The valuation of a law firm is affected by many factors, especially the purpose of the valuation. Law firms may need to be valued for a variety of reasons, including:

- Estate planning
- Marital dissolution
- Insurance coverage
- Capital buy-in of a new owner
- Capital buy-out of a withdrawing owner
- Dissolution of a firm
- Merger or acquisition

The exercise of valuing a law firm is more art than science, and a universally accepted approach to law firm valuation does not exist. The appropriate valuation methodology to use depends upon the objective of the valuation. In certain situations, the valuation methodology required is stipulated by the Internal Revenue Service (IRS) or the courts based on case law precedents, especially in divorce cases. Valuation formulas vary by jurisdiction and some jurisdictions have adopted radically different positions, especially relating to the treatment of goodwill. Valuation methods stipulated by the courts, the IRS or other regulatory bodies should be understood as possible precedents for valuation methodology elsewhere. Appearing before those regulatory bodies and applying a valuation method that deviates from approved methods will require that you not only successfully argue the merits of your alternative method, but also successfully argue against the previously approved method.

The discussion in this article of law firm operations generally and valuation methodologies specifically is based upon experience managing law firms as a chief financial officer (CFO) for a decade, plus 18 years experience consulting exclusively to law firms on management issues including financial management, profitability enhancement, strategic planning and mergers and acquisitions. Accordingly, this analysis discusses the valuation of law firms primarily from a business perspective rather than from a valuation expert’s perspective.

The Legal Marketplace
The legal marketplace in the United States generated approximately $200 billion of gross domestic product in 2008 according to the Bureau of Economic Analysis (http://www.bea.gov/industry/gdpbyind_data.htm). The vast size of the legal market makes references to the legal profession as a single entity overly simplistic. That is, the 1,000-lawyer law firm is not simply 100 times larger than the 10-lawyer law firm. They are vastly different organizations with different clients, geographic reach, service offerings and valuation challenges. This distinction is made because it does not seem to receive the attention it deserves in other discussions of law firm valuations.

The legal profession must be stratified into segments that share some commonality for any valuation analysis to be meaningful. It can be segmented by geographic reach or by size of law firm, and possibly by practice specialties. This last attribute, practice specialty, is complicated by the lack of a universal taxonomy for describing practice specialties. Two firms may practice in exactly the same area, but name their practices differently. Even the appropriate size categories are not without some controversy. Altman Weil has surveyed the legal
profession for over 30 years and yet there is still no general consensus within the industry regarding the definition of a large, medium or small firm. The answer to that question often depends on the specific geographic market in question, since a 100-lawyer firm in New York City may be considered small whereas the same size firm in Albany would be large. For purposes of this topic, law firms in the following size groupings share considerable characteristics and exhibit significant differences between firms in different categories:

Large = 174 or more lawyers
Medium = 31 to 173 lawyers
Small = 11 to 30 lawyers
Tiny = 10 or fewer lawyers

For our purposes, large firms shall be defined as the 250 largest US law firms (as identified in the “NLJ 250” list published annually by the National Law Journal). In 2008 there were 27 law firms with over 1,000 lawyers according to the NLJ 250.1 The average number of lawyers in the NLJ 250 law firms in 2008 was 534, the smallest was 174. The aggregate revenue reported by the AmLaw 200 law firms for 2008 was $84,335,500,000 with average revenue for each of the 200 law firms of over $420 million.2

These are large businesses with very experienced professional CFOs, CMOs, CIOs, and COOs. They have sophisticated business processes, and organize themselves around practice specialties, clients, and locations. There is a growing use of line of business management, or, in professional service environments, probably better stated as practice leadership. They have well-defined performance standards, business models and strategies. Most of these firms have multiple offices that often span nations and continents.

Audited financial statements and sophisticated business records and information are the norm. In contrast are the tiny law firms. Here a designated Managing Partner may exist for administrative matters. Each practice, however, often is managed by each individual partner with little if any supervision. These firms rarely have an internal CFO and instead tend to rely more on their outside accounting firm for financial advice. These firms are less likely to use the level of sophisticated technology applications that are commonly found in large firms. Generally they will have a computer network that facilitates sharing of documents and peripheral computer equipment.

Most tiny firms will have a computerized time and billing application, but some do not. Obtaining documentation of the financial condition of such firms is often more difficult than with larger law firms. Frequently the only historical financial records that exist are tax returns and, absent a computer time and billing system, calendar notations of work performed by the lawyers for specific clients. It is not uncommon for these firms to use fringe benefits generously as additional forms of compensation, which presents a separate set of issues for determining an accurate valuation.

