Case No. 40067-7-II

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

STEVE B. DIXON, a married person,
Respondent/Cross-Appellant,

v.

CRAWFORD, McGILLIARD, PETERSON & YELISH, a Washington general partnership; WILLIAM M. CRAWFORD and the marital community comprising WILLIAM M. CRAWFORD and JANE DOE CRAWFORD; JOHN H. McGILLIARD and the marital community comprising JOHN H. McGILLIARD and JANE DOE McGILLIARD; RICHARD L. PETERSON and the marital community comprising RICHARD L. PETERSON and JANE DOE PETERSON; and MARK L. YELISH and the marital community comprising MARK L. YELISH and JANE DOE YELISH,
Appellants/Cross-Respondents.

RESPONDENT/CROSS-APPELLANT STEVE B. DIXON'S BRIEF IN RESPONSE AND OPENING BRIEF ON CROSS APPEAL

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Cross-Appellant Steve B. Dixon

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I. INTRODUCTION

The Respondent/Cross-Appellant in this matter, Steven B. Dixon ("Respondent"), is an attorney practicing in Kitsap County. This case arises from his disassociation from the Port Orchard, Kitsap County, law firm, now Crawford, McGilliard, Peterson & Yelish (the "Firm"), which, together with the remaining partners in the Firm, are the Appellants/Cross Respondents (collectively "Appellants").

The fundamental premise of Appellants' Opening Brief is that Respondent should not be entitled to compensation on disassociation from the Firm based on the "goodwill" value of certain Kitsap County public defense contracts ("Contracts"). On that basis, Appellants assert that the value of Respondent's interest in the Firm would be limited to the value of the tangible assets of the Firm.

While the Contracts at issue may involve an "expectation of continued patronage" and, therefore, fall within the very broad and well-recognized definition of goodwill, the Contracts are materially different from the kind of goodwill usually at issue. The goodwill in this case is not like the goodwill of an accountant with an expectation that his tax client might come back next year. Rather, each of the Contracts was for a specific term. Unlike the accountant's client, Kitsap County could not take its business elsewhere during the term of the Contract.

Each Contract created a highly-predictable, easily-valued income stream. Each of the Contracts provided minimum payments on a fixed schedule. For example, the felony services contract provided: "County shall pay Attorney the sum of $854,955.00 per year in twelve monthly installments of $71,246.25 as a retainer for providing legal representation" in felony cases for indigents. (*Trial Ex. 12 at CM 0178*). The annual retainers payable to the Firm under the express provisions of the Contracts in force as of Respondent's disassociation in 2006 (*Trial Exs. 11-15*) totaled $1,109,000.

In 2007, the Contracts generated total revenue of $1,314,000 – 56% of the total revenue earned by the Firm in that year. Appellants concede that the:

> [C]ontracts were very profitable to the firm, generating over half its gross income and essentially paying all the firm's overhead obligation and the salaries of the employees who handled most of the work on the public defense contracts. (FF 15, CP 366)

(*Opening Brief at p. 5-6*). In short, the Contracts were lucrative.

As Appellants also concede:

> "The business strategy for the Crawford Firm from its formation was to develop a public defense practice to the point where the practice could be serviced by salaried employees, liberating the Crawford Firm partners to build practices unrelated to and not dependent on public defense work." (FF 13, CP 366) Mr. Dixon was a full participant in that plan, which the partners "successfully implemented" during the 1990s and early 2000s. (FF 13, CP 366)

(*Opening Brief at pp. 4-5*). Respondent was a "full participant" in the implementation of a plan which resulted in the non-disassociating partners receiving millions in compensation from the Contracts after Respondent's disassociation without those same non-disassociating partners contributing any effort. Appellants, thus, wrongly assert that the Contracts have no value, and the Firm had no goodwill for which Respondent should be compensated.

Judge Orlando concluded that it did not "make sense that a law firm that generates $500,000 a year in profit from public defense contracts would have no goodwill." (*CP 341*). Judge Orlando had it right. This Court should reach the same conclusion.

II. RESPONDENT/CROSS-APPELLANTS' ASSIGNMENT OF ERROR

The reported opinions of the four experts who expressed opinions on the value of the Firm as a whole (Joseph Lawrence for Respondent; and Roland Nelson, Steven Kessler and James Weber for Appellants) was that the value of Respondent's interest in the Firm would be based on two potential components of value: (1) the value of "goodwill" of the firm; and (2) the value of the tangible assets of the Firm. (*RP 94:22-96:21*).[1] Three out of four of these experts analyzed the value of the goodwill of the Firm utilizing a capitalization of excess earnings methodology. The methodology is described at RP 96:25-116:8. All of Appellants' experts concluded that there was no goodwill value for the Firm, but also concluded that there was a tangible asset value. (*Trial Ex. 32 at C000003* (*Nelson*)*; Trial Ex. 33 at C000030 and C000035* (*Kessler*)*; and Trial Ex. 34 at C000008* (*Weber*)). The value of the tangible assets, as determined by Appellants' experts ranged from $36,000 to $47,000.

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[1] A fifth expert, Alan VanderHamm, working in conjunction with Mr. Lawrence, opined on the present value of the income realized from the Contracts between Respondent's disassociation and the termination dates in the Contracts.

Judge Orlando made his own calculation of the value of the goodwill. (*CP 341-343*). Judge Orlando used the capitalization of excess earnings methodology using assumptions for discount rate and replacement compensation he believed were supported by the evidence. Judge Orlando concluded that the value of the goodwill was $232,143, the principal amount awarded to Respondent in the Judgment. (*CP 370-373*). Judge Orlando made no separate award for the tangible assets. Respondent contends this is error.

III. STATEMENT OF THE CASE

Generally, Respondent does not disagree with the Statement of the Case made by Appellants. However, Respondent does have some additions/clarifications/corrections.

A. The Public Defense Contracts.

The Contracts at issue are Trial Exs. 11-21. The Contracts in force as of Respondent's disassociation in 2006 are Trial Exs. 11-15. Appellants contend that the Contracts are not assignable. This would be an irrelevant fact even if true because there was no transfer of any interest in the Contracts. Nevertheless, the Contracts actually provide:

> No right, duty, interest or portion of this Contract may be assigned without the prior written agreement of County executed with the same formalities required by the execution of this Contract.

