LAW AND THE FAMILY

## THE VALUING OF LAW PRACTICES

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OF TWO THINGS only are we certain. One is that the valuation of a law practice is confusing and convoluted. The other is that the decisions of the Court of Appeals on the subject almost invariably convey profound uncertainty as to the future development of a uniform rule.

In Hirschfeld v. Hirschfeld, [FN1] the first valuation case, decided in 1983, the First Department vacated a wife's distributive award of $20,700 in lieu of an equitable distribution of her husband's law practice, holding that the wife failed to establish that her husband's law practice had any intrinsic value beyond that which he could potentially earn as an employee of a large firm or corporation.

The trial court [FN2] found that in December 1980, the year preceding the commencement of the action, the husband reported a gross income of $84,030. It was impressed with the credible evidence that the overhead for the average, single practitioner was 45 percent to 50 percent of gross earnings. Since the average, gross earnings for the husband was $67,600 for the five-year period ended December 1980, the court assumed that the husband received average earnings of about $33,800 per year pretax. Assuming that gross income averaged $67,600 and overhead averaged 50 percent, the court concluded that the husband's income was fairly determined to be $33,800. This was $13,800 more than the $20,000 the court determined the husband could earn in a corporate position.

Nothing Has Changed

In 1987 the Court of Appeals first squarely addressed the question of valuation of closely held corporations in equitable distribution cases. Nothing has changed. Amodio v. Amodio, [FN3] was a Second Department case that affirmed a judgment that valued a husband's 15 percent interest in a closely held corporation at $87,500, the value fixed in a shareholder's agreement that had 14 years before its expiration. The agreement required the consent of the shareholders for a sale of the stock and the payment of $87,500 in the event of the defendant's death.

The court stated that the price fixed in a bona fide shareholder's agreement, which predates the marital discord, may be an invaluable aid in determining value. Since there was no evidence of a pending sale of corporate assets or of any other action that might vitiate the husband's obligation under the agreement, the court held that any appraisal based on a potential sale outside of the agreement would be purely speculative.

The Court of Appeals [FN4] in affirming the judgment gave some insight into valuation. It held that while there is no uniform rule for valuing stock in a closely held corporation each case must be studied carefully. It went on, in its analysis, to state that whatever method is used must consider inhibitions on the transfer of the corporate interest resulting from a limited market.

Likewise if contractual provisions restrict the transfer of the stock, where there is a bona fide buy-sell agreement that predates the marital discord, the price fixed by agreement, although not conclusive, is a factor that should be considered. That the stock could not be immediately sold is not dispositive. The court must consider all of the circumstances reflecting on the present value of the property to the titleholder. The Court of Appeals affirmed the judgment because it was the only reliable evidence of value in the record.

In Stempler v. Stempler (decided in 1988), [FN5] the trial court valued the husband's one-third partnership interest in a law firm at $140,000, by calculating one year's compensation and adding to it one-third of the "perks" and the net profit. The court avoided any discussion of goodwill in its calculation. The court held that, "a realistic capitalization rate is 100 percent and the entire net earnings of a single year should serve as the basis of a distributive award." The Second Department [FN6] affirmed the trial court's valuation methodology stating that given the conflicting testimony by the experts for both parties it could not say that the figure of $140,000 for the value of the husband's law practice was unjust.

In Rosenberg v. Rosenberg [FN7] (decided in 1988) the Fourth Department determined, based on "the facts of this case," that the trial court's valuation of the wife's interest in her law partnership was properly governed by the terms of her partnership agreement. It held that the husband was entitled to no greater rights in the partnership for equitable distribution purposes, than plaintiff was entitled by virtue of the partnership agreement. Since the partnership agreement provided the wife only the balance of her capital account upon her leaving the partnership, it was justifiable to hold the capital account to be the value of her interest in the partnership.

In Finocchio v. Finocchio [FN8] (a 1990 decision), both experts used an "excess earnings" method that was adopted by the trial court to value the husband's law practice. The value of the tangible assets of the practice was added to the intangible value or goodwill. The intangible value was ascertained by comparing the husband's earnings in the private practice of law with what he could have earned as a public sector attorney with similar experience. The "excess earnings" were reduced by the value of the husband's return on tangible assets, and the resultant figure was multiplied by a capitalization figure of 2.7, to establish the fair market value of the practice as of the date of commencement of the action.

