

“The valuation of a law practice”

— Part 1

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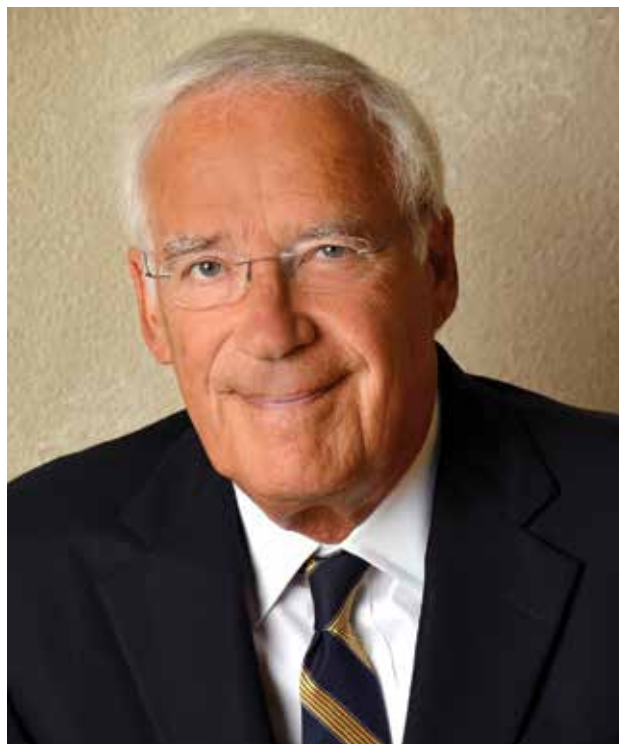
Introduction

There are several reasons why a law practice may have to be valued. In most cases, a valuation would be performed for any one of the following purposes:

- pricing and structuring the purchase or sale of the practice or a partnership interest therein, including a firm merger and the admission of new partners. If a partnership interest, the partnership agreement will be consulted;
- income tax, succession and estate planning;
- firm management and financial planning;
- partner buy-sell agreements;
- litigation support and ADR, including partner disputes, matrimonial litigation involving a partner, and income tax controversies with the fiscal authorities;
- financing, collateralization and securitization, including financing of the firm's operations; and
- disability, retirement, withdrawal or death of a partner.

As each partner may play a different role in the firm, with some partners having additional responsibilities, the firm will be more dependent on certain partners than others.

As is the case for most professional firms, the value of a law practice lies primarily in its intangible, rather than tangible, assets. For example, a review of the firm's financial statement will make it immediately evident that the firm's goodwill and the other intangible assets (which, by far, have the greatest value) are generally not even reflected on the balance sheet. The assets that generally appear on a law firm's balance sheet are cash, accounts receivable, work-in-process (see below) and furniture and



equipment at their depreciated or amortized book (accounting) values.

Intangible value in the form of goodwill can arise, in part, from personal goodwill (attaching to individual partners, in different proportions). Personal goodwill is not transferable. Another type of goodwill relates to the law practice and is commercially transferable. Both types of goodwill require the maintenance of a high level and quality of services and a solid reputation, without which they would lose their value.

A sub-category of goodwill is individual goodwill, which represents the economic benefits that accrue to a law

firm by virtue of its employment of one or more lawyers who have technical skills, contacts and a good reputation. The loss of such individual(s) could have a negative impact on the practice if he or she were to then compete with the firm. In contrast with personal goodwill, individual goodwill does not expire upon retirement or death. For example, the firm may have the capacity to substitute another lawyer to fill the role of the departing lawyer. In an open-market context, non-competition agreements result in individual goodwill having commercial value.

In the valuation of a law practice, it is assumed that a purchaser will have access to the firm's client files and be able to continue with, and develop, a network of contacts that will serve as a basis for generating future professional fees for the firm. However, because each law practice is unique, the valuation must consider each of the firm's different revenue sources and analyze the firm's gross fees by source. Gross fees would be analyzed by source of type of engagement: corporate, litigation, taxation,

Jean-Louis Baudouin, partner and former Quebec Court of Appeal judge appointed as juriconsult to the Québec National Assembly



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"This well-deserved appointment attests to the fact that the legal qualities and profound judgment of our colleague Jean-Louis are universally recognized," noted Éric Bédard, Managing Partner for the Québec region. "Fasken Martineau is privileged to include him as a member of our team."