(*See*, *e.g. Trial Ex. 12 at CM00179*). The Contracts are, in fact, assignable with the Kitsap County's consent.

The Contracts on their face include no requirement that any partner of the Firm provide any services at all. The annual retainers payable to the

Firm under the express provisions of the Contracts in force as of Respondent's disassociation in 2006 (*Trial Exs. 11-15*) totaled $1,109,000. In 2006, the total revenue from the Contracts was $1,239,145.66. (*See Trial Ex. 9 at C000065*). In the year following Respondent's disassociation, 2007, the Contracts generated total revenue of $1,314,971.03 – 56% of the total revenue earned by the Firm in that year. (*Id.*).

Appellants concede the:

> [C]ontracts were very profitable to the firm, generating over half its gross income and essentially paying all the firm's overhead obligation and the salaries of the employees who handled most of the work on the public defense contracts. (FF 15, CP 366)

(*Opening Brief at p. 5*). Since the Contracts were serviced almost entirely by salaried associates, these Contracts allowed the partners to generate very significant profits not attributable to their efforts.

A large part of Appellants' argument is based on the contention that the relationship between the parties to the Contracts violates the Rules of Professional Conduct ("RPC"). The Firm's client under the Contracts is not Kitsap County, the other party to the Contracts – rather, the clients are indigent persons who are not parties to the Contracts. The Firm provides no legal services to Kitsap County under the Contracts. Whether the relationship between Kitsap County, a non-lawyer, non-client, would be subject to the RPC is questionable.

Nevertheless, Appellants assert:

> Valuation and sale of goodwill as part of a buyout price under RCW 25.05.250(2) would necessarily violate ... ethical rules prohibiting solicitation or referral of clients for compensation...

(*Opening Brief at p. 18*). However, Kitsap County is referring clients to the Firm only if arrest and prosecution by Kitsap County can be considered a "referral." Kitsap County is not a lawyer or law firm. No one is paying anyone to get clients. Exactly the opposite – Kitsap County is paying the Firm to service the legal needs of third parties. Any professional duties arising from this relationship are owed to persons other than Kitsap County.

B. Administration/Supervision of the Public Defense Contracts.

Appellants assign error to Finding No. 12 which provides, in pertinent part:

> The assets of the Crawford Firm included public defense contracts with Kitsap County ("Contracts"). ... The Contracts do not require the principals of the Crawford Firm to actually provide any of the legal services contracted for in the Contracts and, in fact, nearly all of the services provided under the Contracts are not provided by the individual Defendants, although the individual Defendants do spend time supervising the provision of services under the Contracts.

(*CP 366*). Appellants offer no direct explanation as to why this Finding is not supported by substantial evidence.

At page 5 of their Opening Brief, Appellants discuss how services were provided under the Contracts. Appellants assert: "After becoming a full partner, however, Mr. Dixon had a civil practice, and spent very little time on the public defense contracts." Appellants suggest that Respondent played no role in providing services under or administering the provision of services under the Contracts.

As Appellants acknowledge:

> "The business strategy for the Crawford Firm from its formation was to develop a public defense practice to the point where the practice could be serviced by salaried employees, liberating the Crawford Firm partners to build practices unrelated to and not dependent on public defense work." (FF 13, CP 336)

(*Opening Brief at p. 4*). Respondent is apparently the subject of criticism because he was successful in accomplishing the very goal the partners set out for themselves in the beginning. The clear inference that Appellants want this Court to draw is that in receiving an award based on the value of these Contracts, Respondent somehow received something for nothing. The challenge to the Finding is baseless, and the suggestion that Respondent played no role in the administration of the Contracts misleading.

First, none of the partners were involved in providing services under the Contracts after 2001, with one minor exception. According to Appellant Partner Richard Peterson, all of the partners had ceased active involvement in providing services under the Contracts by 2001 except Mark Yelish, who "every once in a while took on a case." (*RP 151:3-9*). The valuation report of Mr. Weber summarizes the practice concentrations of each Appellant Partner in Trial Exhibit 34 (at CM000012). Only Mr. Yelish is shown as having any criminal defense work, 20% of his total work, 20% of his total practice. However, it is not known whether this is indigent defense under the Contracts or fee based services.

Respondent's testimony was that, although he was not providing services directly under the Contracts, he continued to act as an advisor to the associates who were, notwithstanding his civil practice. (*RP 34:18-35:3*). Firm Partner John McGilliard testified that all the partners were involved in monitoring the services provided by associates. (*RP 166:21-23*). "All the partners" would include Respondent, consistent with Respondent's testimony. At the time of Respondent's disassociation, the principal responsibility for supervising the provision of services was in the hands of Tim Kelly, who was hired as an associate to provide that supervision. (*RP 35:4-14*).

Which brings us back to the main point here: long before Respondent's disassociation, the Contracts were generating significant profits not attributable to the efforts of the partners. The principal involvement of Firm partners in the Contracts was in renegotiating the Contracts, and it is undisputed that Respondent was involved significantly in the last round of negotiations before his disassociation. (*RP 45:2-46:7*).

C. Goodwill in a Law Practice.

Appellants assign error to Finding No. 17: "The assets of the Crawford Firm as of the date of Dixon's disassociation included 'goodwill,' as that term is defined in Washington law." (*CP 366*).

1. Appellants were Aware of Goodwill in the Firm Before Respondent's Disassociation.

One of Appellants' contentions appears to be that there is no legally cognizable goodwill in a law practice. In this regard, the partners had a series of discussions in the "late '90s, early 2000s" about "a Partnership agreement that defined how much would be paid to a disassociating partner." As part of the process, the Firm partners met with the firm accountant. (*RP 40:14-41:2*). During the course of that meeting, Firm partners were advised that there was goodwill in both the law practice in general and the Contracts in specific. (*RP 41:19-42:13*).

2. Goodwill is Appropriately Valued Using a Capitalization of Excess Earning Methodology.

Appellants assign error to Finding No. 19 which provides, in pertinent part: "All of the experts exclusive of Mr. VanderHamm agreed that a capitalization of excess earnings was the appropriate valuation methodology." (*CP 367*). Mr. VanderHamm offered no testimony regarding the capitalization of excess earnings methodology whatsoever. As discussed below, Mr. VanderHamm only testified as to the value of the income from the Contracts.