To give further perspective to the demographics of the legal marketplace, let’s look at the distribution of US lawyers by size of firm. The following information is consolidated from The 2000 Lawyer Statistical Report, published by the American Bar Foundation. In 2000, there were 909,019 total lawyers in the US. Seventy-four percent, or 672,901 lawyers, were in private practice.

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Therefore, when taken in conjunction with solo practitioners, nearly 70% of the lawyers in private practice were practicing law in firms of 10 or fewer lawyers in 2000.

Law firms offer scores of different legal services to clients. Some common practice areas are corporate, commercial litigation, real estate, trusts & estates, school law, intellectual property (IP), taxation, divorce, personal injury and immigration. Firms that offer a wide range of practice specialties, including most large- and medium-size firms, are called general practice firms. Law firms that concentrate their practice in a particular area of law have many internal similarities. For example, firms that limit their practice to trusts and estates are usually similar to each other in terms of work effort, culture, profitability and organization and are very different from firms that specialize in other areas, such as personal injury and immigration.

Solos, i.e., lawyers in practice alone, comprised 48% of the lawyers in private practice.

<table>
<thead>
<tr>
<th>Size of Firm</th>
<th>Number of Lawyers</th>
<th>Revenue (in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-10</td>
<td>144,784</td>
<td></td>
</tr>
<tr>
<td>11-100</td>
<td>107,323</td>
<td></td>
</tr>
<tr>
<td>101 or more</td>
<td>95,892</td>
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</tbody>
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expenses are unusually high, or if there are other unusual characteristics of the firm being valued. It can also highlight unusual relationships between revenues and particular expenses, such as occupancy expense, client entertainment expense, retirement expense, etc. This background information provides a framework for selecting the appropriate valuation methodology to use for a particular engagement.

A relatively simple way to categorize law firms in terms of their practice is by their clientele. Firms that primarily serve individuals and families may be called “retail” law firms while others that primarily serve corporations may be called “corporate” law firms. Corporate law firms tend to be larger, rely more on professional managers, use sophisticated technology more extensively, have more stringent controls and appear to be more business-like than retail law firms. The latter are often smaller, less wedded to policies and procedures, more family-oriented, and less structured in their operations. Large- and medium-sized law firms primarily serve corporate clients while most small and tiny law firms primarily serve retail clients. Obviously, in such a vast marketplace there are many exceptions to those general rules.

For a comprehensive listing of the various types of law offered by law firms refer to one of the following websites:

- www.Martindale.com
- www.FindLaw.com
- www.Lawyers.com

Understanding the types of law offered by the particular law firm being valued is important since it can provide meaningful information about the law firm, its lawyers, clients, operations, and possibly even the firm’s culture. This background information is very helpful in gaining an understanding of the subject firm, especially in conjunction with the firm’s size and geographic location. It allows for meaningful benchmark comparisons to be made to comparable law firms, which can indicate if the subject firm is exceptionally profitable or unprofitable compared to its peers, if income appears to be understated (for forensic engagements), if

William F. Brennan is a principal of Altman Weil, Inc., working out of the firm’s offices in Newtown Square, Pennsylvania. He can be reached at (610) 886-2000 or bbrennan@altmanweil.com.

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- **Firmwide Strategies for Practice Group Management**  
  **May 18, 2010, Atlanta, GA**
  Topics include: Practice leader roles and priorities; focused, fact-based planning at the group level; client targeting and relationship building; and structural best practices.

- **Excellence in Law Firm Leadership**  
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Law Firm Valuation
Part II

By William F. Brennan

This article focuses on the valuation of U.S. law firms and covers the legal marketplace, law firm financial records and valuation methodologies. It is not applicable to law firms outside the U.S. where different market and regulatory conditions may exist. Part I ran in last month’s issue of RTLM; Part III will appear in next month’s issue.

Law Firm Financial Records
As with all businesses, the financial records that form the foundation of any valuation engagement are the balance sheet and income statement. Most law firms maintain their books and records, as well as their tax returns, on the modified cash basis of accounting. Under this method, revenue is recognized when fees are collected rather than when they are billed or earned (e.g., when the professional services are actually performed). Expenses are recognized when they are paid rather than when the expense is incurred. Fixed assets are capitalized rather than expensed and depreciation, a non-cash expense, is also recorded. At year-end, pension obligations are often accrued, even though they are paid in the following year. That is why this method is a “modified cash method,” but for simplicity it is commonly called the “cash method.” The accrual basis of accounting recognizes revenue when the professional services are earned, which is when they are performed under an agreement with a client. The modified accrual basis recognizes revenues when the fees are billed to a client. In the U.S., law firms generally file tax returns on the cash basis and accordingly report financial results in the same manner. Large law firms are more likely to have audited financial statements prepared according to GAAP.

