



## Section VII

# When Lawyers Divorce: Protecting the Law Firm and the Lawyer

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## When Lawyers Divorce: Protecting the Law Firm and the Lawyer

### Presented By

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## Speaker Biography-Sandy Ain

Sanford K. Ain is a principal and co-founder of Ain & Bank. He has practiced family law for nearly 40 years and is listed in Woodward White's The Best Lawyers in America, in both the family law and real estate law sections. Ranking Sandy # 1 among the Washington, DC area's top divorce lawyers, Washingtonian magazine has written, "Sandy Ain is one of the best divorce lawyers in America and maybe one of the best lawyers, period."

Sandy has successfully resolved some of the most notable and complex family law cases in the country. While well known for his adept negotiation skills, he is equally respected as a "top-flight" courtroom advocate. His appellate cases have created important precedents in family law in the District of Columbia, Maryland and Virginia.

National media often call on Sandy for his legal expertise. He is a frequent lecturer, speaker and panelist on family law issues throughout the country. His articles and papers are widely published, and he serves on the faculty of the Houston Family Law Trial Institute at the South Texas College of Law. Sandy is a fellow of and recent counsel to the American Academy of Matrimonial Lawyers (AAML); past president of the District of Columbia Chapter of the AAML; Counsel to the National Academy 2001, 2005 and 2006; Fellow of the American College of Trial Lawyers; and Diplomat of the American College of Family Trial Lawyers. Once again in 2011, Sandy was selected by his peers for inclusion as one of The Best Lawyers in America® in the practice areas of Family Law and Real Estate Law.

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## Speaker Biography-Stuart Rosenberg

Stuart A. Rosenberg, CPA, CVA, serves as a Partner in Aronson LLC's Forensic & Valuation Services group. He joined the Firm in 1989 and has spent over 27 years in the industry. Stuart earned his Bachelor's Degree in Business Administration from American University in 1984. Stuart's clients include retail, wholesale, service, healthcare, hospitality, professional services, venture capital, construction and real estate businesses.

Stuart specializes in litigation support services including valuations of closely-held businesses, preparation and documentation of lost profits, damages claims, evaluation of accounting and tax issues, financial analysis and investigations, general business issues and related expert testimony and forensic support services.

As an expert in the field, Stuart has provided a variety of articles for publications such as Legal Time's Commercial Litigation. He is a member of AICPA, VSCPA and the National Association of Valuation Analysts. Stuart earned his certification as a Valuation Analyst from the National Association of Valuation Analysts in 1996.

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## Overview

- Protections for attorneys
- Fair Market Value and Intrinsic Value - understanding the difference between the two
- Case law
- Personal vs Practice Goodwill
- Case Study-Valuing an Ownership Interest in a Large Law Firm

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## When You are the Client

- **What not to do:**
  - Do not try to control the process. Remember, you are not lead counsel in your divorce
  - Do not be the judge of what information is important and what is not. Be sure to share everything with your attorney
- **You are not the expert in this area of the law**

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## When You are the Client

- **What to do:**
  - Hire a lawyer as smart, or smarter, than you
  - Take a team approach to the process
  - Share all information with your lawyer

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## Protections to Consider

- **Unmarried Lawyers:** Unmarried lawyers who will be solo practitioners or who are already practicing should enter a prenuptial agreement, with both parties represented by counsel. The agreement should indicate:
  - the law practice is separate property
  - any increase in the value of the law practice is separate property, irrespective of personal efforts
  - the following are all separate property: accounts receivable, work in progress, capital account, and goodwill

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## Protections to Consider

- **Married Lawyers without a Prenuptial Agreement:** Save financial statements, tax returns, and billing data so if forced to value the practice from the date of marriage, that evidence is available
- Make sure to have an arm's-length buy-sell agreement to help establish the value of the partnership. (Keep in mind that this will only be a factor the court considers and not controlling.)