Mr. Weber testified quite clearly that there could be goodwill in a law practice:

> Q. Now, I take it because you applied a net capitalization excess -- capitalization of excess earnings methodology, ... there can be goodwill in a professional practice like this?
>
> A. Correct.

(*RP 235:23-236:2*). Three out of the four experts opining on the value of goodwill, including two of Appellants' experts, expressly identified the capitalization of excess earnings methodology as the basis for their analysis of the value of goodwill. (*See Trial Ex. 33* (*Kessler*), *Trial Ex. 34* (*Weber*) *and Trial Exs. 30 and 31* (*Lawrence*)).

Appellants now contend that the capitalization of excess earnings is a legitimate valuation methodology only in the context of a marital dissolution. However, Appellants cite to no authority from anywhere so holding. Appellants cite to no expert testimony to the effect that a capitalization of excess earnings valuation methodology is not recognized in the industry as a legitimate valuation methodology outside of the marital dissolution context.

Mr. Lawrence testified that this methodology is a recognized business valuation methodology. (*RP 94:22-97:24*). None of Appellants' experts offered different testimony, and two of the three experts testifying on behalf of Appellants specifically and expressly relied on the methodology in forming their opinions of value. If this were not an accepted method of valuation outside the dissolution context, why would Appellants themselves offer testimony as to value based on the methodology?

Mr. Nelson, in fact, offered the opinion that there is no goodwill in a law practice. However, Mr. Lawrence testified that Mr. Nelson's opinion would not be endorsed or recognized by the valuation industry. (*RP 117:20-118:18*).

D. Valuation Testimony.

Appellants assign error to Findings of Fact Nos. 20 and 21, relating to the application of the methodology in this case. Finding No. 21 goes to the opinions and testimony of Respondent's expert Mr. VanderHamm. Mr. VanderHamm used a discounted cash flow methodology (*described at RP 80:19-83:23*) to value net income from the Contracts (*RP 84:12-85:10*). This is a recognized methodology for valuing an income stream, according to Mr. Weber (*RP 236:25-237:4*), and Appellants offered no testimony contradicting Mr. VanderHamm.

"Mr. Vander Hamm was valuing only the profit of the contracts based on the financial statements and tax returns." (*RP 97:6-8*). Mr. VanderHamm did not purport to value the goodwill of the business as a whole. His testimony pertains only to the value of the post-disassociation income stream from the Contracts, although this value is highly relevant to the issues here.

As described, a discounted cash flow valuation turns an income stream into a lump sum "present value" by applying a discount rate to each incremental payment that comprises the income stream. The discount rate is a function of the risk that the income stream may not be realized. A higher discount rate results in a smaller present value. Generally, the longer the period over which the income is to be paid, the higher the discount rate.

Mr. VanderHamm initially determined the value of the Contracts to be $330,000 to $360,000 in the two written expert reports submitted by Respondent. (*Trial Exs. 30 and 31*). Mr. VanderHamm then testified that if you only change the period over which the income stream from the Contracts was realized, terminating the stream in 2009 consistent with the termination dates of the Contracts, but using the same discount rate, it would reduce his estimate of value by about $100,000 (*RP 84:22-85:10, 88:15-23*) to $230,000 to $250,000 from $330,000 to $360,000.

In this regard, Appellants make the following statement:

> When [Mr. VanderHamm was] asked if he could "change the time period" over which the public defense payments were received to terminate in 2009, Mr. Vander Hamm testified that he could not do the math on the stand (RP 87), but then agreed with plaintiff's counsel's claim that the value of a one-fifth share in the contracts would be $230,000 to $250,000. (RP 88)

(*Opening Brief at p. 10*). This is a deliberate mischaracterization of Mr. VanderHamm's testimony. The only thing Mr. VanderHamm testified he could not re-calculate on the stand would be a new discount rate based on the assumption that the Contracts terminated in 2009. (*RP 86:10-87:5*). However, Mr. VanderHamm also testified that recalculating the discount rate would result in a higher present value for the net income from the Contracts. (*Id.* and *RP 88:2-23*). Thus, a value of $230,000 to $250,000 represents a minimum value of the Contracts, based on the undisputed testimony of Mr. VanderHamm.

Finding No. 20 summarizes the Findings of Judge Orlando in relation to the application of the capitalization of excess earnings methodology in this case. Using the capitalization of excess earnings method, three other experts (Messrs. Kessler, Weber and Lawrence) valued the goodwill of the Firm as a whole. The capitalization of excess earnings methodology is described at RP 96:25-116:8.

In a nutshell, in privately-held companies, expenses and particularly owner compensation are often not at market rates. Owners may manipulate their compensation for a variety of reasons. The methodology involves adjusting owner compensation to market rates. The objective is to determine whether the company would be generating additional or greater profits if the services provided by the owner were being provided by a market rate employee with a similar skill/experience set. This is the replacement value/reasonable compensation issue discussed in Judge Orlando's letter ruling. (*CP 341-343*).

To the extent that revenues exceed "normalized" costs – costs adjusted to market, there are "excess earnings." A "capitalization rate" is then applied to the excess earnings to generate the value for the goodwill of the business.

Judge Orlando's conclusion as to the value of the goodwill of the Firm, using a capitalization of earnings methodology based on Judge Orlando's findings as to replacement compensation and discount rate was $232,000. Appellants object to this Finding, Finding No. 24, as well. Mr. VanderHamm's conclusion as to the value of the Contracts was $230,000. The correlation is significant because it suggests that on a cumulative basis, the non-disassociating partners were being overcompensated. The profits of the Firm, and much of the compensation to the partners, were not generated by the activities of the partners.

The opinions of the various experts differed, as noted by Judge Orlando (*CP 341-343*), in the reasonable compensation and discount rate assumptions with both the discount rate and replacement compensation being higher in the Appellants' expert reports. Judge Orlando ultimately rejected the replacement compensation assumptions used by both sets of experts using this methodology and applied his own. The fact that Judge Orlando's determination of value corresponds with Mr. VanderHamm's suggests that Judge Orlando's reasonable compensation numbers were correct.

