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PERSPECTIVE

## Valuing the professional goodwill of an attorney in divorce

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How do you value the goodwill of a lawyer in a divorce proceeding? The courts have struggled with this topic for years, leading to uncertainty and allowing widely varying opinions from forensics who calculate for the benefit of whatever legal position they are hired by. The court in *Marriage of Lopez*, 38 Cal. App. 3d 93, 108 (1974), commented: “It has been aptly stated: ‘Accountants, writers on accounting, economists, engineers, and courts, have all tried their hands at defining goodwill, at discussing its nature, and at proposing means of valuing it. The most striking characteristic of this immense amount of writing is the number and variety of disagreements reached.’”

But it shouldn’t be so — as painful as divorce is, the law has an obligation to make the goodwill calculation more routine and predictable — as it has done by designing the guidelines for child support and which by use of a Dissomaster, parties can quickly obtain child support calculations as well as parameters for spousal support. Goodwill obviously cannot be split up like fungible funds, nor can it be valued like real estate by use of comps. On top of that, the age-old fictional Family Code Section 10,000 (which finds a way to give the husband the business and the wife the family residence) has led many a court to value goodwill unreasonably so as to accomplish what now can be viewed as an outmoded goal — which presumed a stay-at-home wife who did not work and whose primary responsibility was to care for the kids. This traditional and unspoken approach to valuing assets should be officially discarded — it is neither equitable nor consistent with current values and realities.

*Marriage of Iredale*, 121 Cal. App. 4th 321 (2004), confirmed the excess earnings method as standard for valuing a lawyer’s goodwill and particularly the use of the “similarly



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situated professional” as part of the calculation. Calling it “a more rational and reasonable method by which to calculate the value of Iredale’s goodwill,” the appellate court rejected the so-called “typical salaried person” approach, pointing out that Iredale spent substantial time on non-billable work to develop and maintain client relationships and was obviously currently being compensated for those efforts. This change represented the real world recognition that in a given year, attorneys are typically compensated not just for hours billed but also for originations, typically based on actual annual collections. Goodwill is after all about the value of future earnings, and thus a professional may receive extra compensation in anticipation of that lawyer generating new business in future years. But goodwill cannot include what an attorney is already being compensated for. *Iredale’s* refinement of the similarly situated

professional approach has been regularly followed by trial courts in valuing goodwill for attorneys since 2004. The problem becomes how to determine what a similarly situated professional is. Forensics frequently use surveys to obtain an average compensation without properly taking into account the type of practice, the experience and status of the professional, the location of the practice, and the size and reputation of the firm. A New York partner in a multi-national firm with 20 years of experience practicing in mergers and acquisitions should never be compared to a Des Moines lawyer with eight years of experience in a five-lawyer firm practicing bankruptcy law. Sometimes forensics will average various categories but this approach also leads to a false comparison. So for example, if a survey contains average compensation for New York partners, that compensation has to be adjusted based on all the other

factors (since for example, typically partners in New York mega firms earn considerably more than smaller New York firms). Forensics often use averaging techniques to obtain a lower or higher figure, depending on which side hires them, with little concern for intellectual consistency.

Once the similarly situated professional fair market compensation number is determined, it is deducted from the annual compensation of the professional. Just one year of a lawyer’s salary may be an anomaly, so averaging three years is often preferred. On the other hand, using anything other than the current compensation figure can also lead to incorrect results. For example, if the direction of a lawyer’s salary is continually increasing or decreasing, this may mean that only one year’s salary is the best choice in determining current compensation. If an attorney’s compensation is aggressively rising by 20% each year, there would be no reason to average prior years to determine current compensation, since to do so would arbitrarily reduce the lawyer’s compensation when the goal is to determine the then current compensation.

If there is a net negative dollar amount after the deduction of reasonable or market compensation from the lawyer’s current compensation, there is no goodwill; however, if there is a net positive number, the courts then presume that the professional does have personal goodwill (as differentiated from the law firm’s goodwill) because a firm would not pay more than reasonable compensation for the performance of the attorney if it did not expect future earnings from that professional. This presumption is certainly debatable, but since no one really knows what personal goodwill actually is, the trial court has to start somewhere. The next step is to apply a multiplier to the net excess (if any) over reasonable compensation. This is a step that causes a forensic to salivate. There is simply no good way to “capitalize” the net excess earnings in any reliable