Evidence of Enhanced Earnings

At trial, the court prohibited the wife from offering evidence of separate valuations of the defendant's degrees, license and practice. The Fourth Department modified the judgment on the law and remitted the matter to the Supreme Court for further proceedings. It held that the trial court erred in denying the wife an opportunity to offer evidence of the husband's enhanced earning capacity for the full economic life of his license to practice law.

In Harmon v. Harmon [FN9] (a 1992 decision) the Supreme Court valued the husband's partnership interest in a law firm at $292,870, by adding to the value of his capital account ($84,693) 175 percent of his average earnings for three years. At trial both parties' experts evaluated the husband's interest in the law firm by reference to the death benefits provisions in the partnership agreement. The wife's expert valued the husband's interest in the firm at $308,000 as of 1984. The husband's expert used the same method but deducted taxes that would have to be paid by the estate on that portion attributable to the husband's income, to value the husband's interest at $255,800.

The trial court rejected the argument that taxes should be deducted from the death benefit valuation inasmuch as income was being used for valuation and not distribution purposes and no taxable event, i.e., death, had occurred. The Appellate Division agreed with the trial court's determination. It stated that in the absence of a showing that a taxable event is involved, a court is not required to consider tax consequences.

The Appellate Court approved and adopted the valuation method suggested by the wife's expert. It found that the value of the husband's interest in the law firm as of June 19, 1984, was his capital account ($84,693) plus 175 percent of his average earnings for the immediate prior three years ($208,177) for a total award of $292,870.

Average Earnings

In Vicinanzo v. Vicinanzo [FN10] (decided in 1993), the Third Department held that in valuing a law practice, expert testimony is not the only basis upon which the court can base its finding. If the record is developed sufficiently, the court can determine value, even where the expert's opinion is found unacceptable. "If no evidence of value is tendered, an average year's earnings may be representative of a reasonable estimate of the business value." The Supreme Court valued the husband's law practice at $193,273, which approximated the husband's average annual earnings as reflected on his federal income tax returns for 1984, 1985, 1986 and 1987. The Appellate Division excluded an unusually large nonrecurring fee from a personal injury case, which was included in his income during this period, and decreased the resulting average (value) to $152,748.

In White v. White [FN11] (decided recently) the parties were married in 1968. During the marriage the husband became an attorney. When the divorce action was commenced in 1990 he was a partner in a law firm. The Supreme court valued the husband's interest at $431,000 as of the date of commencement, using the "capitalization of earnings approach" and awarded the wife 15 percent of this asset. The Appellate Division held that the capitalization of earnings method is appropriate to use when evaluating a law practice and is apt to reflect its value more accurately than the "net asset method" proffered by the husband.

However, because the opinion of the wife's expert was flawed in many ways and the record was sufficiently developed to permit it to ascertain the value of the husband's interest pursuant to this method, it calculated his interest in his law firm as of April 2, 1990, at $221,691. The court set forth its calculations in an appendix, enabling us to see its methodology.

In calculating the husband's share of "excess earnings" it deducted 38.5 percent for taxes. In computing the partnership's "adjusted net income" it added back to "Net income (loss) per financial statements" nonrecurring professional fees, and actual occupancy expenses of a sublease rental, and deducted reasonable occupancy expenses. In arriving at "Total weighted net excess earnings," it used only two calendar years [1989 and 1990] and divided by 3 to arrive at an "Average weighted net excess earnings."

It then used a capitalization rate of 33 1/3 percent (multiple of 3) to reach a valuation of $221,691.

 The Capital Account

In Burns v. Burns, [FN12] reported this month, the Court of Appeals held that the trial court erred by limiting the wife's proof of the value of her husband's interest in his law firm partnership to the value of his capital account. The parties were married in 1972 subsequent to the husband's achieving partnership status in a Rochester law firm. The action for divorce was commenced in 1987. At the commencement of trial the wife sought disclosure relating to the husbands interest in the firm and a ruling permitting her to introduce evidence of the value of that interest.

Her motions were denied with the exception of compelling the husband to provide copies of K-1 forms indicating his share of partnership income and furnishing his personal income tax returns. The Supreme Court, limited the wife's proof of value to the partnership agreement provision regarding the husband's capital account. The wife appealed from the determination that the husband's ownership interest in the firm was equal to the $35,000 in his capital account and the $40,000 counsel fee award.