To bolster the conclusion of their experts that any goodwill in the Firm had no value, Appellants make a series of assertions.[2] First: "None of the parties paid any consideration for goodwill upon becoming a partner." (*Opening Brief at p. 19*). What Respondent actually testified was that he was not required to buy-in to the partnership. (*RP 51*). Respondent simply was not asked to contribute capital in return for an interest in the assets of the Firm – tangible or intangible. Since there unquestionably were tangible assets (furniture, computers, law library, accounts receivable), the fact that the partners made the economic decision not to require a capital contribution says nothing about whether the assets had value.

Second, Appellants assert: "Goodwill was not and never has been reflected on the firm's balance sheets. (Ex. 30 at 45, Sch. 2; CP 124)." (*Opening Brief at p. 20*). This assertion is simply unsupported in the

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[2] This involves something of a shift in focus going from the generic: "there is no goodwill in law firms;" to the specific: "there is no goodwill in this law firm."

record. ***In fact, no Firm-prepared balance sheets were admitted into evidence.*** The referenced document is not a Firm-prepared balance sheet. It is not even a balance sheet – it is a comparison prepared by Respondent's expert Mr. Lawrence of the value conclusions reached by Mr. Nelson (for Appellants) and Mr. Lawrence. The only Firm-prepared financial statements admitted into evidence were income statements which do not purport to show the value of any asset. (*See, e.g., Trial Ex. 6*).

There are cash basis tax returns. (*See, e.g., Trial Ex. 5*). Those tax returns include "asset reports." (*See, e.g., Trial Ex. 9 at CM000065*). Those asset reports only report depreciable assets to support depreciation deductions and do not purport to show all of the assets of the Firm. For example, note there is no line item for accounts receivable in the "asset reports." Accounts receivable cannot be depreciated.

Third, Appellants state: "Mr. Crawford upon his retirement received nothing for goodwill." (*Opening Brief at p. 20*). Firm Partner William Crawford disassociated from the Firm in 2009 in close proximity to the expiration date of the Contracts. Given the proximity to the termination date of the Contracts, the Contracts would not have had the same value as in mid-2006. Moreover, Mr. Crawford received the income from the Contracts during the three-year period following Respondent's disassociation.

The agreement for Mr. Crawford's withdrawal from the Firm (*Trial Ex. 37*) is dated six months ***after*** Respondent's Complaint in Intervention (*CP 160-164*). The Lawrence valuation report (*Trial Exs. 30-31*) was attached as an exhibit to Respondent's Declaration in Support of

Motion to Intervene. (*CP 59-148*). At the time of Mr. Crawford's withdrawal, the Firm Partners were fully aware that Respondent was claiming that his partnership interest was worth $340,000. (*See Ex. 30 at D000045; and CP 124*).

Trial Exhibit 37 does not enumerate how the buy-out was calculated. In Trial Exhibit 37, however, Mr. Crawford is indemnified from any liability arising from Respondent's claim. So, whether or not Mr. Crawford was compensated for goodwill, he was insulated from joint and several liability for Respondent's $340,000 claim, and the other Firm partners have paid Mr. Crawford's share of the Judgment exceeding $300,000.

1. Goodwill is Appropriately Valued Using a Capitalization of Excess Earning Methodology.

Appellants assign error to Finding No. 19 which provides, in pertinent part: "All of the experts exclusive of Mr. VanderHamm agreed that a capitalization of excess earnings was the appropriate valuation methodology." (*CP 367*).

Mr. Weber testified quite clearly that there could be goodwill in a law practice:

> Q. Now, I take it because you applied a net capitalization excess -- capitalization of excess earnings methodology, ... there can be goodwill in a professional practice like this?
>
> A. Correct.

(*RP 235:23-236:2*). Three out of the four experts opining on the value of goodwill, including two of Appellants' experts, expressly identified the capitalization of excess earnings methodology as the basis for their analysis of the value of goodwill. (*See Trial Ex. 33* (*Kessler*), *Trial Ex. 34* (*Weber*) *and Trial Exs. 30 and 31* (*Lawrence*)).

Appellants now contend that the capitalization of excess earnings is a legitimate valuation methodology only in the context of a marital dissolution. However, Appellants cite to no authority from anywhere so holding. Appellants cite to no expert testimony to the effect that a capitalization of excess earnings valuation methodology is not recognized in the industry as a legitimate valuation methodology outside of the marital dissolution context.

Mr. Lawrence testified that this methodology is a recognized business valuation methodology. (*RP 94:22-97:24*). None of Appellants' experts offered different testimony, and two of the three experts whose opinions and testimony were admitted into the record specifically and expressly relied on the methodology in forming their opinions of value. If this were not an accepted method of valuation outside the marital dissolution context, why would Appellants themselves offer testimony as to value based on the methodology?

Mr. Nelson in fact offered the opinion that there is no goodwill in a law practice. However, Mr. Lawrence testified that this opinion would not be endorsed or recognized by the valuation industry. (*RP 117:20-118:18*).

E. The Cross-Appeal.

The reported opinions and testimony by the four experts who expressed opinions on the value of the Firm as a whole (Mr. Lawrence for Respondent (*Trial Exs. 30-31*); and Mr. Nelson (*Trial Ex. 32*), Mr. Kessler (*Trial Ex. 33*) and Mr. Weber (*Trial Ex. 34*) for Appellants) was that the value of Respondent's interest in the Firm was based on two components of value: (1) the value "goodwill" of the Firm; and (2) the value of the tangible assets of the Firm. Mr. Lawrence's testimony on this issue appears at RP 94:22-96:21.

Three of the four experts (Messrs. Lawrence, Kessler and Weber) did a full analysis of the value of goodwill using the capitalization of excess earnings methodology described at RP 96:25-116:8. The fourth expert (Mr. Nelson) concluded there was no goodwill value without conducting an analysis. (*RP 192:12-16*).

Messrs. Kessler and Weber concluded that there was no goodwill value for the Firm, but also concluded that there was a tangible asset value (*Trial Ex. 33 at C000030 and C000035* (*Kessler*); and *Trial Ex. 34 at C000008* (*Weber*)). The value of the tangible assets, as determined by Appellant's experts, ranged from $36,000 to $47,000.

In his letter ruling, Judge Orlando made his own calculation of the value of the goodwill (*CP 341-343*) based on a capitalization of excess earnings methodology using assumptions for discount rate and replacement compensation he believed were supported by the evidence, concluding that the value of the goodwill was $232,143, the principal amount awarded to Respondent in the Judgment (*CP 370-373*). Judge Orlando's letter ruling did not discuss the value of the tangible assets. (*CP 341-343*).