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## Buy/Sell Agreements

- **Important Provisions to Include:**
  - Transfers must be approved at sole discretion of Managing Partner(s)
  - Unauthorized transfers are null and void unless ordered by a court of competent jurisdiction; even then the interest will only be an Economic Interest
  - **What happens upon Death, Disability or Retirement:**
    - Only entitled to capital account
    - There exists no claim to any goodwill value that may exist
    - No claim to any other tangible or intangible assets of the Firm

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## Buy/Sell Agreements

- **Important Provisions to Include:**

- **Right of First Refusal:** If a shareholder has an offer from a third-party, there is usually a right of first refusal available to the other existing shareholders.
- **What happens upon Divorce:** When an involuntary transfer of shares could occur (as part of a divorce settlement), the agreement should provide for the automatic transfer to the existing shareholders

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## Post-separation Earnings

- Earnings post-separation are generally considered separate property, if maintained as such
- It is important to segregate those earnings in separate bank/brokerage accounts
- Do not commingle marital and separate funds; separate classification assertion can be weakened
- Bonuses paid post-separation are not usually considered all separate unless it is for an identifiable time-period that is post-separation
  - Example 1: Separation date is November 30<sup>th</sup>, yearly bonus is paid December 31; 11/12 may be considered marital property
  - Example 2: Separation date is September 30<sup>th</sup>, quarterly bonus is paid December 31; all of bonus may be considered separate

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## Value - Definitions

- **Fair Market Value** - the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. (IRS Rev. Ruling 59-60)
- **Fair Value** - the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable. (Uniform Business Corporation Act)

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## Intrinsic Value

### Why not a Fair Market Value standard?

Quoting from Howell:

"Bosserman v. Bosserman, 9 Va. App. 1, 384 S.E.2d 104 (1989), defined "value" for equitable distribution purposes; it set intrinsic value as the standard of value. "Trial courts valuing marital property for the purpose of making a monetary award must determine from the evidence that value which represents the property's intrinsic worth to the parties . . . ." Id. at 6, 384 S.E.2d at 107.

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## Intrinsic Value

### The Bosserman Case:

- Dispute over value of interest in corporation that owned a family farm
- By-laws had a prescribed formula for valuation in a transfer of stock
- Until that point, Virginia Courts had not considered issue whether buy-out provisions control the determination of value
- The Court found that the buy-out terms are not controlling
- Ultimately this was a dispute between a value of either \$36,900 or \$7,008

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## Howell Decision

"Intrinsic value is a very **subjective concept** that looks to the worth of the property **to the parties**. The methods of valuation must take into consideration the parties themselves and the different situations in which they exist. The item may have no established market value, and neither party may contemplate selling the item; indeed, sale may be restricted or forbidden. Commonly, one party will continue to enjoy the benefits of the property while the other must relinquish all future benefits. Still, its intrinsic value must be translated into a monetary amount. The parties must rely on **accepted methods of valuation**, but the particular method of valuing and the precise application of that method to the singular facts of the case must vary with the myriad situations that exist among married couples."

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## Valuation Approaches

<b>The Market (Market-Based) Approach</b>	A general way of determining a value indication of a business, business ownership interest, security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities or intangible assets that have been sold
<b>The Income (Income-Based) Approach</b>	A general way of determining a value indication of a business, business ownership interest, security or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount
<b>The Asset (Asset-Based) Approach</b>	A general way of determining a value indication of a business, business ownership interest or security using one or more methods based on the value of the net assets and liabilities
<b>The Cost Approach</b>	A general way of determining a value indication of an intangible asset by quantifying the amount of money required to replace the future service capacity of that asset

SOURCE: International Glossary of Business Valuation Terms

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## Howell Decision

The husband, a tax law attorney, appealed, in part, the trial court's valuation decision of his interest in a law firm, Hunton & Williams (The "Law Firm"). The husband argued that the Law Firm's partnership agreement defined the value of the partnership interest upon termination or death by entitling the partner to receive only the balance of his capital account and his share of the net income. In this case, the two items amounted to \$85,614. The husband maintained that the agreement fixed the value of his partnership interest for equitable distribution purposes, and therefore it precluded consideration of whether his interest had goodwill. The trial court, on the other hand, ruled that his partnership interest had goodwill because the Law Firm's agreement made no provision for goodwill. In affirming the trial court's decision, the Virginia Court of Appeals held the following:

- Neither the existence of goodwill nor the method of its valuation is fixed as a matter of law.
- Whether goodwill exists and how it should be valued is determined on a case by case basis, using the facts of the particular case.

