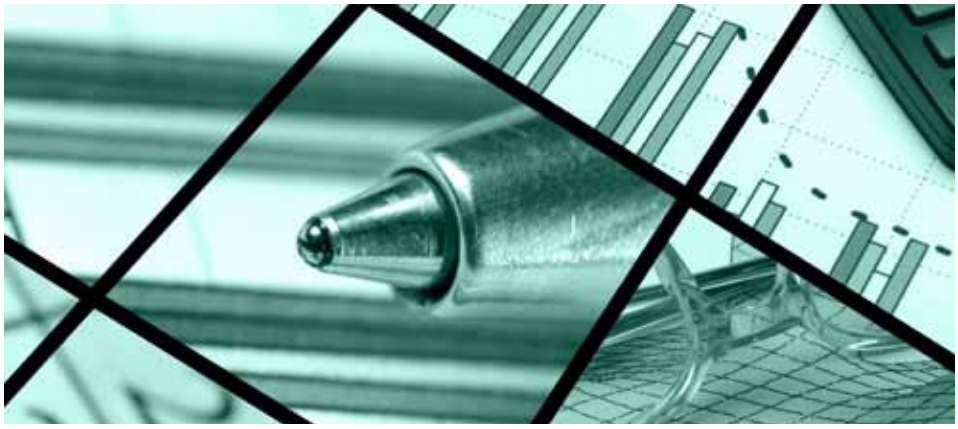


Walsh Appellate Ruling Series

Part One: Segregating Work Effort from Excess Earnings

by Mark Hughes

The appropriate valuation of goodwill in marital dissolutions has long been a subject of intense debate and scrutiny in the Arizona Family Law and Appellate Courts. In October 2012, the Arizona Court of Appeals issued a decision (the "Appellate Ruling") in Walsh v. Walsh (1 CA-CV 11-0269) that clarifies, and builds upon, a history of precedent cases regarding the appropriate valuation of goodwill in law firms and other professional practices. The Court reversed the trial court's decision that to place a value in excess of the firm's buy-sell agreement on husband's ownership interest in a law practice would require speculation. The Court of Appeals held that:

> "In part, on this record the court should not have relied on the realizable benefit approach." and,
>
> "The family court should have considered Husband's personal goodwill in valuing Husband's law practice beyond his stock redemption interest in the firm."

The opinion recognized the challenges associated with placing a value on goodwill in professional practices. Known as the most intangible of intangibles, the valuation of professional practice goodwill requires a highly theoretical approach. This is particularly true for practices such as law firm partnership interests which do not routinely sell on the open market. The Appellate Ruling cites Hollander v. Hollander, 597, A.2d 1012, 1018-19 (Md. Ct. Spec. App. 1991):

"Although assessing the value of goodwill may seem a formidable task, the intricacy of the solution should not force any court to shirk its responsibility nor ignore the basic fact that goodwill holds considerable value for the professional."

The analysis and testimony of valuation experts should provide the family courts with the appropriate information to value goodwill in conformity with the legal principals discussed in the Appellate Ruling which stated:

"Although the family court may have been concerned about speculation, consideration of the Wisner factors and expert testimony help guide the court in its examination of enhanced future earning capacity."

While the Appellate Ruling prescribed no specific methods for calculating goodwill upon remand, the Appellate Court did discuss the appropriate legal constructs that should apply when valuing professional practices for marital dissolution. By considering the legal principles discussed in the Appellate Ruling and other Arizona cases, and applying valuation techniques that align with these principles, valuation professionals can assist triers of fact in objectively valuing professional practices in marital dissolutions.

The Appellate Ruling also stresses that future earnings should not be included in any professional practice valuation by stating:

"In applying the factors discussed above, 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."

In two articles, I will propose valuation techniques that seek alignment with the legal theories expressed in the Appellate Ruling. Understanding the valuation methodologies relating to law firm ownership interests will allow attorneys to better advise their clients in marital dissolutions. A logical starting point to begin an analysis of a professional practice's goodwill for marital dissolution purposes is to segregate historical earnings from work effort from the excess earnings of the practice. In the following sections of this first article, I will illustrate a market-based proxy approach that may be applied to properly segregate post-dissolution work effort from future excess earnings derived from goodwill.

