



# The Florida Courts' Errors on Professional Goodwill: Non-Compete Agreements and the Myth of Personal Goodwill

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*"The cemeteries are filled with indispensable people."*

~ Charles De Gaulle



MICHAEL ELMALEH

This article critiques current Florida case law related to the proper valuation of professional goodwill in marital dissolutions. Florida and other jurisdictions have accepted a distinction between personal and enterprise goodwill. Enterprise goodwill is considered divisible marital property while personal goodwill is not. In making this distinction, Florida courts have confused client, patient and customer attachment to a professional with the professional's ability to transfer those clients, patients and customers to another professional in the sale of their practice. The courts' confusion on this issue is particularly underscored by the misinterpretation of the economic significance of covenants not to compete. In a non-compete provision incident to a sale of a professional practice, the selling professional usually agrees not to perform services for or solicit former patients, clients or customers.<sup>1</sup> The Second and Fourth District Courts of Appeal have held that if a professional practice sale would be contingent on the inclusion of a non-compete agreement, then such a requirement is evidence of the existence of personal as opposed to divisible enterprise goodwill. As things now stand

in the Second and Fourth Districts, a non-equity-owning spouse claiming a marital interest in a spouse's professional practice has to demonstrate that divisible goodwill exists without such a requirement. For most professional practices, this is an impossibility as virtually no professional practices can be sold without such a covenant. The current case law has created an egregious inequity that needs to be redressed by either the Florida Supreme Court or the state legislature.

I will argue that in economic substance there is only one form of goodwill. If a professional practice has repeat customers, patients, clients or referral sources *and* the selling professional can influence those customers, patients, clients or referral sources to patronize a designated successor, then that practice has divisible enterprise goodwill. The key factor that courts and appraisers must focus on is the transferability of the professional's customer, client, patient or referral base. Current case law in Florida implies that a strong attachment and preference to a professional impedes transferability. I will demonstrate that the Second and Fourth Districts have it exactly backwards. Strong attachment actually enhances the transferability of customers, clients, patients or referral sources and thus increases the value of divisible enterprise goodwill.

## Enterprise vs. Personal Goodwill: Florida Case Law

The Florida Supreme Court case of *Thompson v. Thompson*, 576 So. 2d 267 (Fla. 1991), is the seminal case concerning goodwill of a business as a marital asset. The Florida Supreme Court held that "if it exists and if it was developed during the marriage, professional goodwill is a marital asset which should be included in the marital estate upon dissolution." *Id.* at 268.

The court adopted the Supreme Court of Missouri's definition of goodwill:

"It is property which attaches to and is dependent upon an existing business entity; the reputation and skill of an individual entrepreneur – be he a professional or a traditional businessman – is not a component of the intangible asset we identify generally as goodwill." *Id.* at 269 (citing *Hanson v. Hanson*, 738 S.W. 2d 429, 434 (Mo. 1987)). The *Hanson* court defined enterprise goodwill to mean the value of the practice which exceeds its tangible assets and which is the tendency of clients/patients to return to and recommend the practice irrespective of the reputation of the individual practitioner.

In carving out "reputation and skill of an individual entrepreneur" as goodwill, the Florida Supreme Court identified two forms of goodwill: per-



sonal and enterprise goodwill. Enterprise goodwill is *separate and apart from the reputation or continued presence of the marital litigant*. *Id.* at 270. On the other hand, personal goodwill (often referred to as “professional goodwill”) consists of the relationships, skill, reputation and the continued presence of a particular individual. Only enterprise goodwill may be included in an equitable distribution scheme in dissolution cases. *Held v. Held*, 912 So. 2d 637, 639 (Fla. 4th DCA 2005). Personal goodwill may not be considered or included in an equitable distribution scheme.

