

9-1928

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Recommended Citation

Briggs, L. L. (1928) "Goodwill—Definition and Elements in Law," *Journal of Accountancy*. Vol. 46 : Iss. 3 , Article 3.

Available at: <https://egrove.olemiss.edu/jofa/vol46/iss3/3>

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Goodwill—Definition and Elements in Law

BY L. L. BRIGGS

With the phenomenal growth of modern business, goodwill has become a subject of increasing importance. At the present time this intangible asset is recognized as legal property of vast extent and of a considerable degree of complication. The legal aspect of goodwill is vital to members of the accountancy profession because the court decisions involving the numerous phases of the asset are used as precedents for subsequent cases with similar circumstances. Since these precedents are followed by the judges in their rulings, it is essential that the accountant be familiar with the decisions rendered in the leading cases. In order to appreciate these decisions fully, one should have an understanding of the development of the goodwill concept.

The term goodwill has been in use for centuries. In 1571, an Englishman wrote the following sentence in making his will: "I gyve to John Stephens . . . my whole interest and good will of my quarrel." This and similar statements found in other records show that the word was employed in England in various kinds of documents as early as the sixteenth century.

The earliest legal implication of goodwill is found in an English court decision dated 1620. This case involved a consideration paid by the purchaser of the wares of an old shop for the agreement of the vendor not to keep shop in the same vicinity. The vendor failed to keep his agreement and the purchaser sued him for damages. The claim of the proprietor against the vendor was upheld by the court. Although the term was not used in the text of the decision, it is evident that the vendor sold his goodwill with the business when he agreed to refrain from keeping shop in that particular neighborhood. When the contract was made, both parties, evidently, intended that the buyer should benefit by the situation of the business and by the friendly attitude and patronage of the vendor's customers. These are some of the essential elements of goodwill.

While the word goodwill has been used in documents for several centuries and the concept was implied in an early court decision, the law of goodwill is of comparatively recent development. The *Burn Dictionary of Law* which was published in 1792 does not mention the subject. From this fact it may be inferred that

before the 19th century the term was not employed to any great extent by the legal profession.

The law of goodwill developed earlier in England than in the United States. The American people adopted the English common law as it was in 1776 and modified it to suit conditions in this country. The decisions of the English courts subsequent to that date have no binding force upon our citizens. Surrogate Fowler expressed his opinion of the matter in these words: "Goodwill is one of the matters which our post-revolutionary courts are free to develop for themselves without reference to the authority of the older common-law courts. In the department of law, the late British adjudications have no force." Even though the English decisions have no controlling power over the American people, the fact remains that our judges have quoted English common-law decisions on goodwill from the time of the first American cases involving that form of property to the present. The common laws of the two countries in regard to this subject are in substantial agreement. There are a few minor points in which differences appear, but, generally speaking, there is no distinct cleavage between the two.

After 1800, when the extensive industrial progress of England had resulted in an enormous increase of free capital, the business units began to increase in size. The factor of goodwill became an element that could no longer be ignored and it soon became a subject of litigation. Lord Eldon handed down his much quoted decision of *Crutwell v. Lye* (17 Ves. 335) in 1810, and from that time to the present English court decisions involving the numerous phases of this intangible form of property have been rendered by leading jurists of that country.

Analogous industrial changes did not occur in the United States until nearly half a century later, so American decisions affecting goodwill do not date further back than 1859 when that of *Buckingham v. Waters* (14 Cal. 146) was rendered. The number of decisions concerning this form of property slowly began to increase in England after 1850 and in the United States after 1875, but most of the English decisions have been rendered subsequent to 1875 and most of the American cases were decided after 1900.

A period of business consolidations in the United States started in the latter half of the 19th century. In order to facilitate the formation of large business combinations it was of great importance to recognize the variations between the proportionate

earnings of the various constituent concerns and the earnings of the tangible assets contributed to the consolidations. Consequently, it became necessary to establish a value for the goodwill. When this value was determined it usually appeared on the balance-sheet of the consolidation. In some cases it was merged with the values of the other fixed assets but generally it was given a separate caption on the financial statement.