The subject of the value of the tangible assets was discussed between Judge Orlando and counsel for the parties in correspondence prior to entry of Judgment. (*See Trial Ex. 40; CP 350-363*). Judge Orlando declined to make an award for the value of the tangible assets. Respondent assert this was error because a separate asset value for the tangible assets distinct from goodwill was acknowledged to exist by each of the experts valuing the whole business.

IV. DISCUSSION AND ARGUMENT

A. The Purchase and Sale of Goodwill in a Law Practice.

The issue is framed by the Appellants as follows:

> The trial court erred in concluding that a lawyer voluntarily disassociating from a law partnership was entitled to be compensated for the claimed value of ongoing public defense contracts which could not be assigned and for which the attorney had no responsibility once he voluntarily left the firm.

(*Opening Brief at p. 13*).

The "buyout" provisions of the Uniform Partnership Act, Chap. 25.05 RCW (the "UPA") require the purchase of the disassociating partners "interest" in the partnership. Appellants' argument is based on the contention that, in some fashion, that interest is in the specific assets of the partnership. "The court should reverse the judgment premised on the forced purchase and sale of the firm's public defense contracts." (*Opening Brief at p. 21*).

While this is where the argument starts, where it ends is with the assertion that a sale of the "goodwill" in the Contracts will violate the RPC. The RPC argument was first raised after entry of Judgment in a Motion for Reconsideration (*CP 374-379*), which Motion was denied (*CP 472-473*).

Respondent objected to the defenses being raised post-Judgment in response to the Motion for Reconsideration (*CP 429-448*), on the following basis. Illegality and violation of public policy are affirmative defenses governed by CR 8(c). *Jordan v. Dirae*, 34 Wn.2d 934, 257 P.2d 773 (1953). If affirmative defenses are not affirmatively pled, asserted within a Motion to Dismiss for failure to state a claim, or tried by express or implied consent of the parties, such defenses are deemed to be waived and may not thereafter be considered as triable issues in the case. *Rainier National Bank v. Lewis*, 30 Wn. App. 419, 645 P.2d 153 (1981); *Bickford v. City of Seattle*, 104 Wn. App. 809, 17 P.3d 1240 (2001), *reconsideration denied, review denied* 144 Wn.2d 1019, 32 P.3d 284 (2001).

Respondent's Complaint in Intervention is CP 160 to 164. Appellants' Answer to that Complaint is CP 209-210. Appellants failed to plead either illegality or violation of public policy as affirmative defenses. Appellants not only did not plead the defense of illegality or violation of public policy, but the defenses were never mentioned, even in passing, throughout the course of the trial. Because this defense was not timely raised before the Trial Court, it cannot be heard for the first time here.

Even if it were the law that a lawyer cannot sell goodwill, that principle would have no bearing whatsoever with respect to the Court's right to grant a disassociated partner a Judgment for the value of his share of the partnership goodwill. RCW 25.05.250 provides:

> The buyout price of a dissociated partner's interest is the amount that would have been distributable to the dissociating partner under RCW 25.05.330(2) ***if***, on the

> date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner and the partnership were wound up as of that date.

(*Emphasis added*).

The use of the word "if" in the statute entirely eliminates Appellants' argument. The Firm's partners are not purchasing Mr. Dixon's goodwill – they are compensating him for the goodwill he left behind in an amount measured by the value of the goodwill ***if*** the partnership were sold.

For instance, in Marriage of Brooks, 51 Wn. App. 882, 884, 756 P.2d 161 (1988), the Court stated that "the important consideration is not whether the goodwill could be sold without personal services of the professional, but whether it has value to him." In that case, the bylaws of the corporate law firm specifically excluded, as between partners, any value for goodwill. Notwithstanding that fact, the Court held that, "in light of Hall and Fleege (that it makes no difference whether the goodwill can be sold) we hold the court did not err in valuing goodwill even though it was assigned no value in the Brooks & Larson, P.S., Corporate Bylaws.

It had previously been held in Marriage of Hall, 102 Wn.2d 246, 242, 692 P.2d 175 (1984), the goodwill made exist in a professional partnership even though it is not marketable. It had previously been held in In re Marriage of Fleege, 91 Wn.2d 324, 327, 588 P.2d 1136 (1979) that professional goodwill existed even in a business that was not readily salable. In Brooks, involving a law practice, it was specifically stated that there were five non-exclusive methods of valuing the goodwill of the law partnership, one of which is "capitalization of excess earnings," the same method employed by this Court. The forth method was the market value approach which set a value on goodwill by establishing the fair price on the current open market if the practice were to be sold. Clearly, this Court has the ability to determine goodwill without assuming that the practice were to be sold. The same five methods were discussed in *Marriage of Hall*, *supra*. It was specifically held in *McCormick v. Dunn & Black, P.S.*, 130 Wn. App. 873, 167 P.3d 610 (2007), that the holders of shares in a legal professional service corporation could provide by express agreement to redeem the shares of a departing lawyer/shareholder.

The whole argument about violation of the RPC's is based on the contention that, Respondent was selling goodwill in a law practice. "The court should reverse the judgment premised on the forced purchase and sale of the firm's public defense contracts." (*Opening Brief at p. 21*). If there is not a transfer, the argument is inapplicable. This fundamental premise – a forced sale of an interest in the Contracts – is factually incorrect.

Neither Respondent's disassociation nor the Judgment transferred an interest in the Contracts. Following each event, the Firm continued to provide all of the services under the Contracts and receive all the income. The only effect of Respondent's disassociation was that Respondent ceased to participate in distributions of the profits from the Contracts.

Legally, Respondent never owned an interest in the Contracts which was transferable as a matter of law. Under RCW 25.05.060

("Property acquired by a partnership is property of the partnership and not of the partners individually.") and RCW 25.05.200 ("A partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily"), a partner has no ownership interest in the assets of the partnership. Thus Respondent never had an ownership interest in the Contracts themselves.

Under RCW 25.05.205, the ability of a partner to transfer any portion of the interest is limited:

> The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. The interest is personal property.

So, if this Court were to adopt the conclusion that payment of the buy-out price involved a transfer of an ownership interest in partnership assets, the buy-out provision in the statute, RCW 25.05.250, would be in material conflict with numerous other provisions of the UPA.

