See *Todd v. Todd*, 272 Cal. App. 2d 786, 78 Cal. Rptr. 131 (Ct. App. 1969) (the value of a law degree and the right to practice law are not community property); *In re Marriage of Aufmuth*, 89 Cal. App. 3d 446, 152 Cal. Rptr. 668 (Ct. App. 1979); *Muckleroy v. Muckleroy*, 84 N.M. 14, 498 P.2d 1357 (1972) (a medical license is not community property); *In re Marriage of Graham*, 574 P.2d 75 (Colo. 1978) (an M.B.A. is not a marital asset subject to division). *But see Inman v. Inman*, 578 S.W.2d 266 (Ky. Ct. App. 1979) (a dental degree and license are divisible marital property); *In re Marriage of Horstmann*, 263 N.W.2d 885 (Iowa 1978) (the future earning potential of a party due to his acquisition of a law degree during marriage is a marital asset subject to division upon dissolution of the marriage). See also *Daniels v. Daniels*, 20 Ohio App. 2d 458, 185 N.E.2d 773 (1961) and *Moss v. Moss*, 80 Mich. App. 693, 264 N.W.2d 97 (1978) (holding that an award of gross alimony is appropriate to compensate a spouse for the value of a student's education obtained during marriage).

32. See text accompanying notes 29-31, *supra*.

33. *Nail v. Nail*, 486 S.W.2d 761, 764 (Tex. 1972). *But see Geesbreght v. Geesbreght*, 570 S.W.2d 427 (Tex. Civ. App. 1978); *Trick v. Trick*, 587 S.W.2d 771 (Tex. Civ. App. 1979). In *Geesbreght*, the court held that a professional corporation which existed for the purpose of providing physicians for emergency room services for hospitals and which operated under the name "Emergency Medicine Consultants, P.C." had goodwill which was subject to valuation upon the dissolution of a marriage. The court distinguished *Nail* on the basis that the professional corporation in *Geesbreght* was not dependent on the services of

community assets would contemplate the valuation and division of the future earnings of the professional, the Texas court has refused to consider goodwill which inheres in the individual in dividing community assets.<sup>34</sup>

Courts in other community property jurisdictions, however, have recognized professional goodwill as a community asset.<sup>35</sup> The first case in which goodwill of a professional practice was considered in making a division of community property was the California case of *Mueller v. Mueller*.<sup>36</sup> In *Mueller*, however, many of the problems with recognizing goodwill in a professional practice were not present. At issue was the goodwill of a dental laboratory business.<sup>37</sup> The business employed five technicians, operated under the name "General Dental Laboratory," and did laboratory work for dentists in a large geographical area.<sup>38</sup> In addition, Mrs. Mueller had worked for the business as secretary and bookkeeper during much of the marriage. Because of the number of the people doing the work, and the fact that the business did work for dentists over a broad area, the court rejected the argument that the goodwill depended solely on the personal skill and ability of the individual.<sup>39</sup> Despite its atypical facts, *Mueller* became the foundation for subsequent decisions holding that goodwill should be considered in valuing community assets.<sup>40</sup> Most courts which have struggled with the problem of whether the value of goodwill in a professional practice constitutes community property have refused to define goodwill as the likelihood of future earnings. Although an early California case, *Fritschi v. Teed*,<sup>41</sup> unhesitatingly recognized that "the expectation of future professional income was a valuable asset of the marital community,"<sup>42</sup> a subsequent case, *In re Marriage of Fortier*,<sup>43</sup> recognized that the *Fritschi* view of goodwill was contrary to the community property principle that future income should not be divided, and limited the valuation of

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any single individual and that the corporation had contacts with hospitals which would survive the withdrawal of any shareholder. In *Trick* the court relied on the value assigned goodwill in the stock redemption agreement of the professional association in determining the value of goodwill in a property division.

34. *Nail v. Nail*, 486 S.W.2d 761 (Tex. 1972).

