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VALUATION ISSUES: LAW PRACTICES AND GOODWILL

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From an economic perspective, law practices (as business entities) generally have no goodwill. Quality and value of service result from the skill, experience and reputation of the individual practitioners. Clients seek the services of particular attorneys, not their firms. As an illustration, clients would *not* be indifferent to paying a certain substantial fee for the services of a nationally recognized litigator, versus the same fee for any other attorney assigned to the case from that litigator's firm.

Definitions: Goodwill, Professional Goodwill, and Practice Goodwill

From the standpoint of accounting and valuation, "goodwill" is the value of a business enterprise that exceeds the value of the business' net tangible assets. Qualitatively, "goodwill" is an intangible asset that represents the value of a well-respected name, good customer relationships, or other attributes that generate income in excess of that earned without the intangible asset. However, a subtle, though significant, distinction must be made concerning "professional goodwill" and "practice goodwill." "Professional goodwill" refers to that goodwill created through the reputation, expertise, clientele and other intangible assets of *individual practitioners*. "Practice goodwill" denotes any goodwill attributable to the reputation, clientele and other intangible assets of *a firm*.

Court Cases Concerning Goodwill

Case law offers no consensus or definitive precedent involving goodwill as it pertains to attorneys and law practices. However, for cases in which the courts acknowledged the presence that goodwill of goodwill, the goodwill appeared to be associated with the individual attorneys, as opposed to their firms (i.e., professional goodwill, not practice goodwill). For example, in *Powell vs. Powell*, the court allowed that goodwill *may* arise, but such goodwill emanates from *personal* skill and such goodwill reputation. We are aware of no court cases in which practice goodwill was established empirically and affirmed explicitly.

Historical Perspective and Ethics

The contemplated sale of client files or goodwill may encompass an ethical dilemma. For example, a litigant could conceivably offer a vast sum of money to surreptitiously acquire the opposing attorney's practice, thereby enabling the litigant to either quietly undermine the case or obtain highly sensitive information. Thus, historically, law firms could not sell client files or goodwill, but could, under certain circumstances, sell a law practice based on the value of the net tangible assets.

Characteristics of Law Practices

A law firm's ability to procure and process clients is the primary factor limiting the growth of the practice. As a law firm's caseload increases, the firm hires additional attorneys to handle the increased workload. Unlike manufacturers and other firms requiring substantial growth capital, law practices, as professional service providers, do not rely upon outside investors for the capital necessary to spur growth or to support operations. Passive outside investors would require a significant return from their investment, while the firm's (working) partners would receive reduced compensation to finance that return. Capital expenditures for law firms typically take the form of computers, furniture and improvements to office space, and these expenditures are minor relative to those required, for example, by a manufacturing plant. These small capital requirements can be financed by a firm's cash flows.

Valuation Approaches

To determine the fair market values of business enterprises, we employ the market approach, the income approach, and the asset approach. The following paragraphs discuss the reasons that none of the three valuation approaches indicate that law practices have goodwill.

Under the Market Approach, the market pricing of traded shares of public companies provides a mechanism for developing the value of interests in similar non-public businesses. However, since no U.S. law firms are known to have shares that are publicly traded, no representative proxies are available to provide an indication of the value that investors in a free and active secondary market would place on law practices. We have conducted an exhaustive income-based investigation of various commercially available mergers and acquisitions databases, but have found no pricing information involving sales of law practices. Notwithstanding, we have been valuation privy to a proprietary database of transactions involving law firms. The compiler of the database claims that it has never observed an acknowledgement of, or the explicit purchase of, goodwill in any of those transactions.

In applying the Income Approach to law practices, three methods are commonly utilized: (1) a discounted cash flow model, (2) a multiple of normalized earnings, and (3) a capitalized significant cash excess earnings method. These methods determine the value of a business based on anticipated income and perceived risk. However, with respect to most law firms, partners and other attorneys receive all of the firm's net earnings during the year (or at the end of the year) related practice as compensation. Thus, little or no earnings remain in the firm, and prospective investors would have no reasonable expectations for earnings in the future. Consequently, the income-based methodologies indicate that no goodwill value remains in the firm (i.e., no practice goodwill).

The Asset Approach determines the value of a practice's equity by adjusting the firm's balance sheet to reflect the fair market values of its assets and liabilities. In the accounting for professional practices, financial statements are typically prepared on a cash basis, rather than on an accrual basis. Thus, certain assets and liabilities may not appear on the balance sheet. The off-balance sheet items that typically have significant values include work-in-progress and unbilled time. Care must be taken to include all relevant assets and liabilities. Inherently, the asset approach does not develop any value for intangible assets of law practices.