The buyout price in the UPA where the partnership is going to continue in business is defined in RCW 25.05.250(2):

> The buyout price of a dissociated partner's interest is the amount that would have been distributable to the dissociating partner under RCW 25.05.330(2) if, on the date of dissociation, the assets of the partnership were sold at a price equal to the ... value based on a sale of the entire business as a going concern without the dissociated partner and the partnership were wound up as of that date.

RCW 25.05.330(2) provides:

> Each partner is entitled to a settlement of all partnership accounts upon winding up the partnership business. In settling accounts among the partners, profits and losses that result from the liquidation of the partnership assets must be

> credited and charged to the partners' accounts. The partnership shall make a ***distribution*** to a partner in an amount equal to any excess of the credits over the charges in the partner's account.

(*Emphasis added*). Thus, all the statute provides is that the disassociating partner is entitled to a distribution equal to that disassociating partners net equity in the partnership (after any business taken by the disassociating partner is taken out of the calculation) as of the date of disassociation. There is no transfer of any interest in any specific partnership asset.

Appellants assert that the Judgment compensating Respondent for his interest in the partnership would violate the RPC. The initial problem for Appellants is that no attorney-client relationship is created under the Contracts themselves, and no representation relationships were transferred or changed as a result of the Judgment.

Appellants rely principally upon *Walsh v. Brousseau*, 62 Wn. App. 739, 815 P.2d 828 (1991), for the proposition that it a violation of the RPC to sell the goodwill of a law firm. The *Walsh* Court did not so hold. The *Walsh* Court held only that the contract to sell the law practice violated public policy because it contained a promise to refer clients as part of the consideration for the sale in violation of RPC 7.2(c). The case holding has no bearing here.

The *Walsh* case was decided in 1991. In 1996, the Washington State Bar Association issued Formal Opinion 192 (1996), specifically holding that a lawyer may sell his or her legal practice to another lawyer. (*CP 441-446*). In fact, in the Formal Opinion, the authors specifically limit the *Walsh* opinion to its facts stating that the selling lawyer could not affirmatively recommend the purchasing lawyer to his or her clients. *See also*, Informal Opinion 1524 (1993) specifically opining that a lawyer may sell goodwill. (*CP 448*).

The current RPC 1.17 specifically authorizes the sale of goodwill in a law practice.[3] Appellants' reference to RPC 1.17 is, therefore, inapposite. Appellants reference to RPC 1.17 is also inapposite and notable for their failure to mention comment 14 thereto which provides as follows:

> Admission to or retirement from a law partnership or professional association, retirement plans and similar arrangements, and a sale of tangible assets of a law practice, do not constitute a sale or purchase governed by this Rule.

Finally, Appellants' argument that the *Walsh* decision precludes this Court from entering a Judgment for the value of goodwill is patently illogical if one considers the fact that the UPA contemplates an award to an involuntarily disassociated partner, as well as to a partner who voluntarily disassociates. If Appellants' are correct in stating that this Court has no authority to value the goodwill of a law partnership, then a law firm general partnership could rightly or wrongfully cause the involuntary disassociation of a partner from a highly-profitable law firm enjoying significant goodwill without having to compensate that partner for the value of his partnership interest. Such an inequitable outcome

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[3] Formal Opinion 192 (1996) was withdrawn following the amendment of RPC 1.17 in September 2006, presumably because it was redundant with RPC 1.17. However, it was still guidance as of Respondent's disassociation earlier in 2006.

illustrates the absurdity of Appellants' argument based upon the *Walsh* decision.

B. Use of the Capitalization of Excess Earnings Methodology.

Appellants assign error to Finding No. 19 which provides, in pertinent part: "All of the experts exclusive of Mr. VanderHamm agreed that a capitalization of excess earnings was the appropriate valuation methodology." (*CP 367*). Respondent presumes that the assignment of error is based on Appellants' contention that a capitalization of excess earnings valuation methodology is available only in the dissolution context.

However, the contention was never made at trial and, therefore, runs afoul of RAP 2.5. In fact, Appellants' experts relied on the methodology.

Mr. Weber testified:

> Q. Now, I take it because you applied a net capitalization excess -- capitalization of excess earnings methodology, ... there can be goodwill in a professional practice like this?
>
> A. Correct.

(*RP 235:23-236:2*). Three out of the four experts opining on the value of goodwill, including two of Appellants' experts, expressly identified the capitalization of excess earnings methodology as the basis for their analysis of the value of goodwill. (*See Trial Ex. 33 (Kessler), Trial Ex. 34 (Weber) and Trial Exs. 30 and 31 (Lawrence)*).

However, Appellants cite to no authority from anywhere holding that the capitalization of excess earnings methodology is a legitimate valuation methodology only in the context of a marital dissolution. Appellants cite to no expert testimony to the effect that a capitalization of excess earnings valuation methodology is not recognized in the industry as a legitimate valuation methodology outside of the marital dissolution context.

Mr. Lawrence testified that this methodology is a recognized business valuation methodology. (*RP 94:22-97:24*). None of Appellants' experts offered different testimony, and two of the three experts whose opinions and testimony were admitted into the record specifically and expressly relied on the methodology in forming their opinions of value. If this were not an accepted method of valuation outside the dissolution context why would Appellants themselves offer testimony as to value based on the methodology?

Mr. Nelson in fact offered the opinion that there is no goodwill in a law practice. However, Mr. Lawrence testified that this opinion would not be endorsed or recognized by the valuation industry. (*RP 117:20-118:18*).

C. Respondent's Goodwill.

Appellants contend that the exclusion from evidence of Respondent's post-disassociation gross revenue was error. Appellants contend: "Plaintiff's post-partnership income was relevant because it would demonstrate the amount of goodwill that Mr. Dixon took with him when he voluntarily left the firm. (CP 319)." (*Opening Brief at p 29*). Appellants fail to explain, however, how this would be factored into the determination of the "buy-out price" under the UPA. In fact, this information is specifically and expressly excluded from consideration under the statutory standard.

RCW 25.05.250 provides, in pertinent part:

> (1) If a partner is dissociated from a partnership without resulting in a dissolution and winding up of the partnership business under RCW 25.05.300, the partnership shall cause the dissociated partner's interest in the partnership to be purchased for a buyout price determined pursuant to subsection (2) of this section.