35. See, e.g., cases cited in note 2, *supra*; *In re Marriage of Goger*, 27 Or. App. 729, 557 P.2d 46 (1976); *In re Marriage of Lukens*, 16 Wash. App. 481, 558 P.2d 279 (1976).

36. 144 Cal. App. 2d 245, 301 P.2d 90 (Dist. Ct. App. 1956).

37. *Id.* at \_\_\_\_\_, 301 P.2d at 92.

38. *Id.*

39. 144 Cal. App. 2d at \_\_\_\_\_, 301 P.2d at 95.

40. See note 2, *supra*.

41. 213 Cal. App. 2d 718, 29 Cal. Rptr. 114 (Dist. Ct. App. 1963).

42. *Id.* at 726, 29 Cal. Rptr. at 119.

43. 34 Cal. App. 3d 384, 109 Cal. Rptr. 915 (Ct. App. 1973).

goodwill to its sale value at the time of the dissolution of the marriage. Other California cases have recognized goodwill as a community asset, but have valued it as the amount to be paid upon withdrawal from the business.<sup>44</sup> In the cases of *In re Marriage of Foster*<sup>45</sup> and *In re Marriage of Slater*,<sup>46</sup> the California courts continued to state that future earnings could not be used in determining the value of goodwill. In these cases, however, the courts relied on a capitalization of excess earnings method of valuation, which necessarily implicates future earnings.<sup>47</sup> Other states have relied upon the California decisions in determining that the goodwill of a professional practice is an asset which should be considered in the division of community property.<sup>48</sup>

In *Hurley*, the New Mexico court did not resolve the problems raised by considering professional goodwill as community property. Instead, the court merely assembled quotes from the California and Washington courts. Having established that other states consider the value of goodwill in determining community assets upon the dissolution of marriage, the New Mexico court simply paid lip-service to the notion that valuation cannot be based "on the potential or continuing income of the professional spouse."<sup>49</sup> Whether professional goodwill has a value independent of future income depends upon the method of valuation used by the court. A market-value approach assigns to goodwill the value which can be immediately realized from its sale. A capitalization of excess earnings approach, on the other hand, recognizes professional goodwill as future income<sup>50</sup> which can be realized only if the professional remains in practice.

The dilemma which the courts face in analyzing whether the goodwill in a professional practice is a community asset arises because community property concepts artificially enforce a sharp cut-off upon the dissolution of the marriage, but economic concepts contemplate on-going benefits from the continuation of the professional practice. The tangible assets of many professional practices are miniscule. Lawyers often have only a small library and some office equip-

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44. *In re Marriage of Fonstein*, 17 Cal. App. 3d 738, 552 P.2d 1169, 131 Cal. Rptr. 873 (Ct. App. 1976); *In re Marriage of Lopez*, 38 Cal. App. 3d 93, 113 Cal. Rptr. 58 (Ct. App. 1974). *Fonstein* also provides for discounting for present value.

45. 42 Cal. App. 3d 577, 117 Cal. Rptr. 49 (Ct. App. 1974).

46. 100 Cal. App. 3d 241, 169 Cal. Rptr. 686 (Ct. App. 1979).

47. See text accompanying notes 82 to 86, *infra*.

48. *In re Marriage of Goger*, 27 Or. App. 729, 557 P.2d 46 (1976); *In re Marriage of Fleege*, 81 Wash. 2d 324, 588 P.2d 1136 (1979); *In re Marriage of Freedman*, 23 Wash. App. 27, 592 P.2d 1124 (1979); *In re Marriage of Lukens*, 16 Wash. App. 481, 558 P.2d 279 (1976). See text accompanying notes 32 and 33, *supra* for cases *contra*.

49. 94 N.M. at 644, 615 P.2d at 259.