Segregation of Post-Dissolution Work Effort

To properly segregate post-dissolution work effort, one must ask, "What is the typical unit of work effort in a particular profession?" For financial and legal professionals, the typical unit is the billable hour. By identifying the appropriate financial measure of work effort in a profession, the valuation expert can then examine market-based evidence of what professional firms typically pay for this effort to non-owners.

The future is inherently unknowable. To avoid devolving into the realm of specula-

tion when valuing goodwill, experts must rely upon sound valuation techniques and theory. When valuing professional practices, the expert will typically perform an analysis of historical earnings to gain insight into anticipated future results. To avoid including the economic benefits of post-dissolution work effort in a future projection, the expert must determine a reasonable market-based return on the attorney's labor and subtract this return from the total adjusted earnings of attorney. The residual excess earnings, after market-based compensation is subtracted, represent economic returns on the law practice's tangible assets and goodwill. It is these excess earnings that are projected into the future and discounted to a present value to arrive at the value of a law firm ownership interest.

Examining available financial market evidence helps to bring objectivity into an inherently subjective exercise. Often, no perfect non-owner salary information exists. Due to this fact, financial experts are left to access and interpret financial market information that can serve as a reasonable proxy.

Examining available financial market evidence helps to bring objectivity into an inherently subjective exercise.

Total Compensation

To illustrate the segregation of future work effort for an attorney, consider the following example of a hypothetical attorney, Example Partner ("EP"), in an Arizona law firm. We will only consider one year of historical data for purposes of this example. However, it may make sense to perform this analysis for several years to determine overall trends. EP billed 1,750 hours at $450 per hour with a 95 percent collection rate to arrive at collected billings of approximately $748,000. Firm overhead is approximately 40% leaving 60% of collections (Collection to Compensation %) available to EP as compensation of $450,000. In addition, EP receives $100,000 of profit allocation from the firm's leveraging of associate attorneys and staff to bring his total compensation to $550,000. In addition, EP also works 300 hours per year performing administrative tasks for the firm. The details of EP's compensation are presented below.

	Actual		
	Billable	Non-Billable	Total
Actual Hours	1,750	300	2,050
Hourly Rate	$450	N/A	
Collection %	95%	N/A	
Gross Collections	$748,125	$0	$748,125
Collection to Compensation %	60%	N/A	N/A
Subtotal	$ 450,000	$ -	$ 450,000
Firm Profit Allocation	100,000	-	100,000
Total Pre-Tax Income	$ 550,000	$ -	$ 550,000

Developing a market-based level of compensation for EP's work effort requires a careful analysis of the labor components that comprise his $550,000 of total income. EP's total income is derived from three specific sources: personal goodwill, enterprise goodwill and work effort. By applying a market proxy analysis to determine market rates for EP's billable and non-billable hours, we can properly segregate his work effort from excess earnings.

Adjust for Personal Goodwill Factors

Two areas in which EP's personal goodwill financially presents itself are his above average billing rate and his above average collections rate. Obtaining directly comparable empirical data for hourly rates and collections rates can be difficult. At the national level, ALM Legal Intelligence offers resources that may provide relevant benchmark in-

formation for partners in larger national law firms. The State Bar of Arizona publishes the Economics of Law Practice in Arizona approximately every three years which provides information that is helpful for smaller practices. An alternative method of obtaining benchmark information is to conduct a formal or informal survey within a specific legal specialty in the local market. We will assume that market-proxy evidence indicates that most senior attorneys in EP's specialty bill at a rate of approximately $350 and collect approximately 85% of billings.

	Actual Billable	Market Proxy Billable
Actual Hours	1,750	1,750
Hourly Rate	$450	$350
Collection %	95%	85%
Gross Collections	$748,125	$520,625
Collection to Compensation %	60%	50%
Subtotal	$ 450,000	$ 262,500
Firm Profit Allocation	100,000	-
Total Pre-Tax Income	$ 550,000	$ 262,500

By adjusting EP's billing from $450 to $350 in the market proxy analysis, we have removed the excess income associated with the fact that EP bills at a higher rate than his peers in the market due to his 'reputation in the community for judgment, skill and knowledge'. By adjusting EP's collection percentage from 95 percent to 85 percent, we have also removed the excess income associated with the fact that EP collects at a higher rate than his peers due to higher client satisfaction.

