

'Iredale' Clarifies Attorney's Community-Property Interest

By Mitchell A. Jacobs
and David L. Marcus

The court in *In re Marriage of Iredale*, 2004 DJDAR 9523 (Cal. App. 2nd Dist. Aug. 3, 2004), valued the community-property interest of a partner in a large law firm based on the amount the partner would receive under the partnership agreement if she left the firm — rather than based on the value of the firm as a continuing business.

In reaching this finding, the court held that attorney Nancy Iredale did not have an interest in the goodwill of her firm based on the partnership agreement but had a goodwill value as an individual attorney. This appears to be the first opinion to reach this conclusion in the context of a law-partnership interest.

Nancy Iredale and Clifton Cates III were married in 1976. They had two children during the marriage. Iredale, a partner in the law firm of Paul, Hastings, Janofsky & Walker, filed a petition for dis-

partner of the top 100 law firms in the United States, he concluded that she received reasonable compensation so there were no excess earnings and, hence, no goodwill value. Comparing her compensation to partners in Los Angeles-based law firms with more than 100 equity partners resulted in annual excess compensation of \$33,000. He multiplied this amount by 2.5 and determined a goodwill value of \$42,318.

Cates' expert valued the law-partnership interest at \$813,000. He determined this amount by valuing the entire partnership's tangible and intangible assets, then multiplied that by Iredale's ownership interest.

He did not employ the capitalization of excess earnings approach to value her goodwill because there was no valid statistical data to determine reasonable compensation to hire someone with her skills and experience. He determined her goodwill by the cost of hiring an associate to "replicate her services." However, he did not take into account the hundreds of hours that she spent on nonbillable work

with the case of *In re Marriage of Nichols*, 27 Cal.App.4th 661 (1994). In that case, the husband was a shareholder in a law corporation. His shareholder agreement excluded the accounts receivable, work in progress and goodwill from the shareholders' interest in the firm. The court properly based the valuation of the community interest in the corporation on the agreement, even though the husband remained with the corporation.

The court in *Iredale* concluded that, although Iredale did not have an interest in the goodwill of her firm, she had a goodwill value as an individual attorney. The court accepted Iredale's calculation based on the excess-earnings approach, comparing her income to her peers.

Cates argued that Iredale's use of the excess-earnings approach was incorrect because Iredale's earnings must be compared to the cost of a salaried employee whose compensation does not include a share of the firm's profits (known as the "average salaried person" standard established by *In re Marriage of Garrity and Bishton*, 181 Cal.App.3d 675 (1986)), and not compared to the compensation of her peers. The trial court, Cates argued, erred by, in effect, comparing the profitability of various law firms instead of Iredale's goodwill as a partner in a major law firm.

The appellate court responded by stating that the trial court was not bound by the *Garrity and Bishton* formula and essentially could apply any legitimate formula supported by substantial evidence. Second, after the trial in this case, the court in *In re Marriage of Rosen*, 105 Cal.App.4th 808 (2002), held that the "similarly situated professional" standard was an equally legitimate method to determine goodwill.

The court agreed with this holding of *Rosen*. The court gave the following reasons that this standard was more appropriate than the "average salaried person" standard.

First, Cates' expert conceded that the cost to hire "1.4" associates to replace Iredale did not account for Iredale's nonbillable hours. Second, an associate would not have Iredale's client base; and third, comparing Iredale's compensation to a similarly situated attorney instead of a salaried employee was "a more rational and reasonable method by which to calculate the value of [Iredale's] goodwill in this case."

Interestingly, a leading commentator on family law describes the *Garrity/Bishton* "average salaried person" approach as "a significant error." Hogoboom, California Practice Guide: Family Law.

Not only does this case provide good support to the spouse who wants to minimize the value of a law-partnership interest, it also can assist the spouse who wants to value an interest in any business based on a buy-sell agreement or contractual withdrawal rights.