The legal concept of goodwill has been constantly expanding to enable the courts to keep up with the ever increasing complexities of modern business. Although the law was slow to recognize the existence of goodwill as a form of property it has been quite free in making the concept more inclusive. The liberality of the judges may be due in part to the fact that a broad concept has proved salutary in effecting just results to the parties concerned in goodwill litigation. Justice Grace says, "The law, as other big institutions of modern society, is advancing. It has broadened in its conception of human rights, including property rights. . . . Goodwill, by reason of the great progress of society, is considered to be a property right in a good many instances, and under a great many conditions in which it was formerly held not to apply."

Jurists do not always agree in their ideas of goodwill. Most of the judges have treated it as an internal economy, originating in or adhering to the factors of production. Others have looked upon it as an external economy in the field of consumption. In many instances the courts seem to have confused the primary causes of goodwill, such as efficiency and better products which attract patronage, with the goodwill itself. Accountants and business men have closely followed the theories of the courts, but taken as a whole they have so combined the views of judges and economists that the concept is growing more complicated.

Although the term goodwill is constantly used by the business man, the accountant and the attorney, its meaning is not always clear and its real nature is often misunderstood. The courts of England and the United States have made many decisions in which a definition of goodwill has been involved, and the leading jurists of these countries have admitted that its meaning is not easy to state. Chief Justice Fuller of the supreme court of the United States, in speaking of goodwill, made this statement: "There is difficulty in deciding exactly what is included in the term." In an English decision, Jessel, master of the rolls, said: ". . . but practically, it is difficult to understand what is meant

by goodwill." Chelmsford, lord chancellor of England, admitted that "It is difficult to give any intelligible meaning to the term goodwill." Lindley, the author of a standard work on partnership, went so far as to say, "The term goodwill can hardly be said to have any precise signification."

Since the meaning of the term is so elusive and seemingly so difficult for acute legal minds to grasp, the formulation of a suitable definition has been a long-drawn-out and laborious task. Sir John Romilly, master of the rolls, made the following statement in a decision: "There is considerable difficulty in defining accurately what is included in the term goodwill." Justice Cobb has admitted that "Judges have found no little difficulty in framing a definition." Justice Wilkes said, "It is difficult to define what goodwill is." When one considers that the concept of this intangible asset has been rapidly broadening during the last century it is easy to see why the making of an adequate definition for it has been almost an impossibility.

Many attempts to define goodwill have been made by jurists and these efforts have varied greatly in wording and meaning. The word, like many other trade terms, may have different meanings dependent upon circumstances in which it is used and the purpose for which it is intended. Sir John Romilly has said: "It varies in almost every case." Lord MacNaghten made the statement that "What goodwill means must depend on the character and nature of the business to which it is attached." Because the word has been used in so many different senses, a prominent writer in the field of business finance has maintained that "It is almost . . . incapable of definition." Nevertheless, economists, accountants and jurists have attempted to define this term and the definitions made by the leading judges of England and America will be considered in some detail.

The earliest English legal definition of goodwill is found in the decision of *Cruttwell v. Lye* (17 Ves. 335) which was rendered by Lord Chancellor Eldon in 1810. The importance of this case justifies a brief outline of the facts. A man having a wagon trade from Bristol and Bath to London became bankrupt and his business with the goodwill was sold. His friends purchased another carrying business for him. The new route started in Bristol and Bath but terminated in Warminster and Salisbury. As soon as the bankrupt was released from the debts of his former business he started the second one and tried to regain his former customers.

The buyer sued him in the chancery courts and it became the duty of the chancellor, Lord Eldon, to state the meaning of goodwill. This able jurist defined the term in these words: "The goodwill . . . is nothing more than the probability that old customers will resort to the old place." This is the first definition of goodwill in the common-law reports and it is one that has been quoted in decisions by English and by American judges ever since goodwill has been a subject of litigation. It makes goodwill local and an incident of the place where the business has been carried on, not of the persons by whom the concern was conducted. However, it was not taken so literally as to mean that the customers must actually come to the old place, but simply that they will continue their patronage. In that particular place and at that time, the definition probably was adequate. In fact, Parsons says that it ". . . is an exact statement of the legal meaning of goodwill."