way. One method used by forensics to determine a multiplier is the so-called “build-up model,” which is commonly used to value publicly traded companies. The build-up method uses information from U.S. Treasuries and publicly traded companies to “build up” a capitalization rate which then is inverted to achieve a multiplier. Many of the elements of the build-up method are simply left to whatever number the forensic wants to assign. Thus, in addition to being utterly full of subjective and unsupportable guesses by forensics, the build-up method is premised on the lawyer continuing to practice in perpetuity — which is ridiculous. Moreover, stock in publicly traded companies is — wait for it — publicly tradable, making it easily liquidated, whereas the lawyer’s goodwill has no liquidity. As one court put it: “the build-up model is not ... well accepted by mainstream corporate finance theory as a proper way to come up with a discount rate. Indeed, its components involve a great deal of subjectivity.” *In re Appraisal of the Orchard Enters.*, 2012 De. Ch Lexis 165 (2012). That Delaware Chancery court was discussing a fully operating business, not a human being, and it is even more speculative to use this approach for an individual professional. As one commentator noted: “If there is a ‘greatest flaw’ with the excess earnings method, estimating the capitalization rate for intangibles is probably it. This is undoubtedly business valuation hocus pocus at its best ... a business appraiser who divines the capitalization rate for intangibles is plucking it out of thin air.” Paschall, Michael, “Kick the Habit: The Excess Earnings Method Must Go!” *Business Valuation Review*, Vol. 21, No. 3 (Sept. 2001).

Arguably valuation of an attorney’s goodwill is simply too speculative to be supportable. A partner in a law firm is not an independent going concern — rather the firm is. So, for example, Iredale was a partner in Paul Hastings — a large operating entity with assets, business contracts, a lease, etc. — so how could she be viewed as having so-called “personal” goodwill when she was not her own operating business? And while “personal” goodwill is not synonymous with reputation, what else could a lawyer’s “personal”

goodwill consist of? Moreover, since reputation creates *both* current earnings as well as future earnings, and current earnings are accounted for by current compensation, goodwill is less than the value of an attorney’s reputation, making any valuation of goodwill a total conundrum.

But since the courts are required to value a lawyer’s personal goodwill, at least there should be a standard method which is more predictable, less expensive, and does not allow for gross inflation of this intangible asset. Since the excess earnings method, though flawed, is the only approach the courts have approved to calculate the present value of a lawyer’s potential future earnings, the courts should impose reasonable parameters that make it less subject to manipulation. The court should first determine a market compensation based on the average profits-per-partner of the lawyer’s existing firm (or if not available, comparable firms in the same city) with upward or downward adjustments based on status, practice area, experience, etc. Forensic accountants may be able to make such adjustments, but attorneys familiar with compensation in the industry (such as managing partners who set partner compensation) or compensation experts (such as headhunters) would have better foundation. There should not be a presumption that a lawyer’s current compensation cannot in fact be a perfect comp for that lawyer’s market compensation — frequently that is the case. Simply put, lawyers are typically paid what they are currently worth — taking into account hours billed, client collections, etc. It is far less common that an attorney is paid more than he or she is currently worth; if so, then there is goodwill, since a law firm is willing to pay something extra in the hope of future (as opposed to current) billings.

Next comes the multiplier, but multipliers are arbitrarily derived from guesses by accountants, so this guesswork should be eliminated by developing a limited scale for such calculations so as to avoid absurdly high calculations. Age must be the key factor in determining the multiple, since goodwill is the present value of the expectation of future earnings, and that expectation diminishes dramatically with age.

Further, as a lawyer continues to work post-divorce, that lawyer’s goodwill is being supported by non-community efforts, making the goodwill ultimately a product of separate earnings. *Lopez* lists age and health as key factors, so the multiplier should be time or age based, with a possible adjustment downward for health issues that make continued active practice less likely. Therefore, the goodwill calculation should consider no more than four years into the future. The highest multiplier of four is reserved for healthy professionals between the ages of 45-50, since this is typically the peak of their professional development. There should be a multiple of no more than three for lawyers between ages 50-55 or 40-45, then no more than two for ages 55-60 or 35-40 and one for ages 60-65 or 30-35. After age 65 or before age 30, the multiplier should be zero or in other words, no value attributed to goodwill. Age 65 represents retirement age and the total uncertainty of continued future practice, while before 30, a lawyer is so new to the profession that there is no reasonable predictability of goodwill value.

The above approach does not account for the rare superstar attorney who has a thriving practice and exceptional reputation after the age of 65. Moreover, the age of retirement is increasing, and some lawyers practice into their 70s and a few even beyond. But goodwill is based on future earnings, and not only do these

attorneys have the right to retire, they also are increasingly subject to death or illness that will abruptly cut off their future practice. So while zero value is ascribed to the goodwill of a lawyer after the age of 65, a court which finds goodwill after 65 should be required to make specific findings regarding health, status, and intentions which would justify a multiplier of one. However, this flexibility should be allowed only to the age of 75, after which no amount of reputation can make future earnings anything other than pure speculation.

The above approach offers two obvious benefits: first, the goodwill of a professional will be more predictable and more easily calculable; second, it will eliminate much of the expense and time wasted by arguing over the multiple, which is, after all, just a contrived number in a forced sale. Both these benefits substantially enhance the likelihood of settlement, shorten trial time, and avoid arbitrary results based on speculative expert testimony. While the law requires a valuation of a lawyer’s goodwill in a divorce, such a valuation should be simpler and more predictable. Goodwill is an amorphous concept, and the inevitable dispute over its economic value impedes the resolution of divorce cases and gives rise to contentious positions which are difficult for a trial court to evaluate and for lawyers to settle. The law needs to do better. ■

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