Mtre Baudouin is a partner in the Litigation and Dispute Resolution Group. As a result of his thorough knowledge of the law and long trial bench experience, his counsel is notably sought during trial simulations for major cases and in complex arbitration disputes, more particularly in national and international matters.

matrimonial, intellectual property, estates and trusts, insolvency, M&A transactions, real estate and so forth. In commercial litigation, for example, revenues are usually one-time, although the file might remain active for years. With corporate work, on the other hand, the firm often receives annual retainers. Income tax mandates (compliance, planning, consulting, litigation) can be either recurring or one-time, depending on the nature and scope of the engagement. Recurring, or on-going, fees provide a more stable source of income to the firm, and often have more transferable goodwill value. One-time engagements can provide potential new-client possibilities (by way of introductions and networking opportunities).

Valuation methodologies – GENERAL

There are three basic, generally-accepted approaches for valuing a business, business ownership interest or investment:

- Asset-based (Cost) Approach;
- Market Approach; and
- Income Approach.

In certain situations, a combination of two or more of the foregoing approaches may be appropriate.

Asset-Based (Cost) Approach

The Asset-Based Approach is adopted where either (a) liquidation is contemplated because the business is not viable as a going concern, (b) the nature of the business is such that asset values constitute the prime determinant of corporate worth (e.g., vacant land, a portfolio of real estate or marketable securities), or (c) there are no indicated earnings/cash flows to be capitalized.

Market Approach

The Market Approach to valuation uses one or more methods that compare the subject to similar businesses or practices, ownership interests therein and investments that have been transacted. It includes analyses of prior transactions in the ownership of the subject firm, e.g., firm mergers or transactions of partnership interests in the firm.

Income Approach

The Income Approach is a general way of determining a value of a business (or its underlying assets) using one or more methods wherein a value is determined by present-valuing the firm's anticipated earnings or cash flows to a capital amount as of the effective valuation date. The

more common methodologies applied under the Income Approach are:

- Capitalizing the firm's earnings, applying the Earnings Method;
- Discounting the firm's expected future earnings, applying the Discounted Future Earnings Method; and
- Capitalizing the firm's gross fees, applying the Multiple-of-Gross-Fees Method.

Earnings Method

To determine the value of a business applying the Earnings Method, adjusted, normalized, stabilized earnings are substituted for financial statement earnings (which are used simply as a starting point) and then further refined into a level of representative or "maintainable" net earnings.

These adjusted results are then multiplied (capitalized) by a price/earnings multiple (capitalization factor) to arrive at a net present-value (capital sum) as of the valuation date. Net working capital and fixed assets are added. The aggregate so arrived at represents the value of the firm as a whole, i.e., "net worth".

Multiple-of-Gross-Fees Method

This method is most often applied in valuing the types of firms such as law practices and other services firms, including accounting practices, engineering firms, insurance agencies, etc. They have the advantage of attributing a separate value to the goodwill or transferable client list (i.e., the firm's so-called "book of business") without the necessity of adjusting profits over a period of years for extraordinary, non-recurring items, or discretionary overhead expenses. Buyers and sellers of such businesses or practices have developed these generalized methods from their own experience and knowl-

edge, market transactions observed, and have departed from the more conventional methods outlined above.

The Multiple-of-Gross-Fees Method is actually a hybrid in that it employs a combination of the Income Approach and the Market Approach to valuation, by the application of capitalization multiples based on rules-of-thumb observed empirically in market transactions that occurred in the particular industry and the use of a firm's financial data, viz., gross fees.

The multiple is typically judgmental and will vary depending upon the particular characteristics of the practice, as identified below. A different multiple can be applied to each particular source of revenue generated by the firm, depending on factors such as (but not limited to) the level of recurrence of the services (e.g., general corporate practice, litigation, estates, taxation, etc.). Regard must also be had to whether, in a particular fiscal period being used to determine "maintainable gross fees", there might be unusual, non-recurring, or extraordinary fee income, say from a one-time, very large mandate.

APPLYING THE MULTIPLE-OF-GROSS-FEES METHOD

The application of this Method in valuing a law practice generally involves the following steps:

- * determining a representative level of sustainable gross fees based, in part, on the firm's past performance, but in particular, future revenue-generating potential, pursuant to discussions with the senior managing partner(s);
- developing an appropriate price/revenue multiple



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(capitalization factor) – see below – to apply to each source of the firm's fee income in (a), considering the degree of risk attached to achieving the said revenue, the firm's future prospects, as well as observed, available law firm transaction multiples in the marketplace, etc.;

- (c) capitalizing the gross fees in (a) by applying to each source of fees (categorized by type of legal work) an appropriate revenue multiplier; and
- (d) aggregating the net working capital of the firm (cash, accounts receivable and work-in-process, minus accounts payable and current bank advances) to the capitalized maintainable gross fees in (c) to arrive at the fair market value of the firm.