The difference between the various accounting methods used by law firms can be illustrated by Figure 1 on page 4, a graphical depiction of the flow of financial activity in a law firm. It is analogous to the flow of water through a series of three buckets, with the first bucket representing unbilled time, or work-in-process (WIP); the second bucket representing accounts receivable; and the third bucket representing cash.

Law firm timekeepers, including lawyers and paralegals, record their time which is entered into the firm’s time and billing system. Billable time is valued at the appropriate billing rate. This activity is depicted in Figure 1 by the first arrow above, and it is usually called “time value added” or “recorded time value.” Under the accrual basis of accounting, revenue would be recognized when the professional services are actually performed, which is depicted by the first arrow. It is typically about four or five months after the legal services are performed that fees are collected from clients.

This billable, recorded time is added to any prior balance of unbilled time, or work-in-process (WIP) to yield an updated balance of time value. The first bucket represents WIP. A subsidiary WIP ledger indicating the net balance for each client should support the aggregate amount of WIP reported in the firm’s general ledger and most computerized time and billing systems verify the integrity of that relationship each month. The specific accounting entry to record the transaction (as deferred revenue or as revenue) will depend upon whether the firm is using the cash, accrual or modified accrual method of accounting. Typically each month the billing lawyer for each client will make a determination of what amount can and should be billed to the client. Generally two to three months of unbilled time value will reside in WIP at the end of each month.

continued on page 4
Law Firm Valuation ... continued from page 3

The amount that can be billed is converted from WIP to accounts receivable and any variance between the two amounts is written down or up within the computer system. Reverting to the flow of water analogy, billings are reflected by the second (black) arrow and the portion that does not make it to the second bucket, the spillage, or loss, is represented by the small arrow labeled “write-downs.” The firm should have a subsidiary ledger of all accounts receivable balances that supports the aggregate amount of accounts receivable reported in the firm’s general ledger.

Subsequently clients remit their payments to the law firm and the receipts are posted to the client accounts, resulting in the accounts receivable being converted to cash receipts. Any variance may need to be recorded as a write-off in the computer system. Using the flow of water analogy, receipts are represented by the third arrow and the write-offs of accounts receivable are represented by the second arrow labeled “write-offs.” This financial information should be available from almost all law firms except perhaps tiny firms. It is important to analyze trends in these financial statistics to identify aberrations, such as a significant reduction in the inventory of WIP and accounts receivable, which could indicate an impending cash flow shortage and a related reduction in the firm’s value.

Law firms using the cash basis of accounting record revenue when the cash receipts are collected by the firm (the first arrow). These firms would not generally record accounts receivable or unbilled time (WIP) on their balance sheet (although unrecorded subsidiary ledgers usually exist, even if only within the firm’s time and billing system). An accrual basis accounting system would recognize revenue in its income statement when the billable time was recorded (the third arrow). Such firms would record both unbilled time (WIP) and accounts receivable balances on their balance sheet. A law firm using a modified accrual basis of accounting would record revenue in its income statement when the fees are billed to the client (the second arrow). Such firms would likely record accounts receivable on its balance sheet but not unbilled time (WIP).

Figure 1 becomes more meaningful by adding benchmarks to it to show the relative magnitude of values reported for each particular financial statistic. Using data provided by the 2008 Survey of Law Firm Economics published by Incisive Legal Intelligence Surveys (formerly Altman Weil Publications, Inc.), a division of Incisive Media, LLC, Figure 2 on page 5 provides an indication of the magnitude of each statistic for the average law firm participating in the survey.

Each of the statistics in Figure 2 varies for firms of different sizes, practice specialties and geographic location. Unless the law firm that is being valued is truly “an average” law firm, the above benchmark statistics may not be appropriate for comparison to a particular law firm. For example, the average gross receipts for the 200 highest grossing U.S. law firms (the “AmLaw 200” list published annually by The American Lawyer) was $728,500 in 2008. This is 69% greater than the average reported above. It is important to compare the financial performance of a particular law firm being valued to its peer firms to ensure a valid comparison. Benchmarking can aid in the identification of significant variances from the average of comparable firms. Clearly this information could be of substantial assistance in identifying unreported income in a forensic analysis, as well as providing a general indication of the relative profitability of a specific firm compared to its peers, which might be indicative of any goodwill value. It can also indicate the normal relationship between revenue and specific expenses, such as occupancy or entertainment expense. Benchmarking surveys for law firm financial statistics are available from multiple sources. Other law firm financial surveys may also be available. Many of these surveys are relatively inexpensive and may aid in completing a law firm valuation analysis.