The Second District has held that the most telling evidence of a lack of enterprise goodwill is testimony and/or evidence that no one would buy the practice without a non-compete clause. *Walton v. Walton*, 657 So. 2d at 1214, 1216 (Fla. 4th DCA 1995). As stated by the *Walton* court, “[i]f the business only has value over and above its assets if the husband

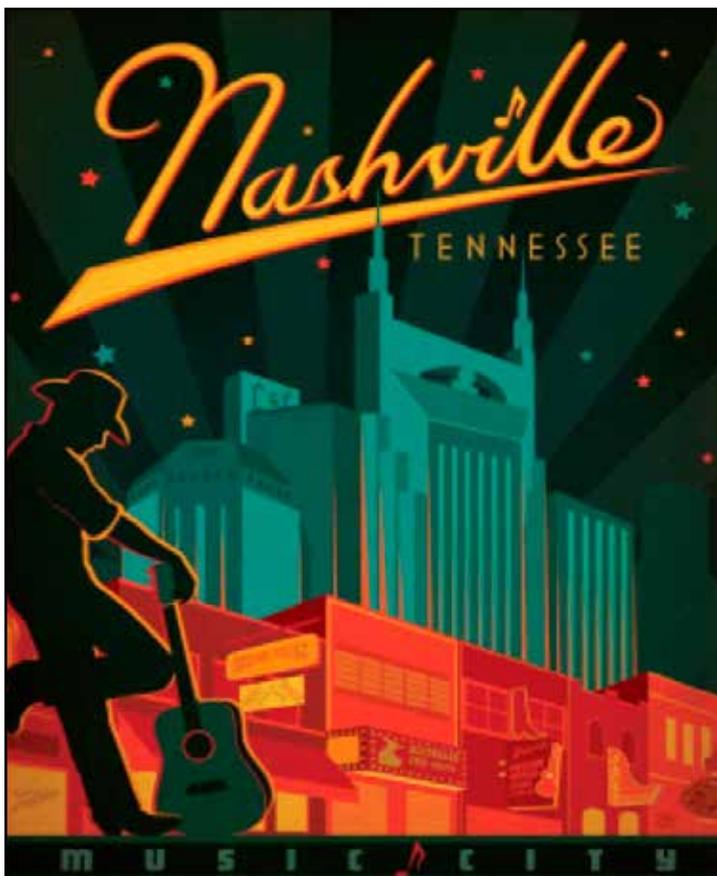
refrains from competing within the area that he has traditionally worked, then it is clear that the value is attributable to the personal reputation of the husband.” *Id.*; see also *Held*, 912 So. 2d at 640; *Williams v. Williams*, 667 So. 2d 915, 916 (Fla. 2d DCA 1996). Thus, generally the court has held that where a non-compete agreement is required to sell the business at a certain price, that would be a good indicator that the goodwill is personal. The Fourth District in *Schmidt v. Schmidt* 120 So. 3d 31 (Fla. 4th DCA 2013), cited the Second District’s reasoning in *Walton* as grounds for overturning a trial court’s acceptance of an appraisal of the enterprise goodwill of a retail optical business.

### Getting the Definition of Goodwill Right

The Florida Supreme Court correctly understands that repeat pa-

tronization of a professional practice is a key characteristic of enterprise goodwill. However, repetitive patronization is a necessary but not sufficient condition for a professional practice to possess enterprise goodwill. There is another critical condition required that involves competitive advantage. From an economic standpoint, a firm possesses enterprise goodwill with a positive value only if the seller of the practice can confer a competitive advantage to a new owner. The conveyed competitive advantage lies in the fact that the buyer of a professional practice will gain immediate access to customers, clients or patients for whom he or she would otherwise have to compete. If the seller can convince his or her clients, patients, customers or referral sources to patronize the successor/buyer of the practice, then the seller has enterprise goodwill. The Florida courts have confused one of the causes of enterprise good-

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will, namely attachment based on skill and reputation, with the effect, namely the existence of a transferable customer, client or patient base. The Second and Fourth Districts assume that a strong client or patient attachment to a particular professional impedes the ability of that professional to transfer their clients or patients in a sale of their practice. In point of fact, a strong attachment usually improves the chances of transferability.