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## Howell Decision

### • The details of the methodology relied on by the Court in Howell

- Peer Group Compensation data was used to determine levels of "Excess Earnings"
- Source of Peer Group Compensation was Survey of Law Firm Economics published annually by Altman Weil
- Peer Compensation Data used in analysis was:

MEDIAN	1996	1995	1994
South	178,192	171,819	166,712
Population % to 1 million	173,320	191,338	173,500
Transactions/Regulation	168,359	175,182	178,088
Year Admitted - 1981	156,500	150,000	144,678
Year Admitted - 1980, South Region	161,078	155,480	147,290
Population and Year Admitted	156,500	162,121	148,526
Average	165,116	167,648	159,957

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## Howell Decision

### • The details of the methodology relied on by the Court in Howell

o Average:

	1996	1995	1994
Average	165,116	167,648	159,957

- o Next, these averages were subtracted from Mr. Howell's actual compensation to arrive at yearly excess earnings
- o After tax-affecting these earnings and making other adjustments, historical after-tax excess earnings of \$64,332, \$45,091 and \$5,383 were determined. Next, a simple average was calculated to be **\$38,269**
- o This \$38,269 of excess earnings was projected out until age 65 and then discounted back to today's dollars to arrive at a value of **\$319,569** for his partnership interest in Hunton & Williams

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## Bosserman – Final Note

- While the court stated that a restrictive transfer agreement will not control value of stock (e.g., by a stated fixed price), the restriction on transfer of stock is a factor which affects the value of the stock for purposes of equitable distribution.

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## Definition of Goodwill

### Quoting Hoebelheinrich:

- The intrinsic value of an asset may include goodwill, which is defined as the "increased value of the business, over and above the value of its assets, that result from the expectation of continued public patronage." Russell v Russell.

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## Professional vs Practice Goodwill

- The value of goodwill can have two components. **Professional Goodwill** (also designated as individual, personal, or separate goodwill) is attributable to the individual and is categorized as separate property in a divorce action. **Practice Goodwill** (also designated as business, institutional or commercial goodwill) is attributable to the business entity, the professional firm, and may be marital property
- One definition of **Practice Goodwill** is the commercial advantage or benefit of an establishment with a strong and positive reputation that allows for repeat clients and generates work from word of mouth by virtue of the reputation of the establishment as a whole. Or simply stated, the probability that the old customers will resort to the old place. (*Brown v. Benzinger.*)

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## Professional vs Practice Goodwill

### Quoting Howell:

- It included no value attributable to him personally, and it did not rely upon any earnings due to the husband's own expertise, reputation, experience, skill, knowledge, or personality.

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## Professional vs Practice Goodwill

### Quoting Howell:

- In valuing the goodwill of the partnership interest, courts must take special care not to confuse the owner spouse's personal future earning capacity with practice goodwill attributable to the law firm in order to avoid double counting. "Further, particular care must be given that future earnings capacity and reputation not be confused with professional goodwill."

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## Goodwill - Professional Attributes

- Experience
- Expertise / specialization
- Training
- Knowledge
- Age
- Health
- Reputation
- Work Ethic

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## Goodwill – Practice Attributes

- Assembled and trained work force
- Facilities
- Size
- Financial capacity
- Institutional referral sources
- Investment in capital
- Management depth
- Name recognition
- Favorable Contracts
- Customer base/list

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## Case Study – Large Law Firm

### Revenue History

	2002	2003	2004	2005	2006	Average 2002 to 2006
Regular fees	\$ 152,151,336	\$ 162,503,450	\$ 183,138,631	\$ 212,327,223	\$ 255,369,578	\$ 193,098,044
Contingent fees	\$ 70,866,439	\$ 140,156,158	\$ 13,625,311	\$ 44,969,274	\$ 25,443,320	\$ 59,012,100
Total fees	\$ 223,017,775	\$ 302,659,608	\$ 196,763,942	\$ 257,296,497	\$ 280,812,898	\$ 252,110,144

- Nationally Recognized Large Law Firm
- Offices in Major U.S. Cities
- Approximately 140 Partners

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## Case Study – Large Law Firm

### Two Other Valuators Conclusions on Peer Group Compensation

	Attorney A	Attorney B
Peer Compensation	\$ 542,000	\$ 1,700,000
Excess Compensation	\$ 912,000	\$ 800,000
After-Tax Present Value of Excess Compensation	\$ 1,890,000	\$ 1,677,000

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## Case Study – Large Law Firm

### Two Other Valuators Conclusions on Goodwill

- Personal Goodwill
  - Partner A: Already Considered in Peer Group Earnings
  - Partner B: 75% Personal goodwill; 25% Practice Goodwill

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## Information Request for Valuation

- Partial list of information/documents
  - Partnership Agreement
  - Description of how partner compensation is determined
  - K-1s and/or W-2s for each of the past 5 years
  - Annual/periodic statements detailing all activity in capital account
  - Annual/periodic statements detailing all activity in capital account loans
  - Schedule for each of past 5 years, showing the following information for the Partner as well as the average for all partners
    - Billable Hours
    - Total Hours
    - Billing Rate
    - Fee Origination
    - Owner Distributions
    - Allocation of Profits

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