Moreover, the case presents a very good road map of the factors to examine regarding the valuation of an interest in a law firm.

Cates' position could succeed if, for example, Iredale played more of a role in building the reputation and goodwill of the law firm. In this case, the firm was well-established when Iredale became a partner. Also, if the partner purchased an interest in the accounts receivable, work-in-process or goodwill, that could form a basis to distinguish this case.

Finally, this case points out the obvious: a need for a thorough understanding of forensic accounting valuation methods. These formulas should not be treated as "black boxes" left entirely to the forensic accountant to apply.

Mitchell A. Jacobs, a certified family law specialist in Los Angeles, limits his practice to marital dissolution and other family law matters. David L. Marcus is an attorney with the firm.



This case provides good support to the spouse who wants to minimize the value of a law-partnership interest.

solution of marriage on Oct. 19, 1998. The trial, which spanned 20 hearings, involved issues of valuation of Iredale's law-partnership interest, support and various other property issues.

Only the portion of the opinion concerning the law-practice valuation was certified for publication.

Iredale practiced through a professional corporation. Her corporation became a partner of Paul Hastings in 1982. She owns a .00781 interest in that law firm, which has 165 partners. She is not involved in the management of the firm.

In 1982, she signed the firm's partnership agreement, the terms of which were not negotiable. Every new partner must sign this agreement. Iredale (and no new partner) was required to buy into the firm's accounts receivable, work in progress, or goodwill. She was expected to bill between 1,800 and 1,900 hours a year and to spend between 600 to 900 hours a year on nonbillable activities to enhance her reputation as an attorney and to attract new clients to the firm.

Paul, Hastings, Janofsky & Walker was formed in 1951. In 1982, when Iredale joined the firm, it had substantial clients and a "fine reputation."

Under the partnership agreement, a partner who retires receives only his/her share of the firm's capital account based on his/her ownership interest. The firm pays out most of its cash, so the firm's capital is relatively small. Sixty partners left the firm during the seven years before the trial, and none received a portion of the accounts receivable, work in progress, or goodwill.

Iredale's expert testified that she had no goodwill interest in the law firm because the goodwill was owned by the firm, not by her. Her interest in firm was \$183,000, calculated by multiplying her interest in the firm by the firm's capital account.

The expert also testified about several calculations of Iredale's goodwill using the traditional capitalization-of-excess-earnings approach. Comparing her compensation with the average profits per

or the value of the business she brought to the firm.

The trial court and Court of Appeal agreed with Iredale's valuation. The court valued the practice at \$238,347, which includes \$42,318 for her goodwill.

Cates claimed on appeal that the trial court erred by valuing the partnership interest on what Iredale was entitled to receive under the partnership agreement rather than her continuing interest in the firm as a continuing business. The correct value of the interest should be \$666,265, including accounts receivable and work in progress, plus \$330,000 for goodwill.

The court began by citing what it called "general principles regarding valuation of a professional practice" set forth in *In re Marriage of Lopez*, 38 Cal.App.3d 93 (1974), as follows: "In determining the value of a law practice or interest therein, the trial court should determine the existence and value of the following: 1) fixed assets, which we deem to include cash, furniture, equipment, supplies and law library; 2) other assets, including properly aged accounts receivable, costs advanced with due regard for their collectability; work in progress partially completed but not billed as a receivable, and work completed but not billed; 3) goodwill of the practitioner in his law business as a going concern; and 4) liabilities of the practitioner related to his business."

Cates cited other cases that appear to require the valuation to include accounts receivable and work in progress and to value the firm based on a continuing concern rather than the "liquidation value."

The court did not apply these general rules, holding that "each professional practice will vary and call for different methods of valuation." The court did not value the partnership at liquidation value but valued it based on what Iredale would actually receive if she left the partnership. The court reasoned that Iredale did not buy or acquire a right to a portion of the accounts receivable, work in progress or goodwill of the law firm as a continuing concern.

The court primarily supported its deci-