### Customer Attachment and Competitive Advantage

Every firm in a competitive market offers potential and existing customers a unique combination of quality, convenience and price. Firms offering the best combination of these factors will be more successful than firms that offer inferior combinations. The combination of price, convenience and quality explain why customers become attached to certain firms and not others. These are *factors of attachment*. Customers' decision weightings of price, convenience and quality very much depend on the nature of the products and services that the firm provides. In sectors where quality is very critical, larger changes in price are needed to shift customer allegiance, as compared to sectors where quality is less critical and convenience is more important. A similar point applies to convenience. For example, a small improvement in the location of a convenience store may suffice to draw significant numbers of customers from other convenience stores in a particular neighborhood. However, we would expect that more significant decreases in price or increased convenience would be required to draw significant customers from one well-established hair stylist or dentist to one of his or her competitors.

Generally, service firms—particularly those of a personal professional nature such as grooming, financial or medical services—have more exclusive relationships with their clients and patients than do firms that sell products. As a consumer I may patronize more than one grocery store, gas station or restaurant, but it is unlikely that I utilize the services of more than one dentist, tax preparer or barber. These types of service firms require a degree of specialized skill in order to assure quality performance. Once I have found a service provider that I believe provides the degree of quality I require at a price and location that meets my monetary and time budget, I am likely to continue to patronize the same firm over and over again. Once I am satisfied with my skilled professional service provider, I become more attached to that person than to my local grocery store or gas station.

But here we need to ask a critical question. Do I choose to use the same barber, accountant or dentist because I believe that professional is the absolute best accountant, barber or dentist in the area or region? Do I believe that my accountant, dentist or barber are irreplaceable? No, I choose to patronize these professionals because I have, based on past experience, found that my barber, accountant or dentist has done a good enough job at a fair price in a convenient location. Often it goes beyond that. Personal familiarity also reinforces attachment. My barber will learn how I like to wear my hair. My dentist will have records of past dental work and my accountant may understand whether I like to take aggressive vs. cautious tax positions. All of these factors can lead to a strong loyalty to individual professional service providers. But does such loyalty impact the transferability of the service provider's client or patient base? The answer is no.

### Conditions of Transfer: Strong Attachment Does Not Impede Transferability

Are there attachments that are so

strong between customer, patient, client and service provider such that their customers, patients and clients would refuse under any circumstances to consider patronizing a different service provider? The answer is of course no. There are practically speaking no such attachments. Imagine going to your favored dentist and learning that she has been tragically killed in an auto accident. You are understandably upset and saddened. But will you be so grief stricken that you will never seek out the services of another dentist again? Of course not. You may even believe that your dentist, barber or accountant was the very best in the world, but that does not mean that you will never again utilize the services of another dentist, barber or accountant given that your *first preference* is no longer available. What applies to the sudden death of a trusted service provider applies to the disability or retirement of that provider as well. Again, as a customer, patient or client you would be disappointed but not so disappointed that you would never get another haircut, or another dental exam or file another tax return again. Now faced with the loss of a trusted service provider, where and how would you look for a replacement?

### What are the Transfer Options?

Many professional service providers have practice continuation agreements with a key employee, a partner or another unrelated professional. What these practice continuation agreements state is that in the event of the sudden death or disability of the service provider, the provider's customers, client or patients will be *referred* to a different service provider. Usually that substitute referred provider will agree to pay the estate of the deceased or disabled professional a certain percentage of the billing for a limited period of time. This payment is in recognition of the fact that the recommended service provider is receiving something of



value: access to a customer base for which he or she would otherwise have to compete.

Now suppose if instead of death or disability, your favorite barber, dentist or accountant decides to retire or relocate. Again, you will be disappointed. Assume that your preferred professional has arranged to sell his or her practice to a designated successor. This successor is most likely a partner, key employee or another local professional service provider. Most of the retiring or relocating service provider's clients, customers and patients will give the recommended successor at least one chance to prove that they will receive a comparable level of quality service at comparable levels of convenience and price.