Adjust for Enterprise Goodwill Factors

After adjusting for the personal goodwill factors described above, we then make adjustments to eliminate the enterprise goodwill component of EP's compensation. The first adjustment is to compute a market rate of overhead that reflects the amount that similarly skilled non-partner attorneys receive in the marketplace as a percentage of their collections. A possible proxy for this is the rate of collections paid to Of-Counsel attorneys practicing in the same legal specialty and geographic market. In this example, we will assume that similar Of-Counsel attorneys receive 50% of their collections. By adjusting EP's Collection to Compensation percentage from 60% to 50% we have adjusted for the lower overhead paid by EP as a result of the firm's enterprise goodwill. We will assume the firm profit allocation is also related solely to the business model of EP's firm. Accordingly, we eliminate this $100,000 return on enterprise goodwill in our market proxy analysis.

Assign Market Wage to Non-Chargeable Hours

After adjusting for certain personal and enterprise goodwill factors, the final step in our market-based compensation analysis is to assign a market wage to the 300 hours of general and administrative time worked by EP. A source of guidance for this information could be salary data for in-house counsel, which is presented annually in a variety of surveys, including the GC Compensation Survey. We have attributed a market-based hourly rate of $125 per hour for these hours.

Calculate Market Wage for Work Effort and Excess Earnings

Based on the procedures above, we have segregated the income produced by personal and enterprise goodwill from income produced by EP's work effort to arrive at a market-based annual salary of $300,000. We then subtract this salary of $300,000 from EP's total business income of $550,000 to arrive at excess earnings of $250,000.

	Actual			Market Proxy		
	Billable	Non-Billable	Total	Billable	Non-Billable	Total
Actual Hours	1,750	300	2,050	1,750	300	2,050
Hourly Rate	$450	0		$350	$ 125	
Collection %	95%	N/A		85%	N/A	
Gross Collections	$748,125	$0	$748,125	$520,625	$37,500	$558,125
Collection to Compensation %	60%	N/A	N/A	50%	N/A	N/A
Subtotal	$ 450,000	$ -	$ 450,000	$ 262,500	$ 37,500	$ 300,000
Firm Profit Allocation	100,000	-	100,000	-	-	-
Total Pre-Tax Income	$ 550,000	$ -	**$ 550,000**	$ 262,500	$ 37,500	**$ 300,000**

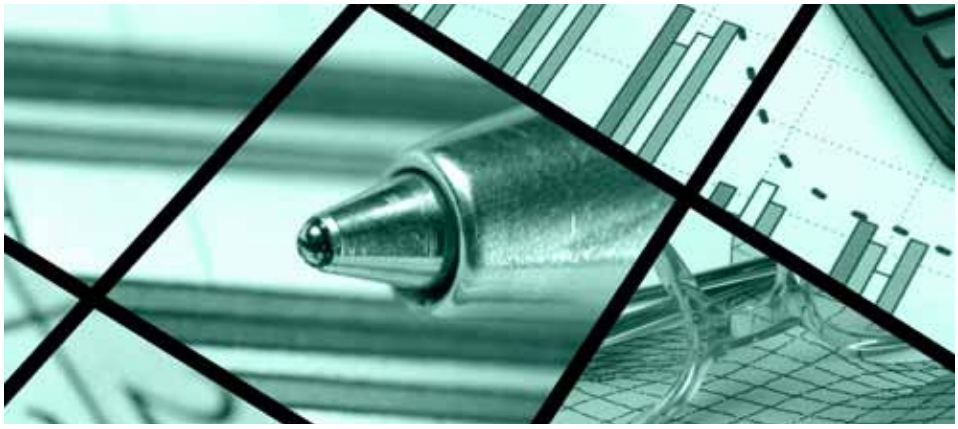
Summary and Conclusion

The Appellate Ruling requires a thorough segregation of economic returns on future work effort from earnings related to goodwill. While the proxy data for senior-level attorney compensation is rarely formally dissected on a per-hour basis in salary surveys, market proxy evidence may be derived from the best available sources in the local marketplace. By utilizing the best available objective evidence in the market, valuation experts can utilize the techniques highlighted in this article to move beyond the realm of pure speculation and assist the courts in properly segregating future work effort from excess earnings for marital dissolution purposes.