The modern business man is aware that the habit of people to purchase from a certain dealer, which is the foundation for any expectation that purchases will continue, may depend upon many things besides place. The doctrine of *stare decisis* compelled many judges to attempt to apply Lord Eldon's definition to cases in which the conditions were entirely different from those of *Crutwell v. Lye*, with the result that this statement of the meaning of the term was found wanting. In the days of this great judge, transportation facilities, as we know them, were undeveloped and trade was more dependent on place than at present. Consequently, goodwill was supposed to be built up about a certain locality. After the steamship was perfected and railroads became common, this narrow conception of place as the source of goodwill became inadequate to meet the needs of business. However, Lord Eldon's definition served as a standard for the English courts until 1859 when Vice-chancellor Sir W. Page Wood, after giving a rather liberal interpretation of it, said, "Goodwill, I apprehend, must mean every advantage, every positive advantage, if I may so express it, that has been acquired by the old firm in carrying on its business, whether connected with the premises with which the business was previously carried on, or with the name of the late firm, or with any other matter carrying with it the benefit of the late business." Vice-chancellor Wood's statement expands the goodwill concept so that it includes all that good disposition customers feel toward the house of business using a particular name, which persuades them to continue

to patronize it. As far as English common law is concerned it is doubtful that this definition has been improved upon in comprehensiveness. According to Lord MacNaghten, goodwill is “. . . the benefit and advantage of the good name, reputation, and connections of a business. It is the one thing which distinguishes an old-established business from a business at its first start.” This statement is open to criticism on the grounds that there are attracting forces other than goodwill which bring in customers and there are things other than goodwill which differentiate an old-established business from a new one. Lord Lindley, in the same case, gave a definition which is slightly more definite than those already discussed. This able English jurist said, “I understand the word to include whatever adds value to the business by reason of situation, name, reputation, connection, introduction to old customers, and the agreed absence of competition, or any of these things.” Lord Lindley mentions at least two factors that have been ignored in other definitions, namely, introduction to old customers and absence of competition.

Many definitions of goodwill have been formulated by American judges and stated in their decisions and writings. The definition which is considered most comprehensive and has been quoted with approval in numerous decisions is that given by Judge Story in his work on partnership. According to Judge Story, “Goodwill of a trade or business may be defined as the advantage or benefit which arises from the establishment of a particular trade or occupation. 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 the 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.” The statement of Judge Story is more explicit than the English definitions because more of the numerous things that go to create goodwill are mentioned. It has the merit of being fairly specific and is comprehensive enough to cover almost every conceivable case. However, it has been severely criticized. Professor Foreman has discussed it in these words: “Yet broad as this definition is, it is largely a hasty collection of ideas, without proper citations from legal opinions. It does not cover the subject of goodwill so as to

give us a clear idea of its exact nature and contents." Bates was less definite but more comprehensive when he said: "Goodwill is every possible advantage acquired by a firm in carrying on its business, whether connected with the person or name or other matter." There are many other American definitions of goodwill which might be considered but these may be summarized by the statement that most of them emphasize the probability of old customers returning to the old place of business, the chance of being able to retain the business that has been established, and the fact that extra profits are gained from these advantages.

The constituent elements of goodwill are many and these elements vary with the particular business with which the asset is associated. It is impracticable to discuss them all, so most attention will be given to those which have been points of litigation in court cases. Place and firm name have been most often mentioned in the decisions, so these elements will be considered in detail.

From the historical viewpoint, place was the first element of goodwill to be recognized by the law. It was the only one recognized, as far as the English courts were concerned, until 1859. All the early definitions of goodwill which were made by various jurists contain some reference to the advantages accruing to the vendee from the situation of the old business.

In a case involving a hotel it was decided that the goodwill was attached to the place. The courts have held that the value of the lease of a mercantile firm was enhanced by goodwill. Justice Sieback, in speaking of this intangible asset, said: "It exists at the place where the business is carried on." In Indiana, the courts have held that goodwill is an incident of locality or place of store-room or place of business. A Louisiana court ruled that the goodwill of a stall in a public market attached chiefly to the place. Where goodwill is attached to a locality, it will pass by a conveyance of the place of business.

While goodwill is generally local, it is not always so. If it were it would exist after the business had ceased. This would be an absurdity. District Judge Holt, in discussing this point, said: ". . . that does not mean that in all cases there can not be any goodwill left if the place of business is changed." There are decisions to the effect that the practice of a dentist, a mail-order house and a laundry have goodwill that is not dependent upon place.