Just as in the cases of practice continuation agreements, in a sale of a professional practice the buyer will pay some remuneration to the departing professional. This remuneration will reflect the value of the enterprise goodwill. The buyer is obtaining a competitive advantage by gaining immediate access to customers, clients and patients for whom they would otherwise have to compete. ***In the case of retirement or relocation, the succession or sales agreement will almost certainly include a covenant not to compete.*** Why is a non-compete covenant needed?

### **The Economic Substance of a Covenant Not to Compete**

When a service provider sells the equity in a firm with repeat customers, and those customers will continue to patronize the firm after the service provider leaves the competitive market, that service provider has sold a valuable asset. The transferred customer, client or patient base will generate revenue in the future much in the way a physical machine produces parts that can generate revenue in the future or a commercial building can generate rents. Qualified and motivated buyers are willing to pay something for this intangible asset if they deem it to be to their com-

petitive advantage and their return on the asset is sufficient to assume the burdens of servicing the customer, client or patient base.

No rational buyer would ever pay to acquire any asset, tangible or intangible (including a customer base), if they thought there was a risk that the seller might steal that asset back. How might the seller of the customer, client or patient base steal this asset back? Quite simply they could continue to compete for their old clients, patients and customers despite their stated intent to retire or relocate. The covenant not to compete provides an assurance to the buyer that the seller will not steal back what they just sold.

### **The Devil You Know**

The Florida cases cited above argue that the need for a covenant not to compete demonstrates that the seller has a special unique non-transferable relationship with his or her customers, patients or clients. Nothing could be further from the truth. All that the required non-compete covenant demonstrates is that given the current competitive options available to the service provider's customers, clients or patients at the time of the equity transfer the seller is the *preferred* service provider. All other things being equal, satisfied clients, patients and customers would prefer utilizing their current provider rather than some new provider. The devil they know is preferred to the devil they don't know. The covenant does not demonstrate any special or unique relationship that the seller has with his or her clients, patients or customers.

### **Varying Degrees of Transferability and the Value of Goodwill**

In the real world, no professional service provider, no matter how talented or esteemed, is absolutely unique or irreplaceable. This is the meaning of De Gaulle's quote in the epigram of this article. As long as

there is a demand for a particular service, the removal of one professional service provider (due to death, disability or retirement) will be followed by the selection of a new service provider. That there will be a replacement for a particular service provider is beyond question. What is subject to question is the degree to which the retiring professional can influence his or her customers, clients and patients decision on a successor. The degree of influence directly impacts the value of goodwill.

Since the value of goodwill to the buyer is immediate access to customers, clients or patients for whom he or she would otherwise have to compete, the more customers, clients or patients that are immediately available to the buyer the more future revenue they will generate and the higher the amount the buyer will be willing to pay the seller. In order to capitalize fully on the value of professional goodwill, a seller has to maximize the chances that his or her customers, clients or patients will transfer to the designated successor. Signing a non-compete agreement is one way of doing this. Often sales of professional service practices have transition agreements specifying a period of time when the buyer and seller work together. In this transition period, the seller's clients can become familiar with the buyer and thus insure greater transferability.

### **Repeat Referral Sources and the Prahinski Error**

Many service professionals rely on referral sources as their primary and ultimate source of revenue. A classic example of this is illustrated in the landmark Maryland case *Prahinski v. Prahinski* (321 Md. 227, 241, 581 A.2d 784, 791 Md. (1990)). Prahinski, an attorney, operated a law firm that did almost exclusively title work. The court found that there was no separate enterprise goodwill on the grounds that there was no repeat business and that only the attorney's

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personal reputation accounted for the firm's continuing revenue stream. But the court and appraisal experts got the economics wrong. The key driver of repeat business for Prahinski was not the parties exchanging real estate even though these parties paid the firm's fees. Rather the driver of revenue was the *referrals* from real estate brokers who referred buyers and sellers even though these brokers paid no fees to the title company. Presumably the brokers referred real estate closings to the title company because the closings were efficiently run. However, the efficiency of the closing process did not rely upon the special unique expertise of Prahinski. Another attorney could easily step in without any loss of efficiency in the closings. Prahinski's referring brokers may very well continue to make referrals in the event of an ownership transfer as long as the new owner maintained the old owner's standard of efficiency. The intermediary referring brokers and not the paying customers were the source of goodwill, but all parties involved in this case seemed to miss this fundamental economic fact.