Valuation Methodologies

There are many different methods for

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**FIGURE 1**

<table>
<thead>
<tr>
<th>Financial Benchmarks Per Lawyer</th>
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<tbody>
<tr>
<td><strong>WIP</strong></td>
</tr>
<tr>
<td><strong>Write-downs</strong></td>
</tr>
<tr>
<td><strong>Acc. Rec.</strong></td>
</tr>
<tr>
<td><strong>Write-offs</strong></td>
</tr>
<tr>
<td><strong>Cash</strong></td>
</tr>
<tr>
<td><strong>Billings</strong></td>
</tr>
<tr>
<td><strong>Gross Receipts</strong></td>
</tr>
</tbody>
</table>

*Source: 2008 Survey of Law Firm Economics by Incisive Media*
valuing businesses, some of which are not applicable to law firms. The fair market value of any business is based upon its ability to generate free cash flow in the future and the underlying risk and timing of the related cash flow. There are three fundamental approaches to valuation: 1) market value; 2) net income; and 3) net assets. Some of the more common methodologies are discussed below along with an assessment of their applicability to law firms.

**Market Value**

*External Market Value*

This method attempts to ascertain the value of a firm by reference to comparable past arm’s length transactions between willing buyers and sellers informed about the facts and not under any duress. This method of valuing firms requires an extensive database of similar sales, which simply does not exist.

The American Bar Association added Rule 1.17, Sale of a Law Practice, to its Model Rules of Professional Conduct in 1990, allowing the sale of an entire law practice, or an area of practice, to another law firm (or lawyer) under certain conditions. The author highly recommends that any person valuing a law firm for any reason and using any method, read, understand and consider Rule 1.17 in its entirety as amended and with its annotations (See Annotated Model Rules of Professional Conduct published by the Center for Professional Responsibility of the American Bar Association) as well as its applicable state counterparts before reaching a conclusion regarding value.

**Internal Ownership Transfers**

An indication of the market value of a law firm may be found in recent data on the internal transfer of ownership from one lawyer to another. Buy-ins of new partners and buy-outs of withdrawing partners may be consummated under terms that are intended to represent the market value of the firm or they may simply reflect the capital requirements of the firm. The amount of capital to be paid usually is either a stipulated dollar amount (e.g., $50,000), a percentage of the new partner’s annual compensation or an amount based on the firm’s cash basis book value or accrual basis book value. If a firm stipulates the dollar amount, it generally decreases as firm size decreases, with most tiny law firms having a nominal buy-in amount. Some have none at all.

Using capital contribution as a value benchmark is complicated by the different ways that law firms handle the requirement. Some firms retain a large portion of a partner’s annual income as capital (as high as 45%) to provide sufficient working capital for the firm without the need to borrow on its line of credit. That retention may be permanent (a true capital contribution) or temporary (a deferred distribution of profits). Other firms prefer to payout as much compensation as possible to owners and only retain a small percentage of a partner’s annual compensation for capital. And, unfortunately, there are some law firms that borrow to increase owner distributions beyond the economic results of their firms (usually as a borrowing against accounts receivable and WIP). They tend to rely more on external financing for working capital needs. These preferences are based on different philosophies about the cost of capital and a willingness to incur debt rather than their perception of the firm’s value.

It is important to note that none of these buy-in methods gives consideration to goodwill. Buy-outs of withdrawing partners typically entail a return of the partner’s paid-in capital. This is especially true for large and medium-sized law firms. Buy-outs of withdrawing partners in small and tiny law firms usually return the partner’s paid-in capital. Some, however, provide for an additional payment to be made that is based on the firm’s net assets as of the date of withdrawal. Unfortunately, except with founders this will likely result in double dipping since new owners rarely buy-in to WIP or AR and are paid those assets immediately upon entry. Some of these firms base the amount of the buy-out exclusively on the portion of the firm’s accounts receivable and WIP outstanding balances attributable to the departing lawyer. And quite often these payments are not reflected as a buy-out, but rather as a deferred compensation. It is extremely rare for internal transfers of ownership to departing continued on page 6
**Law Firm Valuation ... continued from page 5**

partners to involve goodwill in the calculation.

Part of the valuation due diligence is therefore the acquisition of a good understanding of buy-in, compensation, capital development, retirement and buy-out programs of the subject and comparable law firms.