50. See text accompanying notes 82 to 86, *infra*.

ment and furniture; a doctor rarely has elaborate equipment in his office. When faced with having to determine the value of a successful practice, courts are understandably hesitant to value the practice at the low value of the tangible assets. To do so may seem inequitable to the spouse of the professional. Although it may be the better view to allow alimony to affect the balance,<sup>51</sup> there may be tax disadvantages to alimony.<sup>52</sup>

Courts have previously addressed the problem of awarding what appears to be future income in decisions which discuss whether pension plans are community assets.<sup>53</sup> Like goodwill, the value of the pension plan will be realized only in the future. Nevertheless, the right to realize that value accrued during the marriage. Also, like professional goodwill, the future value of a pension plan may never be realized if the participant in the plan dies or changes jobs before he has met the requirements for the vesting of the plan. A California court stated, "nonvested pension rights are not an expectancy but are a contingent interest in property . . . subject to division."<sup>54</sup> New Mexico has characterized interests in unmaturing pension plans as property rights which are vested subject to divestment.<sup>55</sup> Division has been based on the future return of the retirement plan, even though the right to that return has not matured and would be affected by the death of the participant or by his change of job.<sup>56</sup> The present value of such plans has been determined through the use of actuarial tables.<sup>57</sup> This method has been approved by the New Mexico court.<sup>58</sup>

The theoretical basis for recognizing pension plans as community assets is that such plans are a form of compensation by an employer to the employee,<sup>59</sup> and thus represent income earned through the skill of one of the marital partners. Professional goodwill is analogous

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51. New Mexico allows awards of lump sum or periodic alimony in such amounts as, under the circumstances of the case, may seem just and proper. N.M. Stat. Ann. § 40-4-7 (1978). For a discussion of the advantages of a gross sum award of alimony rather than a property division as recompense for a spouse's increased earning capacity due to education obtained during the marriage see Krauskopf, *Recompense for Financing Spouse's Education: Legal Protection for the Marital Investor in Human Capital*, 28 U. Kan. L. Rev. 379 (1980).

52. See Walker, *Tax Consequences of Divorce*, 5 N.M. L. Rev. 233, 250 (1975).

53. For New Mexico decisions, see Hurley v. Hurley, 94 N.M. 641, 615 P.2d 256 (1980); Ridgeway v. Ridgeway, 94 N.M. 345, 610 P.2d 749 (1980); Copeland v. Copeland, 91 N.M. 409, 575 P.2d 99 (1978); LeClert v. LeClert, 80 N.M. 235, 453 P.2d 755 (1969).

54. *In re Marriage of Brown*, 15 Cal. App. 3d 838, 841-42, 544 P.2d 561, 562-63, 126 Cal. Rptr. 633, 634-35 (Ct. App. 1976).

55. Copeland v. Copeland, 91 N.M. 409, 575 P.2d 99 (1978).

56. Wilder v. Wilder, 85 Wash. 2d 364, 534 P.2d 1355 (1975).

57. *Id.*

58. Copeland v. Copeland, 91 N.M. 409, 575 P.2d 99 (1978).

59. LeClert v. LeClert, 80 N.M. 235, 453 P.2d 755 (1969).

to an unmatured pension plan. The enjoyment of each will arise in the future, and each is subject to being either made worthless or diminished in value by some future contingency. The policy underlying recognition of goodwill as a community asset is that the major asset in an on-going marriage may be the continued income of the professional practice. Although goodwill is not compensation paid by an employer, it results from the reputation that the professional has established during coverture. By analogizing to pension plans, courts have available a theoretical basis for recognizing professional goodwill as a community asset.

A decision to recognize professional goodwill in valuing community assets presents two practical problems, in addition to valuation,<sup>60</sup> which should be addressed by the court. Distribution of the value of a commercial business may be accomplished by assigning shares of stock to each party. In New Mexico, however, any shareholder in a professional corporation must be licensed to practice that profession.<sup>61</sup> Because the non-professional spouse cannot be a shareholder, distribution must be made by offsetting the value of the goodwill with liquid assets given to the spouse of the professional. This distribution is made all the more difficult for the professional since frequently there is no way to liquidate the goodwill; the professional may be left with no liquid assets. In regard to retirement plans, the New Mexico Supreme Court has suggested that a flexible approach should be taken toward the problem of distribution.<sup>62</sup> The alternatives suggested by the court are: 1) the trial court should make a determination of the present value of the pension plan and award the spouse an offset amount of community assets; or 2) if community assets are not available for an immediate division, the pension plan may be divided on a "pay as it comes in" system.<sup>63</sup> A similar approach should resolve the problem of distribution of the value of goodwill.