Respondent's disassociation did not result in dissolution of the Firm so that the buy-out price is determined under RCW 25.05.250(2):

> The buyout price of a dissociated partner's interest is the amount that would have been distributable to the dissociating partner under RCW 25.05.330(2) if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern ***without the dissociated partner*** and the partnership were wound up as of that date. Interest must be paid from the date of dissociation to the date of payment.

(*Emphasis added*). RCW 25.05.330 in turn provides, in pertinent part:

> (1) In winding up a partnership's business, the assets of the partnership, including the contributions of the partners required by this section, must be applied to discharge its obligations to creditors, including, to the extent permitted by law, partners who are creditors. Any surplus must be applied to pay in cash the net amount distributable to partners in accordance with their right to distributions under subsection (2) of this section.
>
> (2) Each partner is entitled to a settlement of all partnership accounts upon winding up the partnership business. In settling accounts among the partners, profits and losses that result from the liquidation of the partnership assets must be credited and charged to the partners' accounts. The partnership shall make a distribution to a

> partner in an amount equal to any excess of the credits over the charges in the partner's account.

On its face, the UPA contemplates a distribution to the disassociating partner of the partner's pro-rata share of the equity in the partnership as of the date of disassociation "without the dissociated partner" under RCW 25.05.250(2). The valuation standard set forth here is analogous to the standard under the dissenter's rights provisions of Washington's Corporations Act in that the buyout price of the disassociated partner is the partner's pro-rata share of the value of the enterprise as a whole as of the date of disassociation.[4]

The issue here arises because the enterprise value is "based on a sale of the entire business as a going concern without the dissociated partner." RCW 25.05.250(2). On its face, the enterprise value is to be determined as of the date of disassociation without consideration of the contribution to the value of the firm of the disassociated partner.

While the UPA has not yet received interpretation, it is not hard to discern the logic here. When a professional leaves a professional practice, some value is going to go with that professional, certainly the earning capacity and, for a legal professional with an established practice, at least some goodwill. If a business is valued by taking the contributions of the withdrawing party into consideration, that withdrawing partner is going to end up being paid for value that goes out the door with that partner. All the UPA does is ensure that the enterprise value is "based on a sale of the entire business as a going concern without the dissociated partner"

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[4] *See*, RCW 23B.13.250; *Mathew G. Norton Co. v. Smyth*, 112 Wn. App. 865 (2002).

(RCW 25.05.250(2)) to ensure that the disassociating partner is not compensated for value that the partner takes with him when that partner is disassociated from the firm. It keeps that partner from being overpaid.

On the other hand, if the valuation is discounted by the value of the goodwill that the withdrawing partner takes with him, you will be artificially discounting the value of the partner's interest by the value of goodwill which is not an asset of the partnership. If it was an asset of the partnership, it would not be going out the door with the withdrawing partner. That goodwill is personal to the partner rather than an asset of the business.

Appellants further assert that Respondent was over paid because:

> [P]laintiff's expert analysis calculated the goodwill of the firm as it existed the day Mr. Dixon left without discounting for the significant portion of goodwill that Mr. Dixon took with him out the door.

(*Opening Brief at p. 29*). Nothing could be further from the truth.

The methodology and assumptions used by Mr. Lawrence in his determination of goodwill value based on Firm income are discussed in Trial Exhibit 30 (at D000019-26).[5] Mr. Lawrence calculates the "replacement compensation" and post tax excess earnings. The "replacement compensation" is determined as follows: "**Thus, all of the Partners other than Mr. Dixon will assumedly be capable of replacement for $525,000 per annum.**" (*Trial Ex. 30 at D000021*)

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[5] Mr. Lawrence's trial testimony (*RP 96:25-116:8*) is essentially, a summary of the discussion in Trial Exhibit 30. Judge Orlando reviewed and relied on Mr. Lawrence's written analysis in his ruling. (*See Trial Ex. 40*). Trial Exhibit 31 is a supplemental report by Respondent's expert which considers additional data, but which reaches the same value conclusion.

(*Emphasis in original*). Respondent was not included in the replacement compensation conclusion.

With respect to excess earnings, Mr. Lawrence states:

> For the year 2005 the guaranteed payments to Partners ***other than Mr. Dixon*** was $887,000 and 2006 $1,152,000. Giving slightly more credit to 2006 than 2005 which is closer in time and without Mr. Dixon, I will utilize a figure of $1,025,000 as the actual guaranteed payment to Partner capacity to the firm, less $525,000 replacement value/reasonable compensation, leaving $500,000 "**excess earnings**" of the firm…

(*Trial Ex. 30 at D000020-21*) (*Emphasis added*). The excess earnings calculation was made without consideration of Respondent's contribution to Firm revenues. Mr. Lawrence determined the "post tax" excess earnings to be $375,000. (*Trial Ex. 30 at D000021*). Mr. Lawrence uses his calculation of excess earnings to calculate the value of the goodwill in the Firm using the capitalization of excess earnings methodology. (*Trial Ex. 30 at D000024-5*). Both of the key conclusions on the revenue side on which the value conclusion was based were made without consideration of Respondent's contribution to revenue as required by the UPA.

Very simply, the conclusions as to value reached by Mr. Lawrence did not take into consideration the economic contribution to the Firm made by Respondent. As is clearly contemplated under the UPA, Respondent was not paid for any goodwill that left the Firm with him – Respondent was only compensated for a pro-rata share of the value that was retained by the non-disassociating partners.

D. The Interest Issue.

RCW 4.56.110(4) provides for post-judgment interest. However, a a ***common law*** rule provides that pre-judgment interest can be awarded only in cases where claim is for fixed sum or evidence provides basis for computing recovery with exactness, without reliance on opinion or discretion. Burnside v. Simpson Paper Co., 66 Wn. App. 510 at 532, 832 P.2d 537 (1994). Appellants rely on this rule in contending that the award of pre-judgment interest was in error.

However, the award of pre-judgment interest was not made pursuant to any common law rule – it was made pursuant to a mandatory directive in RCW 25.05.250(2):

> The buyout price of a dissociated partner's interest is the amount that would have been distributable to the dissociating partner under RCW 25.05.330(2) if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner and the partnership were wound up as of that date. ***Interest must be paid from the date of dissociation to the date of payment.***

(*Emphasis added*). Appellants offer no explanation as to why the Legislature would not be empowered to adopt a rule allowing for pre-judgment interest in the context of a partner disassociation.