**Income Based Approach**

**Revenue Multiple**

This method is simple to use and understand since it is computed by multiplying annual revenue by a “rule of thumb” number ranging from .25 to 1.0 or higher. It is frequently used to estimate a company’s value in other industries, but it is one of the least accurate methods for valuing law firms due to operating differences even among law firms of the same or similar range of revenues. A law firm with $20 million in revenues generated by 50 lawyers whose 10 partners each make $350,000 per year in total compensation does not have the same value as a $20 million corporate law firm with 30 lawyers whose 10 partners each make $930,000 in total compensation.

“**What is unreasonable compensation for a lawyer? The IRS has struggled with this for decades ...**”

However, the relationship between professional goodwill and business goodwill remains an extraordinarily difficult question to sort out. And the proper answer will most definitely vary from firm to firm.

Second, this method relies on a concept of excess earnings. To determine excess earnings one must first determine normalized earnings. Normalized earnings rely largely on determining reasonable compensation for the business owners. What is unreasonable compensation for a lawyer? The IRS has struggled with this for decades ever since the evolution of the incorporated professional practice. The IRS’s best salvo was levied in *Pediatric Surgical Associates P.C. v. Commissioner* (see T.C. Memorandum 2001-81) where the tax court determined that compensation paid to the shareholder physicians was unreasonably high because it exceeded the value of the services performed by the shareholder physicians. Using the underlying rationale applied in *Pediatric*, a law firm would have excess earnings derive solely based on the profits generated by non-owner timekeepers. In some firms this would be substantial, particularly where the firm’s profit driver is leverage.

Third is the assumption that the amount of a law firm’s tangible assets is important to the firm’s ability to generate cash flow. This may be applicable to many industries, but it is not applicable to law firms where capital deployed is by most measures quite modest. The amount of a law firm’s tangible assets has very little to do with its ability to generate cash flow.

**Capitalization of Income**

This method is based on historical income normalized for the future. Determining the amount of income to use for this formula involves some judgment. For example, excess fringe benefits provided to the owners of the firm and recorded as an expense should be added back to income. Unusual and non-recurring income such as the collection of a large contingency fee that is not going to be replicated in the future needs to be adjusted out of income.

Unfortunately this method also requires the valuator to adjust the actual compensation paid to the owners of the law firm to “reasonable professional compensation,” which means replacing the actual compensation paid with a theoretical compensation amount that is estimated to be required for a comparable professional(s) to generate the firm’s revenues. The tax court case *Richard Ashare, P.C. v. Commissioner* offers some guidance. Here “a lawyer was the sole shareholder and professional
employee in a law firm that devoted itself to a single class action and won a $12.6 million contingent fee from a 1989 settlement. The fee was paid in 1989-92, and the P.C. paid out the fee as compensation, including $1.75 million in 1993, long after the lawyer ceased performing substantial services. Still, the Tax Court acknowledged that all of the compensation was reasonable, because the shareholder’s personal services had earned the fee.” (See page 13-11, Tax Planning for Corporations and Shareholders, Second Edition, Zolman Cavitch, LEXIS Publishing, 2001).

Under this method the earnings of the business, after being normalized, are divided by a designated capitalization rate or “cap rate.” The cap rate used should be the expected rate of return to be earned given the risk associated with operating the business. The one year Treasury Bill rate could be used as the floor or “risk free” rate of return which would then be adjusted higher to reflect the level of risk inherent to the business. Greater risk requires a higher cap rate and ultimately a lower valuation.

Law firms involve considerably more risk than most businesses because … the firm’s most critical assets, its key partners, can choose to leave the firm at any time.”

Discounted Cash Flow
This method relies on earnings projected for a predetermined length of time, such as five years, and then discounted back to the present. It may also include an estimate for the terminal value of the business after the expiration of the stated time period (i.e., 5 years). Since the value of a business is determined by its ability to generate free cash flow in the future this method attempts to directly value the underlying basis of a company’s worth. This method begins with a trend analysis of historical income statements and then projects them into the future to reflect anticipated changes in the firm’s operations. For example, the addition of new lawyers, retirement of a key partner, a change in office leases, expected billing rate increases, expected collection of contingent fees (using the expected value method described in this article), and other major operational changes can all be factored into the estimation of future profits.

The discount rate used should adjust for inflation and risk. The underlying theory behind this method is that a dollar received today is worth more than a dollar received in the future and therefore future dollars should be discounted accordingly. When computing the future profit of the firm, a critically important variable is the amount of compensation projected to be paid to the partners of the firm. Rather than use

continued on page 8
their full, active cooperation. This is especially true for large and medium sized law firms, and less so for small and tiny law firms.