The types of factors that can impact the multiple applied to the firm's gross fee volume – being the most judgmental part of the valuation analysis – would generally include, as appropriate:

- Vendor firm's ability to transfer clients;
- Nature of fees/services;
- Fee schedules;
- Recurrence of engagements/client loyalty;
- Referral base;
- Types of clients (corporate institutional, personal, government);
- Types of services offered (generic or specialized);
- Diversity of client base;
- Sources of new clients;
- Extent and significance of personal contacts and relationships;
- Dependence on significant clients or client groups;
- Competition, including number of other lawyers in the community offering the same service or specialty;
- Size of the firm;
- Ages and health of the senior practitioner(s);
- Degree of a firm's dependence on a partner;
- Quality of practice's personnel;
- Profitability of the practice;
- Bad debt experience; Hourly billing rates and percentage of available time charged to, and collected from, clients for the practitioners/partners and employees (utilization and recovery);
- Location of the practice and its clients;
- Number of years that clients have maintained a professional relationship with the practitioner(s);
- Community involvement of the practitioners;

- History of the practice in the marketplace and reputation of the firm's practitioners for knowledge, expertise and judgment; and
- Visibility (brand) of the practice in the business and professional communities.

The multiples can often range from 0.3 to 1.2, depending on the particular source of revenues (litigation, corporate, taxation, real estate, matrimonial, etc.).

Other types of issues considered during the negotiation process between a vendor and purchaser that may impact the transaction price of a law firm might include:

- Owning vs. leasing the office premises;
- Duration of the existing office lease;
- The impact on future income of relocating the practice;
- Non-recurring revenue and expense items;
- Existence of a non-competition agreement from the vendor;
- Availability of vendor financing;
- Timing of the payments to vendor; etc.

In valuing a law practice, the three categories of players that must be considered in a sale of the practice are: the market of buyers (successors to the practice), the market of vendors (retiring lawyers) and the clients of the practice, including its referral networks. Client retention is critical, as is the ability of the "new firm" to maintain or increase fees, particularly when there is currently resistance to increased fees and a tendency for some lawyers to leave the larger, higher-priced law firms to join smaller – in some cases, "boutique" – firms.

Work-in-Process

Work-in-process ("WIP"), i.e., unbilled professional time, is an asset included in the value of a law firm. (In some cases, a firm might delay billing intentionally for specific reasons.) A careful analysis must be performed on a file-by-file basis. Discounts may be applicable in valuing a firm's WIP due to potential non-realization or non-collectability.

Contingency Fees

Contingency fees (if permitted) can be difficult to value and, in many litigation practices, might comprise a substantial portion of the firm's WIP (or contingency receivable). Needless to say, the professional hours worked on a contingency-fee case often has little, if any, relationship to the client's ultimate award by the tribunal or

the settlement reached. Regard must also be had to the likelihood of an appeal and the potential outcome in the appellate court. Probability discount factors are often applied by the valuator on a case-by-case basis, following discussion with the lawyers on the file (and sometimes with the firm's auditors). Sometimes a "time rule" – measured from the time the case had opened might be applied.

An example of a method that might be applied in valuing an unliquidated contingency-fee file is as follows, considering, of course, the merits of the case:

- (a) Estimate the average fee per file (considering size of the file), net of direct expenses;
- (b) Assess the firm's success rate or "batting average";
- (c) Estimate the firm's overhead percentage per file;
- (d) Multiply the number of open contingency files by the net average fee per file in (a) times the firm's batting average in (b);
- (e) Deduct the overhead percentage in (c) to obtain the estimated future profit attributable to the contingency-fee case;
- (f) Estimate the average length of time that the firm's cases are open (which could be accomplished by comparing a case's start date to its award date for a number of selected files, assuming the relevant data are available);
- (g) Calculate the estimated date of completion for each ongoing case by considering its start date to the average length of a case;

- (h) Select an appropriate discount rate (present-value rate) to apply to the estimated profit on each contingency file; and
- i) Determine the present value of each case by discounting the estimated future profit in (e) by the discount rate in (h) using, as a time factor, the estimated completion date per case.

In performing these steps, consideration must be given to the typical "variables" in any litigation file, from the perspectives of plaintiff and defendant: The merits of the claim; the jurisprudence; the attorneys on each side; the evidence; the expert(s); the likelihood of there being an appeal; the costs; each party's financial means; the counsel who will be pleading in the appellate court; etc.

In estimating the value of a contingency-fee file, each arrangement must be analyzed, including its enforceability. In a recent decision regarding a contingency-fee bonus that was disputed by the client, the Ontario Court of Appeal affirmed the findings of the trial court that a \$500,000 bonus to the law firm was neither unfair nor unreasonable.¹

Part 2 of this article will discuss the different types of intangible assets of a law practice, including the various forms of goodwill: practice goodwill, personal goodwill and individual goodwill.

¹ *Evans Sweeny Bordin LLP v. Zawadzki*, 2015 ONCA 756.

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