



## GOODWILL HUNTING IN ARIZONA MARITAL DIVORCES

By

Alex Poulos, Tiffany & Bosco, P.A.

Goodwill is an elusive asset that Arizona divorce courts have long struggled to capture.<sup>4</sup> It resides in business entities, including professional practices. It can be enterprise and personal; intangible but marketable or unmarketable; comprised of expected future earnings and earning ability, but divided as community property. Just when you think you've found this chameleon, it changes, because it can be valued in different ways for different people and entities in the same or different cases. Knowing fundamental Arizona community property law is vital to understanding how Arizona courts hunt for goodwill and how you can help find it.

In Arizona, all property acquired during the marriage by either the husband or wife is presumed to be community property.<sup>5</sup> Proving otherwise requires clear and convincing evidence.<sup>6</sup> After service of a petition, community property stays community and any property acquired with community property is community.<sup>7</sup>

Property a spouse owns before marriage or acquires during marriage by gift, devise, or descent, and the increase, rents, issues, and profits from that property are the spouse's

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<sup>4</sup> See *Wisner v. Wisner*, 129 Ariz. 333, 337, 631 P.2d 115, 119 (App. 1981) (declaring, "Admittedly, 'goodwill' value is a term which is elusive of any precise definition, and courts have long struggled to set forth appropriate criteria for its determination.")

<sup>5</sup> A.R.S. §25-211. A.

<sup>6</sup> See *Cockrill v. Cockrill*, 124 Ariz. 50, 52, 601 P.2d 1334, 1336 (1979)

<sup>7</sup> A.R.S. §25-211. B.

separate property.<sup>8</sup> Property acquired after service of a petition if the petition results in a divorce, legal separation or annulment is separate (so long as the property is not acquired in whole or in part with community funds).<sup>9</sup>

Arizona divorce courts must divide community property equitably, though not necessarily in kind, and assign each party his or her respective separate property.<sup>10</sup>

“Equitably” means what’s fair in each

case, which includes dividing property equally or “substantially equally” unless sound reason requires otherwise.<sup>11</sup>

Now, apply this fundamental law to “realizable” and “unrealizable” goodwill. The former, also called “enterprise” or “business” goodwill, reflects a business entity’s value beyond its physical assets.<sup>12</sup> Realizable goodwill can be sold with the business and is valued in numerous, subjective ways, none of which can boast perfect accuracy.<sup>13</sup> The latter, also called “personal” goodwill, exists when a business or profession cannot be sold on the open market.<sup>14</sup>

Professional practices that market the owner’s skill and reputation have “unrealizable” goodwill.<sup>15</sup> This goodwill has value to the professional as an ongoing member of his or her profession.<sup>16</sup> Inclusive factors for determining unrealizable goodwill are the practitioner's age, health, past earning power, reputation in the community for

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<sup>8</sup> A.R.S. §25-213. A.

<sup>9</sup> A.R.S. §§ 25-211 A. 2. & 25-213. B.

<sup>10</sup> A.R.S. §25-318. A.

<sup>11</sup> See *Toth v. Toth*, 190 Ariz. 218, 221, 946 P.2d 900, 903 (1997).

<sup>12</sup> See *Walsh v. Walsh*, 230 Ariz. 486, 492, 286 P.3d 1095, 1101 (App. 2012) (citing Christopher A. Tiso, *Present Positions on Professional Goodwill: More Focus or Simply More Hocus Pocus*, 20 J. Am. Acad. Matrim. Law. 51, 53–54 (2006). (Article defines goodwill and reviews different valuation methods.)

<sup>13</sup> See *Id.*

<sup>14</sup> See *Id.*

<sup>15</sup> See *Id.*

<sup>16</sup> See *Malloy v. Malloy*, 158 Ariz. 64, 66, 761 P.2d 138 (Div. 1. App. 1988) (*Malloy I*).

judgment, skill and knowledge, and comparative professional success.<sup>17</sup> Try putting a dollar value on that.