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60. See Part II, Valuation of Goodwill, *infra*.

61. N.M. Stat. Ann. § 53-6-9 (1978).

62. Copeland v. Copeland, 91 N.M. at 414, 575 P.2d at 104.

63. *Id.* Tax advantages may also be realized by a "pay as it comes in" distribution. Goodwill in a professional corporation often may be the major asset of the community. If the community has enough assets to offset the award of goodwill to the professional with an award of other community assets to the spouse, no taxable event has occurred. See Osceola Heard Davenport, 12 T.C.M. 856 (CCH 1953); Clifford H. Wren, 24 T.C.M. 290 (CCH 1965). However, if the community does not have enough assets to make the offset, the professional may execute a note to his spouse for her share of the value of the goodwill. This constitutes a sale which is a taxable event. See Jessie Lee Edwards, 22 T.C. 65 (1954). If a partial offset is made with compensation for the difference effected by a note, the event is taxable to the extent that the goodwill was purchased with separate funds. See Jean C. Carriers 64 T.C. 959 (1975); but see Rev. Ruling 76-83, 1976-1 C.B. 213. In that Ruling

Another problem arises where alimony is an issue. Giving the spouse of the professional both alimony based upon the earning power of the professional and an interest in the value of the goodwill results in a double award to the spouse, since goodwill is valued by assessing the future return on intangible assets.<sup>64</sup> For example, in *Hurley*, Raymond Zimmer testified that of the \$129,681 earned by Dr. Hurley through Schultz & Hurley, P.A. and Encino X-Ray and Therapy,<sup>65</sup> \$38,147 were excess earnings upon which the value of goodwill was to be based.<sup>66</sup> The supreme court ruled that the award of alimony made by the trial court was so small as to be an abuse of discretion.<sup>67</sup> If, on remand, alimony is calculated on the full income of Dr. Hurley, the excess earnings will have been used in both the calculation of the value of the goodwill and in the determination of the amount of alimony to be paid. This problem, however, can be avoided by subtracting the value of the goodwill from the professional's income before determining appropriate alimony, or by a "pay as it comes in" division of the excess earnings attributable to goodwill.

### III. VALUATION OF GOODWILL

Once it has been determined that goodwill in the professional practice is to be considered in the division of community property, as the *Hurley* case so determined for New Mexico, the question arises as to how that goodwill should be valued.

#### A. Capitalization of Excess Earnings

In *Hurley*, the court held that "capitalization of excess earnings" was a permissible, but not exclusive, method of determining the value of goodwill.<sup>68</sup> Capitalization of excess earnings is a formula approach to determining the value of goodwill and is used to predict probable

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the issuance of a note for \$258 by the husband to equalize the award where the total community property equalled \$300,000, was held not to be a taxable event.

If the court recognizes goodwill as the potential for increased earnings and allows a "pay as it comes in" division of those earnings, no taxable event should occur. This would be analogous to the "pay as it comes in" division of retirement benefits, which is not taxable. Victor, *Divorce and Deferred Compensation Arrangements*, 24 U. So. Cal. Tax. Inst. 469, 487, [hereinafter cited as Victor]. A "pay as it comes in" allocation of goodwill recognizes the spouse's present interest in future earnings but avoids the tax consequences of requiring the professional to purchase his spouse's interest in the goodwill through the execution of a note. In order to take this stance, however, the courts will have to back off from their hesitation to characterize goodwill as the likelihood of future earnings.

64. Walzer, *Divorce and the Professional Man*, 4 Family L. Q. 363 (1970).

65. Record, *supra* note 3, vol. 3, at 977.

66. Record, *supra* note 3, vol. 3, at 979.

67. 94 N.M. at 646, 615 P.2d at 261.

