Goodwill, Though Intangible, Can Be Assigned Value

Methodologies Considered

BY ROBERT STEPHAN COHEN AND ARTHUR J. CIAMPI

INCLUDING GOODWILL in the valuation of a professional practice, and particularly a lawyer's practice, has recently been acknowledged as permissible by the New York Court of Appeals. Placing a value on this intangible asset, however, can be difficult for the uninitiated practitioner.

This article sets forth some of the typical obstacles to the valuation of goodwill in either the matrimonial context or in the context of a partner's claim for an accounting of his partnership interest as the result of a partnership dispute. It then presents two methodologies for its valuation.

Definition

In its most basic sense, goodwill is an intangible asset that is comprised of a reputation that will probably generate future business. The often-cited opinion of Lord Eldon in *Crutwell v. Lye*, 17 Ves. 335, 346, 34 Eng. Rep. 129, 134 (Ch. 1810), defined goodwill as follows: "The goodwill, which has been the subject of sale, is nothing more than the probability, that the old customers will resort to the old place." Id.

Justice Benjamin N. Cardozo, while Chief Judge of the New York Court of Appeals, similarly stated:

> Men will pay for any privilege that gives a reasonable expectancy of preference in the race of competition. Such expectancy may come from succession in place or name or otherwise to a business that has won the favor of its customers. It is then known as goodwill .... The chief elements of value upon any sale of a goodwill are, first, continuity of place; and, second, continuity of name.

In re Brown, 242 NY 1, 6, 7, 150 NE 581, 582, 583 (1926) (citations omitted); see also *Levitt Corp. v. Levitt*, 593 F2d 463 (2d Cir. 1979); H.D. Laube, "Goodwill in Professional Partnerships," 12 Corn. L.Q. 303, 322 (1927).

Issues and Considerations

Some traditional obstacles to the valuation of goodwill of a law practice are: (1) the firm's agreement unequivocally provides that there is no goodwill; (2) a client's absolute freedom of counsel; (3) a lawyer's goodwill is found to be personal to the professional.

If a firm's agreement unequivocally provides that there is no goodwill, the inquiry as to whether goodwill should be valued may end right there. *Dawson v. White & Case*, 88 NY2d 666, 672 NE2d 589, 649 NYS2d 364 (1996); *Amodio v. Amodio*, 70 NY2d 5, 509 NE2d 936, 516 NYS2d 923 (1987); *Burns v. Burns*, 84 NY2d 369, 643 NE2d 80, 618 NYS2d 761 (1994); *Finn v. Finn*, 658 SW2d 735 (Tex. 1983).[1]

In the matrimonial context, courts have considered the terms of a bona fide agreement and concluded that if the agreement was a fair assessment of worth, it was presumptively controlling on a distribution of marital assets. If the professional's "fair" agreement, therefore, specifically excluded a value to goodwill, courts may hold that goodwill cannot be properly valued. The Court of Appeals in *Dawson* made no distinction concerning the treatment of partnership disputes and matrimonial cases.[2]

Courts have also refused to permit valuation of goodwill based upon a client's unfettered choice of counsel. The argument here is that even if the sale of a law firm were permitted, a client is not bound contractually to the purchasing attorney. Thus, there is no guarantee that the old clients will return to the old firm and, therefore, some courts hold no value to goodwill. *Litman v. Litman*, 115 Misc.2d 230, 453 NYS2d 1003 (Sup. Ct. Nassau Co. 1982), rev'd on other grounds, 93 AD2d 695, 463 NYS2d 24 (2d Dept. 1983), aff'd, 61 NY2d 918, 463 NE2d 34, 474 NYS2d 718 (impossible to reconcile concept that law firm has value for one purpose but not another; therefore, since an attorney cannot sell his/her practice as a going concern, valuation of goodwill is impossible). See, e.g., *Smith v. Smith*, 709 SW2d 588 (Tenn. 1985) (goodwill not distributable because, inter alia, one's reputation cannot be sold or pledged); *Holbrook v. Holbrook*, 103 Wis.2d 327, 309 NW2d 343 (Ct. App. 1981) (ethical and contractual limitations to the sale of law firm prevented valuation of goodwill).

Some jurisdictions, while permitting the valuation of goodwill, still maintain that the professional practice is not subject to a valuation of goodwill where the practice is solely dependent on the skills of particular individuals.

While the recent changes to the Code of Professional Responsibility in New York do permit the sale of a law firm in some limited circumstances, a client's choice of counsel remains preeminent and should be taken into account in a valuation methodology. In *Dawson*, the Court of Appeals recognized this fact and stated:

> [T]he existence of law firm goodwill has been recognized in conjunction with the recent promulgation of Code of Professional Responsibility DR 2-111(A), which authorizes the sale of "a law practice, including good will," by a

Robert Stephan Cohen *is the managing partner and senior member of the matrimonial department of Morrison Cohen Singer & Weinstein LLP.* **Arthur J. Ciampi** *is a part-*

Valuing Lawyers' Goodwill

Continued from page S2

> "lawyer retiring from a private practice of law, [or] a law firm one or more members of which are retiring from the private practice of law with the firm" (see, 22 NYCRR 1200.15-a[a]).