The segregation of historical work effort from business income forms the foundation upon which excess earnings can be projected into the future and discounted to a present value to arrive at the value of a professional practice. In the next article in this series, I will discuss the Wisner Factors and their application in valuing the $250,000 of excess earnings produced by EP's practice.

Mark Hughes, CPA, *has performed more than 500 business valuation and litigation support engagements over the past ten years. As a full-time valuation and litigation support professional, he has assisted counsel in areas of financial dispute ranging from valuing professional practices for marital dissolution purposes to the restructuring of large corporations in bankruptcy proceedings. His expertise includes preparation of valuations of privately held businesses for a variety of purposes including marital dissolutions, business acquisition or sales and dispute resolution. He also provides expert opinions regarding business valuation, bankruptcy, loss of earnings calculations and other economic damage issues.*

By utilizing the best available objective evidence in the market, valuation experts can utilize the techniques highlighted in this article to move beyond the realm of pure speculation and assist the courts in properly segregating future work effort from excess earnings for marital dissolution purposes.



Walsh Appellate Ruling Series

Part Two: Applying the Wisner Factors to Value Goodwill

by Mark Hughes

In October 2012, the Arizona Court of Appeals issued a decision (the "Appellate Ruling") in Walsh v. Walsh (1 CA-CV 11-0269) that clarifies, and builds upon, a history of precedent cases regarding the appropriate valuation of goodwill in law firms and other professional practices.

The Appellate Court spends considerable time discussing the attributes of goodwill in a professional practice. In discussing these attributes, the Appellate Court cites factors from the 1981 appellate decision in Wisner v. Wisner, 129 Ariz. 333 (1981) which relied on Lopez v. Lopez, 38 Cal.App.3d 93, 113 Cal. Rptr. 58 (1974). While not exhaustive, the following Wisner Factors provide a framework for the valuation expert in analyzing goodwill:

- Age
- Health
- Past Earning Power
- Reputation in the Community for Judgment, Skill and Knowledge
- Comparative Professional Success

In this second article, I will examine the Wisner Factors and then continue with the EP example from my previous article to illustrate valuation techniques that incorporate the Wisner Factors and align with the legal theories expressed in the Appellate Ruling.

Age

The age of the professional is of critical importance in any valuation of a professional practice. The valuation expert must understand the expected work life for a particular professional in order to properly forecast his or her excess earnings over a reasonable period of time. It is also important to understand what the economic realities (contractual or otherwise) will be upon the professional's retirement.

In valuing most types of businesses, valuation experts assume that the business will continue to exist forever. While most small businesses do not actually continue for hundreds of years, this assumption is generally reasonable as it is often possible to sell the business based on its future cash flows (again projected into forever) upon the owner's retirement. In the case of a professional practice, often an exit based upon future cash flows is neither feasible nor contractually possible. Therefore, projecting a reasonable work life and properly identifying the buy-out that occurs upon a professional's exit is critical to a proper valuation.

In the Walsh Case, the Family Court utilized the net realizable benefit that Mr. Walsh would receive upon exiting or retiring from the firm as opposed to considering the excess earnings that he may earn over his remaining work life. The Appellate Court reversed the Family Court's decision that to place a value in excess of the firm's buy-sell agreement on husband's ownership interest in a law practice would require speculation by stating,

> "In part, on this record the court should not have relied on the realizable benefit approach."
>
> and,
>
> "The family court should have considered Husband's personal goodwill in valuing Husband's law practice beyond his stock redemption interest in the firm."

Wife's expert utilized a capitalization of earnings method to value his estimate of excess earnings. This approach assumes the perpetual nature of a business described above and may have failed to capture both Mr. Walsh's remaining work life and the defined benefit that he will receive upon exit.