68. 94 N.M. at 644, 615 P.2d at 259.

future earnings.<sup>69</sup> This method yields a high value for goodwill, and so is most favored by the spouse of the professional.<sup>70</sup>

At trial, Mrs. Hurley used this approach to arrive at a value of \$190,735 for the goodwill of Dr. Hurley's practice.<sup>71</sup> To arrive at this figure, Mr. Zimmer first determined Dr. Hurley's combined interests, exclusive of goodwill, in the assets of Schultz & Hurley, P.A. and in Encino X-Ray and Therapy. The value of these interests was based upon figures provided by Dr. Hurley's accountant, which were then adjusted in regard to the bad debt reserve and deferred income taxes. Mr. Zimmer next figured Dr. Hurley's income over the past year, including salary, bonus, earnings retained by the corporation, and partnership earnings.<sup>72</sup> A reasonable return on Dr. Hurley's investment in the combined practices, exclusive of goodwill, was then deducted, along with an amount for a reasonable salary.<sup>73</sup> The resulting figure was then multiplied by five.<sup>74</sup> The figures look like this:

Income (including retained earnings of the corporation)	\$129,681
Return on investment exclusive of goodwill (at 10% on an investment of \$65,343)	6,534
	<u>\$123,147</u>
Salary for like practice without goodwill	85,000
Excess earnings	\$ 38,147
Multiplier (no. of years purchase)	<u>X 5</u>
Goodwill	<u>\$190,735</u>

This calculation assigns a value to the goodwill which is almost three times the value of all other assets.

Most writers who discuss valuing goodwill by a capitalization of excess earnings approach suggest that the income figure should be based on at least a five-year average income with unusually high or unusually low years disregarded.<sup>75</sup> Other problems arise in determin-

69. *Levy v. Levy*, 164 N.J. Super. 542, —, 397 A.2d 374, 378 (1978). This opinion provides a clear analysis of methods of valuing goodwill.

70. Even where the goodwill is marketable, the figure yielded by this method is almost always higher than market value. Victor, *supra* note 63, at 384-85.

71. Record, *supra* note 3, vol. 3, at 979.

72. Record, *supra* note 3, vol. 3, at 976.

73. Record, *supra* note 3, vol. 3, at 977.

74. Record, *supra* note 3, vol. 3, at 979. The multiplier in capitalization of excess earnings generally represents "the number of years after a sale of the business for which a buyer, as part of the purchase price, would pay the seller the average net profit of the business. Unless the nature and character of the business in any particular case require a different figure, the number of years purchase period will be considered to be five years." California Inheritance Tax Regulations 13951(h)(6) as quoted in Victor, *supra* note 64, at 382-83.

75. See, e.g., Comment, *Valuation of Professional Goodwill upon Marital Dissolution*, 7 Sw. U. L. Rev. 186 (1975); CCH Stand. Fed. Tax Rep. ¶ 4460.2995 (1981); *Levy v. Levy*, 164 N.J. Super. 542, 397 A.2d 374 (1978).

ing how much should be subtracted as reasonable salary for a like practice. Mr. Zimmer based his figure of \$85,000 upon a survey of the average income of surgeons in the United States and on discussions with a member of his accounting firm who specializes in the area of hospitals and clinics.<sup>76</sup> The \$85,000 figure reflects an estimated salary for a doctor with a similar practice if the doctor were employed by a clinic or hospital.<sup>77</sup> Mr. Zimmer did not compute the reasonable salary figure on the basis of the average income of other orthopedic surgeons in private practice.<sup>78</sup> He claimed that to do so would be to assume that the average orthopedic practice has no goodwill, an assumption he was not willing to make.<sup>79</sup> The figures calculated by Mr. Zimmer present the problem of comparing two very different kinds of figures—the income of a private practitioner and that of a doctor “on staff” at a hospital or clinic. The court in *Hurley* endorsed only the method used by Mr. Zimmer, not the particular application of that method. Nevertheless, the problem of how to compute “a reasonable salary for a like practice” is one of several which face the attorney who wishes to apply a capitalization of excess earnings approach. A doctor on staff may put in fewer hours or may have benefits not available to the private practitioner.