Id. 88 NY2d at 672, 672 NE2d at 593, 649 NYS2d at 368.

Accordingly, rather than be a basis to prevent the valuation of goodwill, an alternative analysis is that this unlimited choice of clients, rather than being a prohibition to valuation of goodwill, should merely be taken into account by applying a discount rate to a goodwill valuation. This discount rate could be in the nature of a percentage reduction, based on an historical attrition rate of clients, from the firm in question.

Some jurisdictions, while permitting the valuation of goodwill, still maintain that the professional practice is not subject to a valuation of goodwill where the practice is solely dependent on the skills of particular individuals. *Wilson v. Wilson*, 294 Ark. 194, 741 SW2d 640 (1987) (to be valued, goodwill must have independent value separate from reputation or presence of a particular professional); *Depner v. Depner*, 478 So.2d 532 (La. Ct. App. 1985), cert denied, 480 So.2d 744 (La. 1986) (goodwill of doctor was solely dependent on personal ability, skill and integrity of the owner/physician and cannot be attributed to professional corporation); *Taylor v. Taylor*, 222 Neb. 721, 386 NW2d 851 (1986) (professional goodwill dependent on presence of a specific individual, not marital property).

In the treatise *Valuing Small Businesses and Professional Practices* (Dow Jones-Irwin 1986), the author, Shannon Pratt, notes the difference between so-called practice and professional goodwill:

> In a professional practice, there are generally two types of goodwill: *practice goodwill* (sometimes referred to as *business goodwill*) and *professional goodwill* (sometimes referred to as *personal goodwill*). *Practice goodwill* is the goodwill associated primarily with the entity, while *personal goodwill* is the goodwill associated primarily with the individual. Practice goodwill is specifically an asset of the practice entity and therefore not really different from the goodwill that can be held by any other small business.

Id. at 294-95 (emphasis in original).

Accordingly, when a component of an award or settlement is alimony, maintenance or child support and, in addition, a separate value is charged to goodwill, this may be the equivalent of "double dipping." In the partnership dispute context, however, the Court of Appeals in *Dawson* specifically reiterated its rejection of this distinction. 88 NY2d at 672, 672 NE2d at 593, 649 NYS2d at 368 (rejecting rationale that cannot have goodwill apart from that of goodwill of constituent members).

Valuing Goodwill

As an intangible asset, dependent by definition upon future contingencies, valuing goodwill is difficult and must be accomplished with extreme care. The New Jersey Court of Appeals, in *Dugan v. Dugan*, 92 NJ 423, 457 A2d 1 (N.J. 1983), aptly stated:

> In *Stern v. Stern*, we acknowledged that "[i]t may . . . be possible to prove that [goodwill] does exist and is a real element of economic worth. Concededly, determining its value presents difficulties." However, difficulty in fixing its value does not justify ignoring its existence. Goodwill should be valued with great care, for the individual practitioner will be obliged to pay "tangible" dollars for an intangible asset at a value concededly arrived at on the basis of some uncertain elements. For purposes of valuing the goodwill of a law practice, the true enhancement to be evaluated is the likelihood of repeat patronage and a certain degree of immunity from competition. See *Levy v. Levy*, 164 NJ Super. 542, 554 (Ch. 1978). Identification of goodwill in this fashion differs from that utilized in evaluating goodwill in businesses where an identification of a return on tangible assets is made.

Id. 92 NJ at 435, 457 A2d at 7. (citations omitted).

Given this difficulty, some courts have identified five methods of valuation of goodwill. The Court of Appeals of the State of Washington listed the following five methods:

> Five major formulas to value goodwill have been articulated. Of these, three are accounting formulas: straight capitalization; capitalization of excess earnings; and Internal Revenue Service (IRS) variation of capitalized excess earnings. The fourth method is the market value approach which sets a value on goodwill by establishing the fair price on the current open market if the practice were to be sold. The fifth method is the buy-sell agreement method which values goodwill by relying on a recent actual sale or an unexercised existing option or formula set out in a corporate or partnership agreement. These are not the exclusive formulas available, nor must only one method be used in isolation.

In re Marriage of Brooks, 51 Wash. App. 882, 890, 756 P2d 161, 165-66 (1988) (footnotes omitted).

The courts, however, basically use two methods: the discounted future earnings method and the excess earnings formula.

Future Earnings

The discounted future earnings method is commonly referred to as a formula approach used to establish a value of an entity at a given point of time. The discounted future earnings method has been described as a "conceptually excellent method" for valuation. Pratt, supra at 164. It has also been cautioned, however, that the discounted future earnings method can be speculative if unreliable data is used. This can be problematic if the firm being valued is small, new or has unaudited financial records. Pratt states:

> There certainly are some small business and professional practice valuations to which the discounted future earnings method of valuation would apply; those would be businesses and practices whose earnings could be predicted with enough reliability to make the exercise useful and whose earnings result largely from forces already in place.