Then consider that this dollar value is supposed to represent and predict the controlling spouse's enhanced future earning ability resulting from personal goodwill that existed during the marriage.<sup>18</sup> But aren't future earnings separate property? Yes. Find this confusing? Our courts have, too.

In divorce cases from *Wisner* in 1981 to *Walsh* in 2012, Arizona courts struggled in their hunt for goodwill in legal, medical, and accounting professional practices. Our Supreme Court overturned our Division 2 Appellate Court, which ruled that unmarketable (unrealizable) goodwill was not a divisible community asset.<sup>19</sup> Our Division 1 Appellate Court issued two opinions (*Malloy I and Malloy II*) in the same case, twice finding that the trial court misapplied the law on goodwill.<sup>20</sup> Cases before *Walsh* approached goodwill, but didn't quite capture it and left a dusty trail. For example, some believed *Malloy II* held that only "realizable" goodwill was a divisible community asset.<sup>21</sup> *Walsh* distinguished prior cases and strove for clarity by defining realizable and unrealizable goodwill in professional entities, explaining that they both are divisible community assets under Arizona law.

But what about distinguishing future earnings attributable to future labor from enhanced earning ability attributable to goodwill that existed during the marriage? *Walsh* acknowledged the risk that the controlling spouse's separate future earnings may be caught up in a goodwill calculation.<sup>22</sup> But then declared, "In applying [the *Wisner* factors and

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<sup>17</sup> See *Walsh*, 230 Ariz. at 491, 286 P.3d at 1100 (citing the "Wisner Factors" from *Wisner* 129 Ariz. at 337-8, 631 P.2d at 119-120; see also, *Carriker v. Carriker*, 151 Ariz. 296, 297, 727 P.2d 349, 350 (Div. 2. App. 1986)(noting, the *Wisner* factors are inclusive.)

<sup>18</sup> See *Walsh* at 492, 286 P.3d at 1101.

<sup>19</sup> [Compare \*Mitchell I\*, 152 Ariz. 312, 315, 732 P.2d 203, 206 \(Div. 2. App.1985\) to \*Mitchell II\*, 152 Ariz. 317, 320, 732 P.2d 208, 211 \(1987\).](#)

<sup>20</sup> Compare *Malloy I*, 158 Ariz. 64, 761 P.2d 138 (App. 1988) to *Malloy v. Malloy (Malloy II)*, 181 Ariz. 146, 888 P.2d 1333 (App. 1994).

<sup>21</sup> See *Malloy II*, 181 Ariz. at 151, 888 P.2d at 1338.

<sup>22</sup> *Id* at 495, 286 P.3d at 1104.

expert testimony], a court must ensure that it does not divide as community property future earnings which are based solely on the professional's post-dissolution work effort."<sup>23</sup>

Is this a demand for perfection? No. *Walsh* was addressing the trial court's decision not to divide personal goodwill, because its valuation required speculation.<sup>24</sup> *Walsh* explained that the "formidable task" of valuing goodwill "should not force any court to shirk its responsibility nor ignore the basic fact that goodwill holds considerable value for the professional."<sup>25</sup>

*Walsh* didn't explain how to ensure that the division of community goodwill excludes future earnings based solely on future labor. But according to *Cockrill* and *Rueschenberg*, our courts are to select a valuation method that "will achieve substantial justice between the parties" when apportioning community and separate property (including goodwill) that is combined and not easily determined.<sup>26</sup> So, until we mortals achieve mathematical perfection, it appears we must hunt for goodwill in legal ways that achieve substantial justice under the circumstances of each case.

Some basic goodwill hunting rules. Fundamental community property law applies when determining realizable and unrealizable goodwill for any entity.<sup>27</sup> This may seem obvious to Arizonans, but many states don't recognize unrealizable goodwill as a divisible community asset.<sup>28</sup> In Arizona, goodwill has value even if it can't be sold.<sup>29</sup> Any supportable goodwill valuation method may be used so long as it applies to the case facts

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<sup>23</sup> Id at 493 and 495, 286 P.3d at 1102 and 1104. (Emphasis added.)