It is a fact of common observation that locality has little effect upon the practice of a dentist. Almost any reasonable place suffices. Few dentists have their offices on the ground floor in the busiest section of the city. The situation of a mail-order house in a particular city rarely has any influence on the amount of business which it transacts. Most of these concerns are in the outlying districts where rents are low. The out-of-the-way situation is no handicap because the orders come through the mail and consequently the customer is not required to seek out the place of business. If a laundry collects and delivers, it would seem that the site of its buildings would have but little effect upon the amount of business done and, through this, upon goodwill. The cash-and-carry laundry would consider situation to be an essential element in its goodwill.

Firm name ranks next in importance among the several elements of goodwill. The absence of sanctioning precedent caused the courts carefully to avoid recognition of this as an element before 1859. Judge Story, in his *Commentaries on the Law of Partnership*, did not include it in his definition of this asset. As trade grew and expanded it became necessary to recognize that a firm name might be so used as to become impersonal to those conducting the business, and indicate the article dealt in. In such a case it was desirable that the name be considered a part of the goodwill of the business concerned. It finally became necessary for the courts to decide the point. Vice-chancellor Wood rendered a decision in 1859 in which he said: "The firm name is a very important part of the goodwill of the business carried on by the firm." The precedent being set, the courts since 1859 have felt free to include the firm name as an element in goodwill. However, there is an American decision of a date as late as 1880 in which the court refused to allow the buyer of a business to use the firm name of the seller. On the other hand, the firm name is not necessarily a part of goodwill merely because it is an established firm name, and it can not be so regarded if the business depends upon the personal attributes of the owner.

The fact that a vendee buys a business and its goodwill does not give him the right to use the name of the vendor. According to North Dakota *Compiled Laws of 1913*, section 5466: "The goodwill . . . does not include the right to use the name of any person from whom it was obtained." Vice-chancellor Hall, in an English decision, said: "It seems to me that the question whether

goodwill does ordinarily include the right to use the name of a living person should receive a general answer, viz., that it does not."

It has been ruled that the name under which a business has been established and carried on can not be the sole constituent of the goodwill of that business. However, in a case involving a St. Louis newspaper, Chief Justice Fuller of the United States supreme court held that the goodwill wholly attached to its name rather than to the place of publication.

Personal qualities which attract patronage, may in many cases, be a very important element of goodwill. The courts have recognized honesty, politeness, promptness and other personal characteristics which tend to draw customers to the business which is so fortunate as to have a management and employees possessing them. Often they overbalance all other elements of goodwill. The business which is carried on by people having these attractive personal qualities often succeeds and develops a valuable goodwill even though it may have a poor situation and other disadvantages.

The patronage which may be attracted by favorable personal qualities may be casual or regular. According to Surrogate Ketcham, "Whether its customers dealt for cash or not, whether they were constant or not, furnishes no criterion for a finding as to whether a business has goodwill. An established and respected trade which appeals to casual customers, is at least as much the subject of goodwill as one which caters to a fixed and faithful number of patrons. The qualities which successfully serve a fluctuating class of customers coincide peculiarly with the elements upon which, according to the authorities, goodwill grows into an asset of calculable value."

All other things being equal, the concern which has been in existence over a long period of time is more likely to have a valuable goodwill than the business which is trying to get started or the one which has existed only a few years. The reason for this is that the effects of favorable and unfavorable characteristics tend to become cumulative. The young business, even though it may have many elements which result in goodwill, has not had the time for them to reflect themselves in the profits to such an extent that excess profits, which are the criterion of goodwill, result. Factors which destroy goodwill tend to eliminate the business. The older business generally is the one which has the qualities

fitting it to survive and these same qualities are those that develop goodwill.

In one case on record the licence of a saloon was considered an element of goodwill. However, licences, patents and franchises are not usually considered to be elements of this kind of property. They are intangible assets but they differ from goodwill in that they are subject to depreciation.

Partialities and prejudices against a concern may be an element in the goodwill of a competing organization. If a man does not like the religion or political affiliation of Trader A he is quite certain, other things being equal, to give his business to Trader B if the latter belongs to his church and political party. Thus, prejudice against A served to increase the profits of B with a resulting increase in any goodwill that B may have.

One judge maintained that goodwill was embodied in a label on a wrapper. This decision is very unusual and has not been cited in subsequent cases. A land agent's book containing the names and addresses of prospects was held to be the sole element of goodwill in that particular land business. Perhaps the broadest statement of the elements of goodwill is that they include all that goes with a business in excess of mere capital and physical labor.