For some firms, the work life is defined by a mandatory retirement age. In the absence of a mandatory retirement age, factors that

can be considered include the age at which other professionals in the firm have retired, the industry average retirement age, discussions with the professional, examination of any documents regarding retirement intentions, and the health of the professional. For younger professionals with remaining work lives of greater than 15 years, projecting an accurate date of exit is of lesser importance and more traditional perpetual techniques may be utilized, as the difference is immaterial on a present value basis.

The historical earnings of a professional practice often provide the most objective and reliable evidence of anticipated future results.

Health

A professional's health is relevant to the valuation for two reasons. The first consideration is to help project a remaining work life, as described above. It is also relevant to consider the professional's health when assessing the risk of the projected future cash flows over the remaining work life. Health can greatly impact the risk profile of projected future cash flows. Valuation experts can examine the degree of technical work done by a particular professional to understand the risks associated with projected future income should the professional no longer be able to perform the same technical work for a short duration or long-term. For attorneys, the health-related risk profile for an attorney that was active in briefing and trying cases might be greater than that of an attorney who was primarily responsible for business development and relationship management.

Past Earning Power

The historical earnings of a professional practice often provide the most objective and reliable evidence of anticipated future results. To properly segregate historical work effort from excess earnings, a market salary must be applied to each component of the professional's work effort (as described in the first article in this series). However, the past is only relevant to the extent it is predictive of the future. The valuation expert must consider the trend, volatility and sustainability of historical excess earnings in order to develop a reasonable projection of future excess earnings. Understanding industry trends and forecasts, along with understanding the dynamics of a particular legal niche, provides valuable information to assist in developing a reasonable projection.

Reputation in the Community for Judgment, Skill and Knowledge

For many professionals, his or her reputation in the community will be reflected in their past earning power. However, in some circumstances the current reputation of a professional will not be reflected in the historical earnings of his or her practice. This could be true for younger professionals who have recently reached a new level in the professional community through notoriety or distinction. The opposite could also be true for a professional who has recently suffered a serious blow to their reputation through bad publicity or a general change in market perception. When assessing a professional's reputation in the community, valuation experts must examine the reputation as of the valuation date and determine if there is any material difference in reputation from the historical period being analyzed.

Illustrative Example

In the first article in this series, I discussed the importance of segregating work effort from excess earnings. To illustrate this point, I applied a market proxy analysis to determine a market-based compensation for a hypothetical partner in an Arizona law firm, Example Partner ("EP"). This example determined that EP had historical excess earnings of $250,000.

We will assume EP is 60 years old as of the date of valuation and that his firm's mandatory retirement age is 65. Partners receive $20,000 upon their retirement, which is equal to the amount they paid to buy in to the firm. EP's health is stable but he has recently been diagnosed with high blood pressure and is taking medication. His reputation in the community is strong and is built upon 30 years of successful litigation practice in

Arizona. However, in talking with other attorneys in the same niche area, EP is known to be winding down his involvement on some cases and no longer works around the clock in the weeks leading up to trial.

Develop the Discount Rate

To develop a proper discount rate, the valuation expert must consider the risk attributes associated with the excess earnings being projected. There is no public market data available for rates of return for professional practices. Thus, we must analyze available market data and apply judgment to develop an appropriate discount rate.

It is important to note that, when valuing a partner's ownership interest in a large law firm, the expert is not valuing the firm itself and then multiplying that value by the partner's ownership percentage. Rather, in a family law context, the expert is valuing only the projected future excess earnings (in excess of market compensation) over the professional's remaining work life.

Rates of return for the smallest publicly traded companies are approximately 15%. While these companies may be the smallest in the publicly traded category, they are vastly greater in size and diversification than the typical professional practice. Considering the Wisner Factors discussed above as they relate to EP's practice, we will assume that 30% is determined to be an appropriate discount rate.

Capitalization of Earnings Method

As previously discussed, the capitalization of earnings method values a projected income stream into forever. We will assume that the $250,000 of EP's excess earnings results in $162,500 of after-tax cash flows. We then utilize the 30% discount rate and subtract inflationary growth of 3% to arrive at a capitalization rate of 27%. The $162,500 of cash flows are then divided by 27% resulting in a value of the practice of $600,000.