<sup>24</sup> See *Walsh*, 230 Ariz. at 493, 286 P.3d at 1102.

<sup>25</sup> Id. (quoting *Hollander v. Hollander*, 89 Md.App. 156, 597 A.2d 1012, 1018–19 (1991).)

<sup>26</sup> *Cockrill v. Cockrill*, 124 Ariz. 50, 54, 601 P.2d 1338 (1979)(Emphasis added); see *Rueschenberg v. Rueschenberg*, 219 Ariz. 249, 254, 196 P.3d 852, 857 (App. 2008).

<sup>27</sup> See *Malloy I*, 158 Ariz. at 66, 761 P.2d at 140; see also *Mitchell II*, 152 Ariz. at 320, 732 P.2d at 211 ([comparing goodwill to pension rights: both are community property "in a form in which the enjoyment is deferred."](#))

<sup>28</sup> See *Walsh*, 230 Ariz. at 492, 286 P.3d at 1101 (citing Christopher A. Tiso, *Present Positions on Professional Goodwill: More Focus or Simply More Hocus Pocus*, 20 J. Am. Acad. Matrim. Law. at 54 (2006)(Article categorizes different state approaches to goodwill.)

<sup>29</sup> See *Walsh* at 491, 286 P.3d at 1100 (citing *Malloy I*.)

and complies with the law.<sup>30</sup> The mandate to equitably divide community goodwill controls the application of corporate and partnership statutes in divorce cases.<sup>31</sup> Entity documents, like stock redemption and deferred compensation agreements, aren't necessarily conclusive, but are one factor to consider in determining goodwill.<sup>32</sup> A non-controlling spouse may show that a controlling spouse's goodwill interest exceeds any value (or non value) set by such agreements.<sup>33</sup>

As for your valuation experts (whether or not jointly retained), make sure they know Arizona law on determining goodwill and can distinguish realizable and unrealizable goodwill in your particular cases. Highlight relevant facts and perhaps address legal arguments that our courts have accepted and rejected. Remember, goodwill is elusive and no experts can pinpoint precise values. They must consider subjective factors in valuing community goodwill – and there lies the risk of capturing separate future earnings. With appropriate attention to detail, your experts can select and implement valuation methods that will guide our courts in achieving substantial justice for both parties.

*Alex Poulos is a Shareholder at the law firm of Tiffany & Bosco, P.A.  
He can be reached at (602) 255-6030 or [ap@tblaw.com](mailto:ap@tblaw.com)*



<sup>30</sup> See *Walsh* at 490, 286 P.3d at 1099 and at 494, 286 P.3d at 1103, FN 8; see also *Malloy II*, 181 Ariz. at 150, 888 P.2d at 1337 (citing *Mitchell II* quoting *Wisner*.)

<sup>31</sup> See *Mitchell II*, 152 Ariz. at 321-322, 732 P.2d at 212-213.

<sup>31</sup> See *Walsh*, 230 Ariz. at 491, 286 P.3d at 1100 (citing *Mitchell II* at 321-22, 732 P.2d at 212-13); see also *Malloy I* 158 Ariz. at 67, 761 P.2d at 141.

<sup>31</sup> See *Walsh* at 49-493, 286 P.3d at 1101-1102; see also *Malloy I* 158 Ariz. at 67-8, 761 P.2d at 141-42.

<sup>32</sup> See *Walsh*, 230 Ariz. at 491, 286 P.3d at 1100 (citing *Mitchell II* at 321-22, 732 P.2d at 212-13); see also *Malloy I* 158 Ariz. at 67, 761 P.2d at 141.

<sup>33</sup> See *Walsh* at 49-493, 286 P.3d at 1101-1102; see also *Malloy I* 158 Ariz. at 67-8, 761 P.2d at 141-42.