Editor’s Note: This article originally appeared as a chapter in the book, Valuing Professional Practices and Licenses (Wolters Kluwer, 3rd edition, 2010). Reprinted with permission. All rights reserved.

William F. Brennan is a principal of Altman Weil, Inc., working out of the firm’s offices in Newtown Square, Pennsylvania. He can be reached at (610) 886-2000 or bbrennan@altmanweil.com.

1. 2009 AmLaw 200; Incisive US Properties, LLC
2. Incisive Legal Intelligence Surveys, A Division of Incisive Media, Inc., Survey of Law Firm Economics (http://www.incisivesurveys.com/r5/showkiosk.asp?listing_id=2287603);
   Executive Summary of the 2008 Survey (http://www.altmanweil.com/index.cfm/fa/r.resource_detail/oid/41f6ad2-da67-406e-9999-ca2aaaee63539/resource/New_Survey_Focuses_on_Law_Firm_Economics.cfm);
   Citi Private Bank’s Annual Survey of Law Firm Financial Performance (https://www.privatebank.citibank.com/our_services/law_firms.htm);
   IOMA Law Firm Practice Management Performance Benchmarks (http://www.ioma.com/issues/SPCRPT/1616865-1.html);
   PriceWaterhouseCoopers Law Firm Statistical Survey (http://www.pwc.com/Extweb/pwcpublications.nsf/docid/39179D3959A1E1D6852571240062678A);
Law Firm Valuation
Part III

By William F. Brennan

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Asset Based Approach

Book Value
This method is based on the Balance Sheet of the organization and is equivalent to the value of the Partner’s Equity. It is calculated as Total Assets minus Total Liabilities which are reported based upon their historical cost. This is a simplistic method for valuing businesses and is not considered to be an accurate measure of a company’s value. Since most law firms maintain their books on the cash basis, this method merely reflects the net assets of the firm after consideration of transactions affecting cash. Some law firms use the Book Value method as the basis for determining the amount of capital a new law firm partner must pay to become a partner, but the primary reason for doing so is the method’s relative simplicity and ease of use rather than its precision in ascertaining the firm’s value. A firm’s Book Value can be readily obtained at the end of each month when the firm’s monthly financial statements are prepared. Although it is readily accessible and easily understood, it is not a good indication of a law firm’s value.

Debt Assumption Method
This valuation formula is based upon the amount of debt that can be supported from the current cash flow of the business. The assigned value is equivalent to the maximum supportable debt level. This theoretical value represents the highest amount of debt an independent party might lend to the firm if it used all of its free cash flow for debt service. One problem with this method is how to define “free cash flow.” Since almost all law firms are taxed on the cash basis, they tend to bonus out as compensation the firm’s annual profits, which results in little or no “free cash flow” after recognizing owner compensation. Should the amount of owner compensation used for this purpose be the entire amount of distributable partner profit or should it be an amount computed after some theoretical compensation amount is paid to the firm’s partners? The subjective nature of the adjustments required by this method render its theoretical computations subject to challenge. This method is not considered to be an appropriate method of valuing a law firm.

Adjusted Book Value
Slightly more complicated than the method above, but more accurate, are two types of Adjusted Book Value: Tangible Book Value and Economic Book Value. Tangible Book Value begins with a company’s book value (presumably on an accrual basis) and is modified to exclude intangible assets such as goodwill, capitalized start up costs, etc. such that the arrived at book value relates only to the “hard” assets of the business such as land, buildings, etc. Since few law firms have goodwill or startup costs recorded on their balance sheet in the first place, this method is very similar to the Book Value method mentioned above. This method is disadvantaged by two things: 1) the fact that the accounting records are primarily based upon historical cost so that the resulting book value may not approximate current fair market value, and 2) that law firms carry very

continued on page 4
Law Firm Valuation ... continued from page 3

modest amounts of tangible assets at year-end. This is somewhat compensated for by the second type of Adjusted Book Value, the Economic Book Value method.

“Interestingly, it is extremely rare for law firms to pay more than the adjusted book value for the net assets acquired in a merger or acquisition.”

The Economic Book Value Method

The Economic Book Value Method adjusts the assets to their current market value, or net realizable value in the case of accounts receivable and WIP. For certain assets, such as furniture, equipment, computer systems, and leasehold improvements, the amounts are supportable through the use of independent appraisals (although used furniture and equipment are rarely worth more than a fraction of their historical cost, if that). The Economic Book Value method is a good indication of at least a portion of a law firm’s value and is therefore a preferred valuation method.