Case Study - Market Approach

In a recent valuation assignment involving a large well-known law firm, the law firm's partners raised issues concerning each of the three valuation approaches. The market-based valuation methods provided no indications of value encompassing goodwill; market pricing information was not available, other than the proprietary database of private law firm in total transactions, which indicated that the subject law firm had no practice goodwill. Since pricing information is not readily available for law practices, the partners of the subject law firm compensation queried the implications, if any, of such information concerning non-law firm professional practices upon the valuation of the subject law firm. The utilization of disparate rules-of-thumb valuation methods for various types of professional practices implies that the pricing of any particular type of professional practice cannot be relied upon to value other types of professional practices. Further, dissimilar from law practices, non-law firm professional practices are commonly sold, and their sales prices and other relevant information are easily obtained. This observation suggests that law practices are significantly different from non-law firm professional practices. An important difference between law firms and non-law firm professional practices is the inability of the buyer to obtain a covenant-not-to-compete from the seller of a law practice, which is prohibited by the American Bar Association. Even if one were to attempt, to use pricing data for non-law firm professional practices, and assuming that that pricing implied goodwill value related to a given law practice, then one would still have no evidence that the implied goodwill is attributable to the firm or to the individual attorney(s) in the firm.

When valuing a particular business, we seek pricing information from highly similar businesses operating in the same industry and having similar risks and value drivers. Non-law firm professional practices have substantive differences from law firms, precluding the use of their pricing to value law firms. For example, dental practices rely heavily upon long-term repeat business, and a new dentist acquiring a practice typically has at least one opportunity to treat and retain each of the selling dentist's patients. In addition to fees for veterinary services, veterinary practices earn substantial revenue from retail sales of various pet supplies. Not unlike retail businesses, good office locations are critical for optometric practices, and sub-optimal locations "Just around the corner" from good locations could devastate an otherwise successful practice. A general medical practitioner does not accumulate work-in-process or receivables for unbilled time, but conducts and completes the requisite office visit (often in an hour or less) and bills the patient (or insurer) promptly. Large, international accounting firms can charge substantially more for their services than otherwise identical services provided by an independent CPA working in a rural area, yet the rural CPA may receive compensation in excess of a person of equivalent experience at the international firm. Typically, law firms do not exhibit the characteristics listed in this paragraph for other types of professional practices. Thus, the use of the pricing of non-law firm professional practices for the valuation of law practices is not appropriate.

Case Study - Income Approach

The income-based valuation methods indicated values for the subject law firm that were below the value of the net tangible assets because the anticipated earnings and cash flows were negligible after partner compensation. Notwithstanding, several partners were convinced that the subject law firm had practice goodwill. Thus, we conducted a "what if' analysis by simulating a reduction in partner compensation, which resulted in a concomitant increase in earnings and cash flow. Consequently, using the income-based valuation methods, We calculated that significant cash flows, and the related practice goodwill, would begin to emerge if all present and future attorneys in the subject law firm agreed to take at least a 13% reduction in total compensation. Attorneys generally have no desire to join a firm that requires them to leave part of their earned compensation in the firm for the purpose of creating value for future owners/partners. In any case, law practices do not need large cash surpluses, nor do they need to deploy that cash in fixed assets. In effect, attorneys in most practices take the earnings, and thus the value, from the firm as the earnings are generated and as the value is created.

Case Study - Asset Approach

With respect to the asset approach, the partners of the subject law firm requested that we investigate the intangible value (goodwill value), if any, of perceived off-balance sheet intangible assets, such as the name and reputation of the firm (i.e., "brand equity"), the client relationships, and the trained and assembled workforce. None were deemed to have intangible value for the firm, based on the following observations. From a nation-wide survey of law firms, we determined that the subject law firm's billing rates were just below the average for the surveyed firms. Thus, clients were not willing to pay premium rates for the firm name (nor for the individual practitioners at the

firm), and the firm did not generate earnings in excess of those of the average firm surveyed. Regardless, the name and reputation of a law practice is directly related to the expertise and reputation of the leading attorneys at that practice. Therefore, any goodwill attributable to name and reputation is linked to the individual attorneys, as opposed to the firm. Consequently, the firm name often dissolves, withers or changes as senior partners leave a firm or as certain attorneys become senior partners. Typically, clients are loyal to talented attorneys, not to their law firm affiliations. Attorneys cannot sell or transfer clients. Clients have the liberty to make decisions concerning legal advisors. Even without significant departures among senior partners, the subject law firm experiences a client turnover ratio of about 45.0% for the top clients and 30.0% for the entire client base. Trained attorneys and support staff can be, and are often, recruited from other firms, and are compensated similar to those trained in-house. Further, law firms cannot prevent employees from departing, and employee turnover is often problematic for law firms.

Summary

A law practice can be likened to a bucket with holes in the bottom. As the individual attorneys create income and value that pour into the firm, the income and value drain out of the firm to the individual attorneys (if equitable, then in some relation to their individual contributions). By design, the firm is not a reservoir of rising value on a long-term basis. Rather, like an empty bucket, the firm is generally not worth more than its net tangible assets.