There are always going to be factual questions that need to be addressed in these types of cases. The key question does not involve the distinction between personal and enterprise goodwill, but rather the degree of transferability of a professional's customers and referral sources. If a professional relies heavily on just a handful of referral sources, can that professional convince those referral sources to continue making referrals to a designated successor? If the answer is yes, then that professional has enterprise goodwill. If the answer is no, then that professional does not have goodwill. But note, if the referral sources would not heed the advice of the selling professional for a succes-

sor, it is not because that professional simply has some kind of personal goodwill. Prahinsky had no special unique skill that was irreplaceable or unique. When Prahinski takes down his shingle, title work will be referred to someone else who will provide the service. If he can convince his referring brokers to continue referrals to a designated successor, then he has enterprise goodwill because the successor will benefit from future referrals. In the end, there really is no such thing as personal goodwill. There are only degrees of customer, patient, client and referral source transferability.

### The Impossible and Inequitable Hurdle: Distinguishing Between Horses and Unicorns

The Florida Second and Fourth Districts have placed an impossible burden on non-equity owning spouses in divorce cases. In these districts, such spouses must demonstrate that a professional's practice would have value even if that professional were unwilling to sign a covenant not to compete. Since no rational buyer would ever pay for another living, active professional's practice absent a non-compete agreement, this effectively eliminates the assignment of enterprise goodwill to professional practices. This is an egregious inequity as many, if not most, professionals will, post-divorce, be able to sell their practices subject to a covenant not to compete for significant multiples above the value of the practice's tangible assets. The non-equity spouse will be cheated out of a fair share of a marital asset due to the appellate court's failure to understand the underlying economic significance of such covenants.

While there have been attempts to methodologically parse goodwill value into personal versus enterprise, in the end, there is no systematic way to do so.<sup>2</sup> All appraisers can and ought to do is assess the probabilities of transferability of a professional's

client, patient, customer base and/or referral sources. This is a more tractable exercise. It is also a cornerstone of goodwill value. Most of the methods that vainly attempt to parse the sources of goodwill miss this point. The facts and circumstances usually tell a clear story. If the professional has many repeat patients, clients, or customers, usually a well-planned exit strategy involving a recommended successor combined with a non-compete covenant will lead to a significant percentage of the customer base being transferable. On the other hand, if the professional relies on only a few referral sources for most business, the situation may be more difficult to assess. If, as in *Prahinski*, the practice relies exclusively on referral sources, then the question is whether or not the retiring professional can influence the referral sources to continue referring to the designated successor. If so, then there is a competitive advantage to a buyer, who will have access to referral sources for whom he or she would otherwise have to compete.

### Who Should Have the Burden of Proof?

If the professional practice is in a sector where equity exchanges are common place (such as accounting, dental and chiropractic), then this should tell the courts that most such practices have transferrable client and patient bases. The equity owning spouses should have to show why their practices do not have transferable client or patient bases. Only in cases where there are not many exchanges should the burden of proof shift to the non-equity spouse. These would be practices where the services are so specialized and referrals are the source of most revenue. Here is a hypothetical example.

