

What is my Practice Worth to my Spouse, My Partners or to Another Attorney?

Ronald L. Seigneur CPA/ABV MBA CVA
Denver, Colorado

Our CPA/consulting firm is nationally recognized for its work with law firms on a wide range of administrative management issues. In conjunction with providing these services, we have been engaged on several occasions to value law firm equity interests for various reasons. As a valuation specialist, I find the work in this area to be especially challenging due to certain trends particular to law firms and professional service providers in general.

This article will explore and comment on some of the more unique and possibly controversial issues related to the valuation of an equity interest in a law practice.

In the context of litigated disputes regarding the valuation of law firm interests, it is critically important to recognize that there is a wide variation between states in some areas critical to a proper measurement of value due to differing state law and case precedents.

One such area of extreme difference between states is in the recognition and measurement of professional goodwill in comparison to what is referred to as practice or enterprise goodwill. Professional goodwill is essentially the intangible value inherent in the individual attorneys ability to build and maintain a successful practice. Practice goodwill is the intangible value associated with the enterprise itself. One rather simplistic way to view these two types of intangible value drivers is from the perspective of the client, in terms of whether their allegiance and confidence is to the individual and his or her perceived abilities and competence, as opposed to the efficiencies and reputation of the larger enterprise.

In divorce courts, some states, such as New Jersey, California and Washington have case law which strongly favors the recognition of professional goodwill, while other states, including Wisconsin, Kansas, Tennessee and Illinois have case law precedents which do not favor the recognition of professional goodwill. Other states, such as Nebraska and Missouri are somewhat in the middle of the road on this point. This factor can make a distinct difference in the measurement of value, especially given the fact that certain recognized valuation methods place great emphasis on the measurement and quantification of professional goodwill as a significant component of overall value.

One such widely recognized valuation method is called the excess earnings approach. This method was first advocated by the U.S. Treasury in 1920 and subsequently by the Internal Revenue Service in 1968 in Rev. Proc. 68-609 and has since been regularly used in valuation assignments of professional practices, as well as other types of business interests. In the context of a professional practice, the excess earnings method of valuation considers the excess of a specific practitioner's earnings over the comparable earnings of his or her peers as an indication of excess intangible value. The excess, if any, is capitalized at an appropriate percentage rate of return to capture a measure of professional goodwill value. Sometimes this "cap rate" is expressed as a multiple (i.e. a

25% cap rate [1/25%] is equal to a multiple of 4). In other applications of this method, the excess earnings are measured as the excess earnings over a satisfactory return on tangible assets of the enterprise.

It is important to recognize that the preceding discussion of the mechanics of excess earnings approach is overly simplified and beyond the scope of this article. More information can readily be found in current valuation literature, including excellent discussions in the treatise Valuing Small Businesses and Professional Practices, by Shannon P. Pratt, Robert Reilly and Robert P. Schweihs, Irwin 3rd edition; and Valuing Professional Practices and Licenses, by Ronald L. Brown, 3rd edition, Aspen Law & Business.

Many valuation specialists believe the excess earnings method of valuation is overused and abused. It has gained such a wide acceptance in dissolution of marriage proceedings, that often it seems to be the method of choice by the bench merely because it is the one method that has been used so routinely that most everyone, including the judge, thinks they understand it. One critical problem in applying this method is in the precise measurement of the excess earnings base to be capitalized. Often valuation professionals attempt to compare a specific practitioners performance to economic survey statistics produced by local bar associations and nationally by Altman Weil Publications, Inc. based in Philadelphia, PA. These direct comparisons can lead to very misleading conclusions due to the fact that the survey data typically is not adjusted for differences in the underlying work ethic between practitioners. In other words, if an individual makes more money merely because they choose to work harder than “average”, this excess income is not necessarily an indication of excess earnings and, in turn, professional goodwill, but rather is indicative of someone who works harder than their peers.

Another critical valuation issue concerns what is referred to as the standard of value. Typically valuation assignments are conducted with agreement between all interested parties as to an appropriate standard of value to be applied to the valuation conclusion. Most often a standard of fair market value or fair value is used, although a liquidation standard may be applicable in situations where the premise of going concern is no longer a given. Going concern essentially means that the enterprise will continue to operate in substantially the same fashion as it has historically for purposes of the valuation exercise.