Another problem arises in determining which multiplier to use. Mr. Zimmer testified that in the valuation of a business for sale, a multiplier from one to ten is used in determining goodwill.<sup>80</sup> This number, according to Mr. Zimmer, is based on considerations such as:

set earnings of the business, the stability of those earnings, the trend of those earnings, the economic outlook not only in the general community, the outlook for the particular business or profession, and the factor of the potential buyer of a business and how he would estimate his ability to realize that goodwill might be.<sup>81</sup>

Other commentators have classified the multiplier as representative of “number of years purchase” and as usually being between three and five.<sup>82</sup> The “number of years purchase” concept reflects the number of years someone buying into the business would pay the

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76. Record, *supra* note 3, vol. 3, at 978.

77. *Id.*

78. Record, *supra* note 3, vol. 3, at 987.

79. *Id.*

80. Record, *supra* note 3, vol. 3, at 980.

81. *Id.*

82. See, e.g., *Levy v. Levy*, 164 N.J. Super. 542, 397 A.2d 374 (1978). Comment, *Valuation of Professional Goodwill upon Marital Dissolution*, 7 Sw. U. L. Rev. 186 (1975); CCH Stand. Fed. Tax. Rep. ¶ 4460.2995 (1981); Bedford and Burton, *Goodwill in Handbook of Modern Accounting* 21-16 (S. Davidson and R. Weil, eds., 2nd ed. 1977).

seller, as part of the purchase price, the net profit of the business.<sup>83</sup> The use of such a multiplier is arbitrary where, as in *Hurley*, there is no market for the goodwill. In *Levy v. Levy*, the New Jersey court stated, "[T]he multiple to be applied by way of 'number of years purchase' will vary inversely with the amount and intensity of competitiveness in the line of business being appraised."<sup>84</sup>

The uncertainty with which the variables of reasonable income and number of years purchase are determined in the capitalization of excess earnings approach creates an unpredictable result. Even applying the same method, the expert witnesses of the professional and the non-professional can counter each other with mathematical fancy which gives the court no clear guidance.

One writer has suggested that the result derived by capitalization of excess earnings should be discounted to present value.<sup>85</sup> Understandably, courts have been reluctant to discount to present value because to do so would indicate that the court was recognizing goodwill as an expectancy rather than as a current asset. As such, valuing goodwill in the determination of community assets would be highly suspect. The courts, however, should not hesitate to confront the problem of goodwill in the professional practice head-on. If, for policy reasons, the courts decide that goodwill should be considered to be a community asset even though it is potential or future earnings, a discounting to present value would be appropriate.<sup>86</sup>

### B. Alternative Methods of Valuation

Aside from capitalization of excess earnings, methods of valuation which have been adopted by the courts or suggested by accountants include market value,<sup>87</sup> the value determined by the buy-sell agreement,<sup>88</sup> or the value or a percentage of the value of one year's average gross income.<sup>89</sup> The imprecision of determination is summed up

83. See note 73 *supra*.

84. 164 N.J. Super. at \_\_\_\_\_, 397 A.2d at 380.

85. Comment, *Valuation of Professional Goodwill upon Marital Dissolution*, 7 Sw. U. L. Rev. 186 (1975).

86. A discounting to present value was made in *In re Marriage of Fonstein*, 17 Cal. App. 3d 738, 552 P.2d 1169, 131 Cal. Rptr. 873 (Ct. App. 1976).

87. See *In re Marriage of Foster*, 42 Cal. App. 3d 577, 177 Cal. Rptr. 49 (Ct. App. 1974), *In re Marriage of Nichols*, 606 P.2d 1314 (Colo. App. 1979), *cert. granted*. \_\_\_\_\_ P.2d \_\_\_\_\_ (Colo. 1980).