A surgeon has perfected a "cutting edge" new surgical procedure. Her new techniques have generated attention in academic and professional journals as well as the mainstream media. For a number of years after



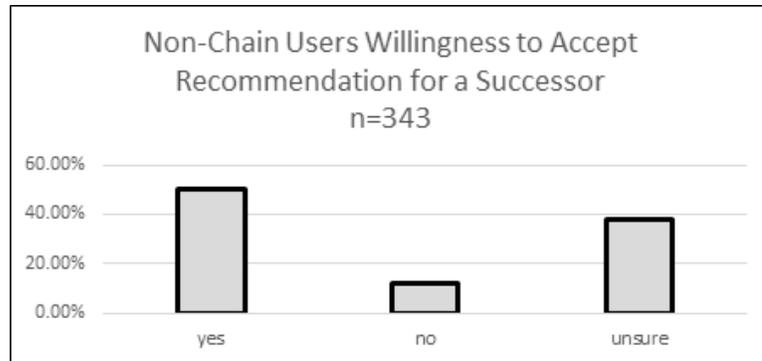
her breakthrough, she gets referrals and calls from all over the world to perform this specialized new surgery. She is quickly backlogged with surgical requests. She is performing many surgeries but can't handle the volume of requests. What will she do? This depends upon whether she is entrepreneurial or not. If she is entrepreneurial she will hire other surgeons and train them to perform the specialized surgery. She will expand her surgical practice to include other surgeons. If she is not entrepreneurial, her receptionist will answer requests by saying that due to the high demand she is no longer taking new patients. The receptionist will no doubt be asked about other surgeons who can perform the surgery and perhaps the innovative surgeon has provided the receptionist with a list of such surgeons. Now note that these referrals can have significant economic value to the referred surgeons, but, due to anti-kickback laws<sup>3</sup> the referring surgeon cannot collect a fee for the referral. So, given these facts, does she possess goodwill or not? If she sets up a firm with her name on it and trains other surgeons to perform the surgery as she does, **and** referrals will continue even if she retires from active surgery, then she has enterprise goodwill. The question of value turns not on the surgeon's reputation or past innovation or skill. The question of value turns on the future response of her existing referral sources. Will they or will they not continue referring patients to her surgical firm once she retires from active practice? But note also that no other surgeons would rationally invest in such a surgical practice if the founding surgeon was allowed to continue performing the surgeries because those referral sources would continue to refer to her and not the new owners of the surgical center.

**Some Empirical Research**

As part of my development of a new model for appraising goodwill for small service firms I conducted sur-

vey research that directly bears on the question of transferability.<sup>4</sup> I utilized Survey Monkey Audience to obtain appraisal relevant answers from customers of "male only" barber shops. One of the questions I sought to answer was what percentage of customers would typically follow their current barber's recommendation for a replacement in the event of an equity transfer.

I asked respondents who patronized non-chain barbers to indicate the likelihood they would accept their current barber's recommendation for a successor. I found that in aggregate nearly 50 percent of the non-chain customers indicated that they would accept their barber's recommendation.



I drilled down into the data on respondents' willingness to accept a recommendation for a successor to see if there are statistically significant relationships that would allow for refined predictions of transfer rates. One variable I considered was the relationship between the frequency of patronization and the willingness to accept the seller's recommendation for a successor. Here are the responses broken down by five categories of patronization frequency:

	<u>Weekly</u>	<u>Semi-Monthly</u>	<u>Monthly</u>	<u>Every 6 weeks</u>	<u>&gt; 6 Weeks</u>
<b>Yes</b>	78.6%	61.7%	52.4%	45.2%	39.4%
<b>No and Unsure</b>	21.4%	38.3%	47.6%	54.8%	60.6%

Utilizing these categories, the relationship between frequency of patronization and willingness to accept the old owner's recommendation is highly significant (p = .0155).<sup>5</sup> Here are the upper and lower bound "yes" percentage responses broken down by frequency of patronization:<sup>6</sup>

	<u>Yes</u>		
	<u>%</u>	<u>Lower Bound</u>	<u>Upper Bound</u>
<b>Weekly</b>	78.6%	74.2%	82.9%
<b>Semi-Monthly</b>	61.7%	56.6%	66.8%
<b>Monthly</b>	52.4%	47.1%	57.7%
<b>Every 6 weeks</b>	45.2%	39.9%	50.4%
<b>&gt; 6 Weeks</b>	39.4%	34.2%	44.5%

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It makes intuitive sense that the more frequent customers would form closer bonds with their barber, and hence be more willing to accept their recommendation for a replacement buyer. This result underscores an important point. The closer the attachment a patient, client or customer has to their professional the more likely they are to listen to their recommendation for a replacement. This is the reverse of the interpretation that the Second and Fourth Districts applied to the covenant not to compete. For the appellate courts, close attachment implies an absence of transferability. To the contrary, close attachment enhances transferability, and hence the value of enterprise goodwill.

