



# 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.

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### 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.

	<b>Actual</b>	<b>Market Proxy</b>
	<u>Billable</u>	<u>Billable</u>
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.

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