



## Effect of Partnership Agreements on Valuation of Law Practices in Divorce

Two recent cases—both concerning law practices—highlight the effect the operative agreements can have in valuing the practitioner’s interest for purposes of division in divorce.

Identifying the applicable valuation standard is important, too. In *Hartley v. Hartley*, 2010 WL 2071444 (Ala. Civ. App.)(May 21, 2010), a buy-sell agreement limited the repurchase of a departing partner’s interest to \$10 per share; or in the husband’s case, a mere \$1,000. When the wife requested supplemental discovery for the firm’s financial records and client accounts, the husband objected, claiming the buy-sell agreement made her requests irrelevant “as an evidentiary matter,” because any valuation of his interest would be limited to the buy-sell formula. The wife claimed that under applicable law, the buy-sell did not control the valuation in divorce—but the trial court disagreed, limiting discovery to only the husband’s compensation and tax returns, in addition to the buy-sell. “If he leaves the firm, he has contractually agreed to get \$1,000.00,” the court said. “If the firm dissolves in the future, the speculative value of any profit or loss cannot be determined at this point.”

In an interim review by the Court of Appeals, the wife claimed the “majority rule” in the U.S. holds that a buy-sell agreement does not control the ultimate value of a shareholder’s interest in a private practice. After the parties briefed the issue, the same court adopted the equitable “fair value” standard in divorce (see *Grelrier v. Grelrier* 2009 WL 5149267 (Dec. 30, 2009)). Under this standard, “We need not ... conclusively determine for all cases the proper valuation of an ownership share of a partnership of legal-service providers,” the Court of Appeals explained. Rather, the crucial inquiry in divorce cases was “to determine the *fair value* of the parties’ assets rather than to adhere in all cases to their ‘fair market value,’ i.e., to the price that the general market might assign to them,” it said (emphasis added).

Accordingly, any discovery that was reasonably tailored to obtain information related to an asset’s “fair value” fell within the scope of the state’s version of Rule 26. In this case, the trial court’s order prevented the wife from obtaining discoverable materials by effectively limiting the “fair value” of the husband’s law partnership interest to the buy-sell price, “even though the law firm will almost certainly remain a going concern for an extended period after a final judgment,” the court said. That position “makes little sense,” it added, and granted the wife’s requests for additional discovery.

**Applying the appropriate earnings period.** In *In re Marriage of Ross*, 2010 WL 1693552 (Cal. App. Dist 2)(April 28, 2010)(unpublished), the husband-attorney earned over \$700,000 per year prior to the couple's separation and over \$1 million afterward. At trial, both parties' experts used the law firm's year-end financial information closest to the separation date, and both used the capitalization of excess earnings method to determine goodwill. Only the husband's expert did not include the value of his capital account (\$456,000), because the operating partnership agreement did not give it to him on withdrawal or retirement. The expert also used the husband's average earnings over the five years prior to separation to assign a range of values for his interest, from approximately \$205,000 to \$473,000.

The wife's expert included the value of the husband's capital account, because the partnership agreement made the funds available to the husband throughout his employment. Further, he used the husband's 2003 income as the "most representative" of his earning power at the end of the marriage, ultimately valuing the law practice interest at just over \$1.2 million. The trial court adopted this value (adjusted to \$941,000), and the husband appealed, claiming his expert's calculations better represented his earnings, which "fluctuated wildly" during the marriage. But adding the value of the partnership account to the expert's top value would have produced an overall value of approximately \$1 million, the appellate court observed. Moreover, the operative agreement addressed a partner's rights on departure; it did not deprive the husband of a "present, possessory interest" in the account. Because the trial court assessed the husband's interest in the law practice for purposes of divorce (not his contractual rights on withdrawal), the appellate court upheld its \$941,000 valuation.