The classic definition of fair market value is the value, in cash or cash equivalents, that an interest would change hands between a hypothetical willing buyer and hypothetical willing seller, each being knowledgeable of all pertinent facts and neither being under duress to complete the transaction. Fair value is a subset of fair market value where an interest, which is less than the whole enterprise, is valued without applying something called a minority interest discount, which reduces the value of a minority share of an enterprise as measured under the fair market value standard in recognition of the inferior attributes of ownership that come with owning less than a controlling interest in an enterprise.

In recent years, a new standard of value has emerged. This is something that we have come to refer to as the “Huff standard” here in Colorado (In Re Marriage of Huff[834 P 2d 244 Colo. 1992]). This landmark case, regarding the valuation for divorce of a law partners interest in a large law regional law firm, essentially established that the

appropriate standard was the value to the practitioner. Simply put, what would the practitioner be willing to pay to retain their own earnings stream, as opposed to what a hypothetical willing buyer would pay. Many other states have adopted case precedents which fall in line with this perspective on value.

Lets also give mention to two other areas related to valuation determinations, which warrant discussion. First is a consideration of how quickly the goodwill value of a professional practice can dissipate upon the death or extended incapacity of a professional practitioner. Roughly speaking a measure of this loss in value over time might be conveyed as follows:

	Goodwill value (and loss)
Day before death/incapacity	100%
Date of death/incapacity	-10 to -20%
Each <u>day</u> , the first week	-1 to -3%
Each day, 2 nd week to end of first month	-2 to -4%
Value after one month	20 to 60% of original value

Highly specialized and smaller solo practices generally will be more susceptible to rapidly diminished values given the inability, as compared to larger practice units, of fellow practitioners to efficiently step in to assume responsibility for the underlying client relationships.

The fact that the goodwill component of value in a professional practice dissipates quickly is good reason to explore a second emerging area of interest. The ABA House of delegates adopted new rules in 1990 which allow for the sale of a law practice. Most states today have either adopted or are seriously considering adoption of ABA Rule 1.17 which works to eliminate longstanding disparities between large law firms and small solo practice units in the treatment of both clients and attorneys.

Under these new rules, a lawyer may sell or purchase a law practice, including the associated goodwill, if the following conditions are satisfied:

- a. Seller ceases to engage in the private practice of law in the jurisdiction in which the practice has been conducted.
- b. The practice is sold as an entirety to another lawyer or law firm in good standing.
- c. Written notice is given to each of the seller's client's regarding:
 - i) the proposed sale,
 - ii) the terms of any proposed change in the fee arrangement, also see section d) below
 - iii) the client's right to retain other counsel or to take possession of the file
 - iv) the fact that the client's consent will be presumed if no action or objection within 90 days (requires court order in some circumstances)
- d. The fees charged to the client may not be increased by reason of the sale. The purchaser may, however, refuse to undertake representation unless the client consents to pay the purchaser fees at a rate not exceeding the fees charged by the practitioner for rendering substantially similar services.

States which have adopted Rule 1.17 in some form:

Alaska, Colorado, Florida, Hawaii, Idaho, Indiana, Iowa, Massachusetts, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Washington, West Virginia, Wisconsin & the Virgin Islands.

California Rule 2-300, is similar and actually predates ABA Rule 1.17.

States which are considering Rule 1.17 (some may have also adopted as of this date):

Arkansas, Mississippi, Ohio, Pennsylvania, South Carolina, Utah, Georgia, Louisiana, Maine, Montana, Nebraska, New Hampshire, Tennessee, Vermont, Texas and Puerto Rico

The Illinois supreme court rejected the rule, but it has been endorsed by the state Bar.

The advent of these new rules effectively allow solo practitioners or their estates to proactively package a practice for sale on par with the transference techniques which have effectively been in place in larger firms for many years. Given the rapid dissipation of value for a professional practice once it is no longer actively engaged, attorneys are urged to establish appropriate arrangements for the handling of such affairs if circumstances warrant. Use of a formal practice continuation agreement between capable practitioners can serve to protect such value and, at the same time, be in the best interests of the clients being served.

This article has covered a wide range of current issues in the valuation of a law practice equity interest. Obviously, more study is required prior to making informed judgements and decisions in the areas addressed.

Ron Seigneur, Accredited in Business Valuation by the AICPA, is a Denver based law firm consultant and valuation specialist. He can be reached at 303/980-1111 or at

ron@cpavalue.com.

Visit his website at www.cpavalue.com.