The applicable rule of law is:

> [T]he state constitution is not a grant, but a restriction on the lawmaking power, and the power of the legislature to enact all reasonable laws is unrestrained except where, either expressly or by fair inference, it is prohibited by the state and federal constitutions. Where the validity of a statute is assailed, there is a presumption of the constitutionality of the legislative enactment, unless its

> repugnancy to the constitution clearly appears or is made to appear beyond a reasonable doubt. Where possible, it will be presumed that the legislature has affirmatively determined any special facts requisite to the validity of the enactment, even though no legislative finding of fact appears in the statute.
>
> It is also axiomatic that no person has a vested interest in any rule of the common law.... As the supreme court of the United States said, in the opinion of Mr. Justice Waite, in _Munn v. State of Illinois_, 94 U.S. 113, 24 L.Ed. 77,
>
> '* * * A person has no property, no vested interest, in any rule of the common law. That is only one of the forms of municipal law, and is no more sacred than any other. Rights of property which have been created by the common law cannot be taken away without due process; but the law itself, as a rule of conduct, may be changed at the will, or even at the whim, of the legislature, unless prevented by constitutional limitations. Indeed, the great office of statutes is to remedy defects in the common law as they are developed, and to adapt it to the changes of time and circumstances. * * *'

Shum v. Dept. of Labor and Industries, 63 Wn. App. 405 at 412, 819 P.2d 399 (1991).

Appellants' argument in this regard is a single conclusory assertion that: "the Legislature exceeded its authority in purporting to make an award of interest mandatory in adopting Section 701 of the RUPA, RCW 25.05.250." (*Opening Brief at p. 35*). In light of the presumption of validity and the Legislature's right to adopt statutes in derogation of the common law, this argument is misplaced. .

E. The Cross-Appeal.

The reported opinions and testimony by three of the four experts who expressed opinions on the value of the Firm as a whole

(Mr. Lawrence for Respondent (*Trial Exs. 30-31*); and Mr. Nelson (*Trial Ex. 32*), Mr. Kessler (*Trial Ex. 33*) and Mr. Weber (*Trial Ex. 34*) for Appellants) was that the value of Respondent's interest in the Firm was based on two components of value: (1) the value of the "goodwill" of the Firm; and (2) the value of the tangible assets of the Firm.

Three of the four experts (Messrs. Lawrence, Kessler and Weber) did a full analysis of the value of goodwill using the capitalization of excess earnings methodology described at RP 96:25-116:8. Messrs. Kessler and Weber concluded that there was no goodwill value for the Firm, but also concluded that there was a tangible asset value. (*Trial Ex. 33 at C000030 and C000035* (*Kessler*)*; and Trial Ex. 34 at C000008* (*Weber*)). Appellants' third expert (Mr. Nelson) concluded there was no goodwill value without conducting an analysis (*RP 192:12-16*), but concluded the value of the tangible assets was $37,900 (*Trial Ex. 32*). The value of the tangible assets, as determined by Appellants' experts ranged from $36,000 to $47,000.

In his oral ruling, Judge Orlando made his own calculation of the value of the goodwill based on a capitalization of excess earnings methodology. (*CP 341-343*). Judge Orlando rejected the replacement compensation conclusions of both sides. Using his own conclusions for replacement compensation incorporated in the Findings of Fact and Conclusions of Law (*CP 364-369*) at Finding No. 20 (*CP 367*), but using Mr. Lawrence's conclusion for the applicable capitalization rate from Trial Exhibit 30, Judge Orlando concluded that the value of the goodwill was $232,143.[6] This is the principal amount awarded to Respondent in the Judgment. (*CP 370-373*). Judge Orlando's letter ruling did not discuss the value of the tangible assets.

The subject of the value of the tangible assets was discussed between Judge Orlando and counsel for the parties in correspondence prior to entry of Judgment. (*Trial Ex. 40; CP 350-363*). While Judge Orlando stated that his award was intended to include the value of both tangible and intangible assets (*CP 356*), the calculation made in his letter ruling was solely a calculation of the value of goodwill. Judge Orlando's calculation simply left out the final step in the analysis of the experts, the addition of the goodwill value to the value of the tangible assets. (*CP 355-356*). Judge Orlando's decision to "abide" by his conclusion of value is the equivalent of a finding that the tangible assets had no value, contrary to the testimony of every expert in the case.

Respondent does not challenge the findings of Judge Orlando from which Judge Orlando's conclusion as to goodwill value is derived. Rather, Respondent contends that the decision of Judge Orlando not to include additional value for the tangible assets is not supported by substantial evidence. The undisputed evidence, is that Judge Orlando's calculation only determined the goodwill value. As Judge Orlando himself noted that determination was consistent with Mr. VanderHamm's calculation of the value of the Contracts. Mr. VanderHamm's calculation was itself exclusive of the value of the tangible assets. Thus, the clear

[6] Appellants assign error to Finding No. 20 but, other than the assignment, no where do Appellants discuss the issue further, or explain the basis for the assignment of error.

evidence is that the calculation of the value of Respondent's interest should have included some amount for the tangible assets.

V. CONCLUSION

On the basis of the foregoing, Respondent respectfully requests that Appellants' appeal be denied. Respondent further requests that Respondent's cross-appeal be granted and this matter remanded to Judge Orlando for entry of findings as to the tangible asset value to be awarded to Respondent, and a re-calculation of interest

DATED this 23rd day of August, 2010.

BRAIN LAW FIRM PLLC

By:____________________
Paul E. Brain, WSBA #13438

Counsel for Respondent/Cross-Appellant
Steve B. Dixon

CERTIFICATE OF SERVICE

I hereby certify that I have this 23rd day of August, 2010, served a true and correct copy of the foregoing document upon counsel of record, via the methods noted below, properly addressed as follows:

Attorneys for Appellants:

Catherine W. Smith	____ Hand Delivery
Edwards, Sieh, Smith & Goodfriend, P.S.	____ U.S. Mail (first-class, postage prepaid)
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I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 23rd day of August, 2010, at Tacoma, Washington.