This method is commonly used in law firm mergers and acquisitions, in our experience. Interestingly, it is extremely rare for law firms to pay more than the adjusted book value for the net assets acquired in a merger or acquisition. That is, goodwill is rarely ever recorded in conjunction with an actual arm’s length transaction between the owners of one law firm when combining it with another law firm, in either a merger or an acquisition. This may be because the owners of the firm being acquired are merged into the larger law firm and are expected to continue performing legal services for the acquired firm’s clients and, accordingly, are expected to be paid the same amounts for doing so. This would explain why there is no goodwill value recognized in most law firm combinations: there is no “free cash flow” to capitalize. This explanation appears reasonable because most law firm combinations are more appropriately described as a marriage than as an acquisition, with most of the lawyers in the acquired firm continuing to practice with the combined firm. Obviously this is not applicable for true acquisitions where the ownership changes after the effective date of a combination. The adjusted book value method is one of the preferred methods for valuing a law firm and the specific procedures to be used are described in more detail below.

The Economic Book Value method is based on the balance sheet, which in most instances will be prepared on a cash basis. Initially it may be necessary to adjust the balance sheet to an accrual basis. The following adjustments may be appropriate for this purpose.

1. Record the balance of outstanding accounts receivable, including both fees and billed client costs.
2. Record the balance of unbilled time, including unbilled fees and costs.
3. Record a reserve for uncollectible accounts receivable and unbilled time and costs to reduce them to net realizable value. It is best to have the law firm’s executive managers conduct a review of the accounts receivable and WIP reports to estimate which client accounts are not fully collectable and to provide their estimate of the amount which is collectable. This is called the “specific identification” method of creating a reserve for uncollectible accounts. If that is not feasible, an estimate of the uncollectible amount can be generated by first aging the account balances (i.e., segmenting into aging buckets: under 30 days, 31-60 days, 61-90 days, 91-180 days, and over 181 days) and then applying an assumed percentage of uncollectable accounts to each aging bucket.
4. Record an estimate of the expected value of all contingent fee cases, reduced to net present value. This will require input from the law firm’s executive managers, who will need to provide information for each matter such as the claim amount, the fee percentage negotiated with the client, the expected settlement amount, the estimated settlement date, and the probability of winning the lawsuit, along with an estimate of any referral fees and client costs and additional legal services that will need to be expended to resolve the litigation. Without that data it will be extremely difficult to develop a reasonably accurate estimate of the value of such contingent fee cases. If a period of several years has elapsed since the valuation date, it may be possible to reconstruct the value of these contingent fees by analyzing the actual fees generated by them subsequently.
5. Record any additional unre corded assets on the balance sheet. These may include prepaid items such as annual insurance premiums.
6. Record the balance of accounts payable as of the valuation date. This may be available from the firm’s computerized accounts payable software or by analyzing disbursements made after that date, combined with a review of the underlying invoices to determine if the expenditure related to an expense incurred prior to the valuation date. If so, it needs to be accrued as of the valuation date. If the detailed disbursement records and related invoices are not available, an estimate might be generated by computing the average monthly overhead expenses of the firm and then computing an amount to be accrued equal to one or two months of expenses, depending upon how quickly vendors were typically paid by the law firm.

7. Record any salary accrual required as of the date of the valuation by reference to the payroll records and the period covered by the latest payroll compared to the valuation date. Record also the associate payroll tax liability as well as any required retirement contributions associated with the payroll.

8. Record a liability for accrued “paid time off” for employees, including their vacation and sick time. This amount can be very substantial in a law firm depending upon the firm’s policies governing the employees’ accrual of such benefits and their ability to carry benefits over from one year to the next.

9. Record the net present value of any unfunded partner retirement liability. If the law firm cannot provide this information it may be necessary to create a worksheet for this purpose. It should include a listing of all partners who are entitled to retirement payments, including any who are already collecting these benefits. A computation of the estimated amount to be paid to each qualifying partner should be made and inserted in the columns designated for each year it is to be paid. The aggregate amount of all such payments should be calculated in this manner for each of the next ten or more years. The net present value should be computed using a discount factor that is appropriate given the anticipated inflation rate as well as the inherent risk involved.

10. Record any additional unrecorded liabilities in existence as of the valuation date, including profit sharing or pension expense, unearned client advances not in IOLTA accounts, severance payments that may be required for personnel who will not be included in the combined firm as well as the premium for a tail malpractice insurance policy.

