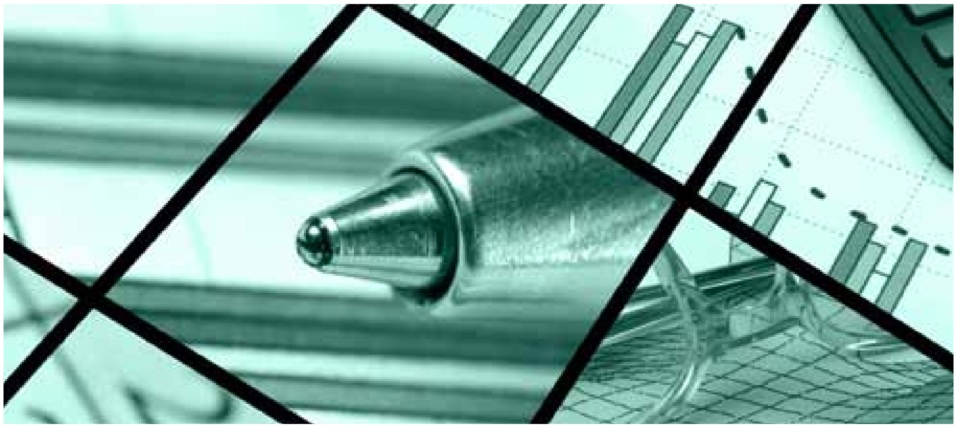

Walsh Appellate Ruling Series

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.

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