The Appellate Division, Fourth Department, modified certain provisions of the judgment but held that the Supreme Court correctly determined the value of the husband's interest in the firm and that the counsel fee award was proper.

The Court of Appeals, noting that the Supreme Court's ruling was on constraint of the Appellate Division decisions in Rosenberg and Dignan, [FN13] held that this was error. It referred to its rulings in Amodio that "Even where the transfer of stock in a given corporation was governed by an agreement predating the marital discord, the price fixed by the agreement is only one factor to be considered and would not be conclusive of the value of the stock"; that "there is no uniform rule for valuing stock in closely held corporations"; and that "methods must be tailored to each case with due consideration give to enlightened prediction of the future."

As the husband conceded that he could have more of an interest in the firm's assets if it were to dissolve, the court concluded that:

... uncertainty concerning future events should not bar attempts to assign value to an asset. To limit defendant's interest to the capital account, which measured a partner's interest on withdrawal from the firm, is to ignore defendant's status as a continuing and productive partner in an ongoing enterprise."

However, it cautioned that "... whether plaintiff will ultimately prevail in her attempt to prove that defendant's interest exceeds that circumscribed by the documents she was provided at Supreme Court is another question we do not address."

The court held that the appreciation during marriage of the defendant's partnership interest is marital property for equitable distribution and that the wife was entitled to discovery from the law firm on this issue: "As in Amodio the capital account here may be considered as one factor but is not conclusive of the partner's interest." [FN14]

FN1. Hirschfeld v. Hirschfeld (1983, 1st Dept) 96 AD2d 473, 464 NYS2d 789.

FN2. Hirschfeld v. Hirschfeld, 187 New York Law Journal, May 4, 1982, p. 7, col. 1 (Sup. Ct., N.Y. Co.).

FN3. Amodio v. Amodio (1986, 2d Dept.) 122 AD2d 757, 505 NYS2d 645.

FN4. Amodio v. Amodio (1987) 70 NY2d 5, 516 NYS2d 923, 509 NE2d 936.

FN5. Stempler v. Stempler, NYLJ, April 26, 1987, p.20, col.5, Sup. Ct., West. Co. (DiFede, J.H.O.).

FN6. Stempler v. Stempler (1988, 2d Dept) 143 AD2d 410, 532 NYS2d 550.

FN7. Rosenberg v. Rosenberg (1988, 4th Dept.) 145 AD2d 916, 536 NYS2d 605, and, app den, in part (4th Dept.) 149 AD2d 985 and app

den 74 NY2d 603, 543 NYS2d 396, 541 NE2d 425.

FN8. Finocchio v. Finocchio (1990, 4th Dept.) 162 AD2d 1044, 556 NYS2d 1007.

FN9. Harmon v. Harmon (1992, 1st Dept.) 173 AD2d 98, 578 NYS2d.

FN10. Vicinanzo v. Vicinanzo (1993, 3d Dept.) 193 AD2d 962, 598 NYS2d 362.

FN11. \_\_\_ AD2d \_\_\_, 611 NYS2d 951 (1994, 4th Dept.).

FN12. \_\_\_ NY2D \_\_\_, \_\_\_ NYS2d \_\_\_, NYLJ, Nov. 2, 1994, p.2, col. 3.

FN13. In Dignan v. Dignan (1989, 4th Dept.) 156 AD2d 995, 549 NYS2d 539, app dismd 75 NY2d 915, 554 NYS2d 832, 553 NE2d 1342, the Appellate Division held that the wife was not entitled to disclosure of certain financial records and the tax returns of the husband's law firm in which he was a partner because they were not material or relevant in valuing the law firm. The court held that Amodio [70 NY2d 5], Stern [66 NJ 340] and Revenue Rulings 59-60 and 68-609 were inapplicable because the partnership agreement limited the husband's share of the practice to the assets in his capital account.

FN14. The Court of Appeals also held that (1) non-vested pensions are subject to equitable distribution; and (2) that notwithstanding a pendente lite award, Domestic Relations Law ss236(B)(6) and (7) required that the final maintenance and child support awards be retroactive to "the date of application therefor," which was the date of the summons requesting it.

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