The next step is to adjust the balance sheet accounts, including the accrual accounts added per the steps listed above, to the amount which represents their market value on the valuation date. Depending upon the purpose of the valuation, this may entail some or all of the following adjustments.

1. Since the firm’s fixed assets will be recorded at net book value based upon historical cost reduced by accumulated depreciation, the reported amount may be substantially different from their fair market value. Valuing these assets at fair market value, assuming they are used equipment in place, seems most reasonable as opposed to either their replacement cost or disposal value.

2. Accounts receivable and WIP should already be recorded at their net realizable value based on the procedures specified above. If appropriate, make an additional adjustment to reduce these assets to their net present value.

3. Assets which are not included in the combination should be eliminated.

Economic Conditions
When any business is being valued it is necessary to evaluate the economic conditions prevailing at the time. When the economy is booming it is easier for companies to thrive, but during a recession the profitability level of the company is challenged and possibly even the financial viability of the company may be in jeopardy. The market takes this information into consideration when placing a value on any asset, as indicated by stock market fluctuations during a bull or bear market. Similarly, the valuation of a law firm must reflect the economic conditions existing when the valuation is being performed.

The level of uncertainty in the legal marketplace in 2009-2010 is greater than it has been at any time in the past several decades. Many law firms that thrived during the 1970s, 80s, 90s and the early part of this decade are now struggling financially. Most large law firms in the country laid off lawyers and staff during the end of 2008 and/or the beginning of 2009 in response to a precipitous drop in demand from clients for legal services. In addition to layoffs, law firms are experiencing resistance to price increases from clients and more buyers of legal services are insisting upon lower costs to service their needs and a more predictable pricing method, such as a fixed fee. The expected effect of these changes is that profits of a great many law firms will likely decline, at least for the next few years.

The global recession has exacerbated the financial stress on law firms, but forces were already in play...
before the recession began that have been suppressing law firm profit levels for several years.

• Technology — Smart technologies are replacing the need for some low-end legal services.

• Non-traditional competitors — Accounting firms, banks and even paralegals have been taking away some work that was previously performed by lawyers.

• Outsourcing/off-shoring — Buyers of legal services are replacing law firms with less expensive suppliers from other countries, especially India, for low-end or commoditized legal services.

Over time these forces have had an adverse impact on law firm profit levels. In light of current economic trends and projections for the future, there is more risk inherent in law firms today than there has been in the past. This may cause a further reduction in law firm market values at least for the foreseeable future.

Another factor that may have a significant impact on law firm valuations in the future is the possibility of non-lawyers being able to invest in law firms. Australia already allows non-lawyers to own law firms. Slater & Gordon in Australia became the world’s first publicly traded law firm in 2007 floating a minority interest of its ownership in the capital markets. The United Kingdom passed legislation, the United Kingdom’s Legal Services Act 2007, that will allow UK firms to have non-lawyer investors beginning in 2010. There is considerable speculation about what impact it would have on US law firms if similar legislation were passed in this country. Some anticipate a dramatic increase in law firm valuations if this were to happen. This can only happen if there is free cash flow available to the investors, which at least for now would come in the form of lowered owner incomes. The answers of course are unknown at this time; but if it were to happen, it certainly could change law firm valuations dramatically, depending upon the specific regulations that might be adopted.

Proposed Valuation Method

The proposed method of valuing a law firm (assuming a different method is not required by the IRS or case law precedents for a particular jurisdiction, or to achieve a specific purpose) is a combination of two of the above methods. One of the two methods is a balance sheet approach and the other is based upon the income statement, so that the valuation reflects both the value of the firm’s net assets on the valuation date plus the value of the firm’s “economic engine,” or ability to generate future free cash flow. These two methods are the Adjusted Book Value method and the Discounted Cash Flow method, each of which is discussed above. The two values obtained should be added together to derive an accurate indication of the value of a particular law firm. The value of the net assets existing in the law firm on the date of valuation would be reflected. In addition, the net present value of the free cash flow of the firm’s future operations, if any, would be added to the value. If adopted, this method would reconcile the observations in the real world regarding the market value of law firms with the potential to be applicable in the future if law firm ownership restrictions are changed to allow public ownership of law firms.

1 http://findarticles.com/p/articles/mi_qa3975/is_200801/ai_n24393061/
2 http://www.journalonline.co.uk/Magazine/52-12/1004787.aspx

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William F. Brennan is a principal with Altman Weil, Inc., working out of the firm’s offices in Newtown Square, Pennsylvania. He can be reached at (610) 886-2000 or bbrennan@altmanweil.com.