## Fixing the Appellate Courts Errors

In summary, the distinction between personal and enterprise goodwill rests on a misunderstanding of a key element of divisible goodwill: the transferability of the professional's customer, patient, client, or referral sources to a designated successor buyer. Personal goodwill is largely a myth. There are no irreplaceable professionals. No matter how esteemed the professional, when they are no longer able or willing to practice their repeat customers, clients, patients or referral sources will seek out a replacement. If that professional can influence their patients, customers, clients or referral sources choice of a replacement they have the ability to command remuneration from the designated successor. This remuneration is divisible enterprise goodwill. There is no other kind. The Second and Fourth Districts' error is particularly egregious because they misinterpret the economic significance of seller covenants not to compete. The court interprets these covenants as evidence

of non-divisible personal goodwill. The economic reality is the opposite.

There are two avenues to fix the Florida appellate courts' error on the interpretation of covenants not to compete: legislative action or the Florida Supreme Court overturning the Second District's original standard. At first look, a legislative remedy would appear unlikely as the standard affects very few people. On the other hand, the broader use of covenants not to compete for other economic reasons has begun to receive some legislative attention. Some companies have demanded that lower level employees sign non-compete agreements. The Illinois legislature enacted a prohibition of this practice in 2016.<sup>7</sup> If the Florida Legislature were to consider a similar bill, it is possible that a provision overturning the Second and Fourth Districts' standard could be included. Barring this, an appeal of a Second or Fourth District case to the Florida Supreme Court in the only other remedy.

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## Endnotes

<sup>1</sup> Usually the seller's covenant is limited to a fixed period of time and/or a geographic location.

<sup>2</sup> A widely used method is the Multi-Attribute Utility Model developed by David Wood. See "Goodwill Attributes: Assessing Utility" in *The Value Examiner*, pp. 21-29 January/February 2007. The method focusses on the attributes of the professional to achieve an allocation between enterprise and personal goodwill. As I have argued here the only attribute of any professional that has any economic relevance is the professional's ability to influence their patients', clients', customers' or referral sources' decision on a designated replacement.

<sup>3</sup> The Stark Anti-Kickback legislation (Title 42, Section 1395nn, "Limitation on certain physician referrals") prohibits most forms of fee splitting arrangements which would make it difficult for the hypothetical surgeon in this example to collect fees for referrals.

<sup>4</sup> See pp. 165-184 of my book *Goodwill in Small Service Businesses: Negotiating a Fair Price*, Booklocker.com, Inc., 2017 for a full description of the survey methods and results summarized here.

<sup>5</sup> "P" values are measures of statistical significance. "P" represents the probability of obtaining the sample result under an explicit assumption that there is **no** relationship between the variables of interest. A low "p" values indicates that the relationship between the variable is non-random. Survey question results were evaluated using "Chi Squared" tests. By convention we do not say that a relationship is statistically significant unless the "p" value is .05 (5%) or less.

<sup>6</sup> Statisticians recognize that when attempting to determine a population statistic based on sampling from that population error is inevitable. Such error is referred to as sampling error. Sampling error arises because no matter how carefully a sample is drawn, it is unlikely to represent the population precisely. The lower bound and upper bounds are based on confidence intervals assuming that the true mean is between plus or minus two standard deviation units from the sample mean.

<sup>7</sup> Illinois Freedom to Work Act, Ill. Comp. Stat. 820, Sec. 5, Sec. 10 (2017).

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