Pratt, supra, at 165.

The methodology is based on a calculation of the present value of a future income stream. Accordingly, what this method attempts to do is to place a present value on the potential earnings of a business. This is accomplished by applying a growth rate to a business's present earnings. Typically, the discount rate is the rate of return the marketplace would require for comparable investments. In determining the appropriate rate, one must consider whether earnings are available to equity only or to a total investment. Inflation should also be considered.

For example, (1) assuming current earnings of $300,000 and a growth rate of 5 percent per year for the next five years; and (2) assuming the present value factor is 12 percent:

Valuing Lawyers' Goodwill

	Income	P.V. Factor	Value
1996	315,000	.9449	$297,644
1997	330,000	.8437	279,054
1998	347,287	.7533	261,611
1999	364,652	.6727	245,301
2000	382,884	.6005	229.922

Discounted Future Earnings Amount $1,313,532 (plus residual value of Company)

Continued from page S8

IRS Revenue Policy 68-609 describes the manner for applying the excess earnings method. It states in pertinent part:

> A percentage return on the average annual value of the tangible assets used in a business is determined, using a period of years (preferably not less than five) immediately prior to the valuation date. The amount of the percentage return on tangible assets, thus determined, is deducted from the average earnings of the business for such period and the remainder, if any, is considered to be the amount of the average annual earnings from the intangible assets of the business for the period. This amount (considered as the average annual earnings from intangibles), capitalized at a percentage of, say 15 to 20 percent, is the value of the intangible assets of the business determined under the "formula" approach.

Recently, the New York County Supreme Court described this method as follows:

> That is Husband's earnings from the firm are computed with adjustments, the "reasonable compensation" of a similar attorney are subtracted to determine Husband's "excess earnings," which are then tax impacted. The earnings from tangible assets and capital are subtracted and the remainder is capitalized to produce a "good will" figure which is then added to the tangibles and capital to determine the total value of the interest in the firm.

Rochelle G. v. Harold M.G., NYLJ, Aug. 14, 1996, at 22 (Sup. Ct. N.Y.Co.).

The excess earnings method, known as ARM 34, however, has been criticized by the IRS Appellate Conference Valuation Training Program:

> ARM 34 has been applied indiscriminately by tax practitioners and by members of the Internal Revenue Service since it was published. On occasion the Tax Court has recognized ARM 34 as a means of arriving at a fair market value. The latest and most controlling decisions on valuation, however, relegate the use of a formula to a position of being a last resort. ARM 34 was published in 1920, but since that time it has continually appeared in the annals of tax valuation and resulted in many improper appraisals.
>
> By such a formula the same value would be found in 1960 as in 1933, although values per dollar of earnings actually were very different in those two years. The basic defect is apparent; the rates of return which are applied to tangibles and to intangibles are completely arbitrary and have no foundation in fact.
>
> All that can be said for ARM 34, or a similar formula method of capitalization using two rates of interest, is that you hope to get a good answer based upon two bad guesses. It is difficult enough to get a reasonably accurate rate of capitalization using normal and the other for intangibles, other than by the use of pure guesswork, is impossible ....

U .S. Internal Revenue Service, *IRS Appellate Conference Valuation Training Program* 82-86 (1978).

Pratt summarizes the steps in applying the excess earnings methodology as follows:

> (1) Determine the value of net tangible assets.
>
> (2) Determine the normalized level of earnings. ["Normalized level of earnings" are earnings adjusted to reflect the true earning ability of the entity by subtracting from income the typical payment to a proprietor.]
>
> (3) Apply an appropriate rate of return to the net tangible asset value and subtract the result from the normalized earnings. [The rate of return on net tangible assets is a risk factor expressed as a percentage rate of return.] The result is the excess earnings; that is, the amount of earnings above a fair rate of return.
>
> (4) Apply an appropriate capitalization rate to any excess earnings. [In selecting a capitalization rate, the same criteria should be considered as discussed above.]
>
> (5) Add the values from steps 1 and 4.

Pratt at 156-57, as quoted, with approval, in *Wright v. Wright*, 904 P2d 403, 407 (Ala. 1995).

For example, (1) assuming net tangible assets of $300,000; (2) assuming earnings of $1 million, which is then reduced by $200,000 to reflect the reasonable compensation to the proprietor for a net income of $800,000; (3) assuming an appropriate rate of return of 12 percent to the net tangible asset value equals $36,000; (4) assuming a capitalization rate of 50 percent, which equates to a multiple of two:

Net Income	**$800,000**
Rate of Return on Net Tangible Assets ($300,000 x .12)	**-36,000**
	$764,000
Capitalization Rate (Multiple)	**2**
Value:	**$1,528,000**

(1) There are currently numerous cases being litigated which undoubtedly will further elucidate the extent to which an agreement will determine the scope of the valuation of goodwill.

Daily columns in the *Law Journal* cover developments in laws affecting antitrust, arbitration, aviation, bankruptcy, appellate practice, international business transactions, consumer protection, products liability, entertainment, estate planning, taxes, commodities trading, trial practice, labor and management, securities