Projected After-Tax Cash Flows	$	162,500
Discount Rate		30.00%
Long-Term Growth Rate		3.00%
Capitalization Rate		27.00%
Sum of Present Value of Cash Flows	$	601,852
Value of Professional Practice (Rounded)	**$**	**600,000**

This method, while simple, fails to capture EP's 5 year work life and the fact that he receives $20,000 upon retirement as opposed to selling his practice based on future cash flows.

Discounted Cash Flows Method

The discounted cash flow method ("DCF") values future cash flows over a defined period of time. We will utilize the same $162,500 of after-tax cash flows and 30% discount rate as the previous method. As opposed to projecting inflationary growth of 3%, we will project no growth in earnings due to the slightly diminishing reputation of EP. We will project these cash flows over EP's remaining 5 year work horizon and then add the $20,000 exit

payment at the end of year 5. This method results in a value of the practice of $400,000.

	Year 1	Year 2	Year 3	Year 4	Year 5	Buy-Out
Projected Pre-Tax Excess Earnings	$ 250,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000	$ 20,000
Less Income Taxes at 35%	87,500	87,500	87,500	87,500	87,500	-
After-Tax Cash Flows	$ 162,500	$ 162,500	$ 162,500	$ 162,500	$ 162,500	$ 20,000
Discount Rate 30.00%						
Present Value of After-Tax Cash Flows	$ 125,000	$ 96,154	$ 73,964	$ 56,896	$ 43,766	$ 5,387
Sum of Present Value of Cash Flows	$ 401,167					
Value of Professional Practice (Rounded)	**$ 400,000**					

For a professional with a relatively short work life, the discounted cash flow method allows the valuation expert to more realistically project excess earnings and exit payments over a timeframe that reflects reality. The capitalization of earnings method above reflects a value that is $200,000 higher, representing a 50% increase, than the discounted cash flow method. This example is intended to highlight the importance of considering a professional's age, work life and exit benefits when valuing a professional practice for marital dissolution.

Summary and Conclusion

The Appellate Court specifically stated that valuation experts should help guide the court in properly addressing the issues surrounding professional practice valuation. By utilizing the best available market evidence, valuation experts can bring objectivity to an inherently subjective exercise that may be understood by the trier of fact. Understanding the legal principles surrounding professional practice valuation in Arizona, and developing valuation techniques that align with these ples, will allow experts, attorneys and the judiciary to consistently and equitably value professional practices.

The Appellate Court specifically stated that future work effort must be excluded from the valuation of a professional practice. The market proxy analysis illustrated in the first article in this series seeks to utilize the best available market data to compute a market rate for compensation and excess earnings. The Appellate Court also expressly cited the Wisner Factors as being fundamental to a proper valuation of a professional practice. The example in this second article is intended to show the impact of the Wisner Factors when properly considered.

While the debate surrounding professional practice valuation for marital dissolutions in Arizona is likely to continue, all stakeholders can benefit from a basic understanding of how the current legal rulings intersect with modern valuation theories and techniques. Bringing clarity to this issue requires a partnership between attorneys, valuation experts and the judiciary. By sharing my thoughts as a valuation expert, I hope to have illustrated valuation techniques that align with the current legal landscape in Arizona with respect to this issue. I look forward to being part of this fascinating debate going forward.

Stay ahead of the curve by attending the half-day Business Valuation Conference also available as a webcast on December 6.

Mark Hughes (author) will moderate a panel on Arizona Case Law with Barry Brody and Taylor Young.

***Mark Hughes, CPA,** has performed more than 500 business valuation and litigation support engagements over the past ten years. As a full-time valuation and litigation support professional, he has assisted counsel in areas of financial dispute ranging from valuing professional practices for marital dissolution purposes to the restructuring of large corporations in bankruptcy proceedings. His expertise includes preparation of valuations of privately held businesses for a variety of purposes including marital dissolutions, business acquisition or sales and dispute resolution. He also provides expert opinions regarding business valuation, bankruptcy, loss of earnings calculations and other economic damage issues.*