88. See *In re Marriage of Fonstein*, 17 Cal. App. 3d 738, 552 P.2d 1169, 131 Cal. Rptr. 873 (Ct. App. 1976). In *In re Marriage of Slater*, 100 Cal. App. 3d 241, 160 Cal. Rptr. 686 (Ct. App. 1979), a California court ruled that "the value of the contractual withdrawal right may provide a basis for ascertaining the value of the community interest (cites omitted); however it does not preclude a consideration of other facts." 100 Cal. App. at 246-47, 160 Cal. Rptr. at 689.

89. Testimony by George Harbison, CPA, in *Mueller v. Mueller*, 144 Cal. App. 2d 245, \_\_\_\_\_, 301 P.2d 90, 95 (1956).

by the testimony of Donald Heller, an accountant who testified as an expert for the spouse of the professional in *In re Marriage of Foster*. The opinion in *Foster* quotes Heller:

One way is to take the net income for the year and subtract from that what a comparable employer [sic] would have as a salary in a comparable situation and take that difference, and multiply that by a factor anywhere from, one year factor of anywhere from two to ten. . . . You can take the net earnings of the business, . . . You can take two years of net earnings of the business. You can take three years of net earnings. You can take three months charges to accounts receivable. You can take three months receipts on accounts receivable. . . . [I]t is always just somebody's opinion.<sup>90</sup>

Few courts have carefully analyzed the methods of valuing goodwill.<sup>91</sup> In *Mueller*, the first case to address the issue of valuation of the goodwill of a professional practice for the purpose of making a division of community assets, the court stated that the issue was one of fact to be determined by the trial court.<sup>92</sup> The different methods which the courts have adopted for valuing goodwill may lead to widely disparate results. For example, in *In re Marriage of Fortier*, the California trial court used a market value approach to determine that the value of goodwill in a medical practice was \$10,963.<sup>93</sup> On appeal, Mrs. Fortier claimed that market value was an inappropriate means of valuing goodwill and urged the court to adopt a capitalization of excess earnings approach. Such a method resulted in valuing the goodwill at \$293,000.<sup>94</sup> The court held that the method championed by the wife could not be used because future income controlled when capitalization of excess earnings was used to value the goodwill.<sup>95</sup> Subsequent cases distinguished *Fortier* on the basis that in that case there was an arms-length transaction by which the market value of goodwill could be determined<sup>96</sup> and accepted capitalization of excess earnings as a valid method of valuation.<sup>97</sup> The wide disparity in *Fortier* between the market value (\$10,963) and the capitalization of excess earnings value (\$293,000) suggests that courts should establish a precise means of determining the value of goodwill.

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90. *In re Marriage of Foster*, 42 Cal. App. 3d 577, 580, 117 Cal. Rptr. 49, 51 (Ct. App. 1974).

91. The notable exception is *Levy v. Levy*, 164 N.J. Super. 542, 397 A.2d 374 (1978).

92. 144 Cal. App. 2d 245, \_\_\_\_\_, 301 P.2d 90, 96 (Dist. Ct. App. 1956).

93. 34 Cal. App. 3d 384, 109 Cal. Rptr. 915 (1973).

94. *Id.*

95. 34 Cal. App. 3d at 388, 109 Cal. Rptr. at 918.

96. *In re Marriage of Foster*, 42 Cal. App. 3d 577, 117 Cal. Rptr. 49 (1974).

97. *Id.*

## CONCLUSION

In *Hurley*, the New Mexico Supreme Court determined that the goodwill of a professional practice should be considered in valuing community assets. This holding raises the questions of whether such goodwill is an award of future income of the professional spouse and if so, whether this contravenes community property principles. Policy reasons may validate the court's decision to recognize goodwill in the professional practice, but such a position should not have been taken without a careful analysis of the nature of goodwill, its relation to community property principles, and the policies both for and against including goodwill in the professional practice as a community asset where such goodwill is nonsalable.

A second problem which arises if goodwill in a professional practice is to be considered in valuing the community's assets is one of valuation. Clear guidelines need to be drawn. Trial courts should not have the discretion to choose between complicated methods of valuation which yield differences of 3000%.<sup>98</sup>

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98. See text accompanying notes 92-96, *supra*.