LAW AND THE FAMILY

'MCSPARRONIZING' DISTRIBUTIVE AWARDS

Joel R. Brandes

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IN McSPARRON V. McSPARRON, [FN1] the Court of Appeals re-wrote all we thought we ever knew about the distribution of professional licenses and practices. The Court held that even after a professional degree or license has been used by the licensee to establish and maintain a career, it does not "merge" with the career or ever loses its character as a separate, distributable asset. In eliminating the concept of "merger," the court adopted "a common-sense approach that recognizes the ongoing independent vitality that a professional license may have and focuses solely on the problem of valuing that asset in a way that avoids duplicative awards."

The Court cautioned that care must be taken to ensure that the monetary value assigned to the license does not overlap with the value assigned to other marital assets derived from the license, such as the licensed spouse's professional practice. It emphasized that "courts must be meticulous in guarding against duplication in the form of maintenance awards that we premised on earnings derived from professional licenses."

The Fourth Department attempted to heed McSparron's admonition to avoid duplicative awards in Wadsworth v. Wadsworth [FN2] where, rather than limit the maintenance award, it "McSparronized" the property distribution by holding that to avoid a double count, the income used in determining the present value of the law practice must be deducted from the caIculation of future enhanced owning, capacity, and that where there is a maintenance award "the court [is] obliged to reduce the value of the enhanced earnings by the amount awarded in maintenance. Not to do so would involve a double counting of the same income."

New Method of Distributing Value

Last month, in Grunfeld v. Grunfeld, [FN3] the First Department adopted a different method for distributing the value of a professional license and practice, and for awarding maintenance without directing double payment out of the same assets. Justice Saxe explained that the term "double counting" is frequently used to refer to the use of the same stream of income to calculate the value of more than one asset, and that "double dipping" is sometimes used to refer to the court-ordered payment of more than one financial obligation from the same source.

The potential for "double counting" arises because in determining the value of a spouse's interest in a law practice, the court takes into account not only the practice's tangible assets and liabilities, such as accounts receivable and inventory, but also the intangible value of the practice, known as its "goodwill." [FN4]

Justice Saxe defined goodwill as "the amount a buyer would pay for the practice above and beyond the market value of its net tangible assets; it generally is considered to include such items as established customer base and business reputation." He explained that the value of goodwill is often determined, as it was in this case, by the " excess earnings" approach. To arrive at it, we subtract from the spouse's actual earnings (using a weighted average of past annual earnings) the "reasonable compensation" for a similar attorney, and then multiply the difference, i.e., the "excess earnings," by a factor that, for these purposes, is usually from 1 to 3. This factor is called the capitalization rate. In applying a capitalization rate, what is being calculated is the present value of the expected future stream of income.

A professional license is also valued by reducing to present value the future stream of expected income. That value is obtained by reducing to present value, after taxes, the enhanced earning capacity created by the license or degree during the lifetime of the licensee. To determine the value of a professional license, an expert will usually prepare a projection of the licensee's lifetime earnings. If the professional already has an earnings history, the projection will be based upon that.

'Spectre of Double Recovery'

The court in Grunfeld noted that the "spectre of double recovery" was first raised soon after the Court of Appeals held in the O'Brien [FN5] decision that licenses were marital assets available for equitable distribution. The issue was presented in Marcus v Marcus, [FN6] where the husband obtained his medical license and spent the following 30 years developing his psychiatric practice.

The Second Department concluded that the wife was not entitled to two separate awards, for the husband's license and for his psychiatric practice, finding that the license merged into the practice and that the value of the professional license was subsumed into the value of the practice (the "merger doctrine").

Justice Saxe next pointed out that in McSparron the Court of Appeals rejected the merger doctrine, holding that it should be discarded in favor of an approach that focuses solely on the problem of valuing an asset in a way that avoids duplicative awards. The McSparron court explained that [e]ven after the licensee has had the time and opportunity to exploit the license and to realize a portion of the enhanced earning potential it affords, the license itself retains some residual economic value, although in particular cases it may be nominal.

Thus, it concluded that the monetary value assigned to the license must not overlap with the value assigned to other marital assets derived from the license, and that the court must guard against maintenance awards that are premised on earnings derived from professional licenses.

In Grunfeld, the Appellate Division found that the trial court properly valued defendant's law practice and his license to practice law. However, in its attempt to avoid "double dipping," it inequitably diminished the wife's entitlement.

The parties were married on Dec. 26, 1971. Plaintiff was 52 years of age at the time of the appeal. Defendant was managing partner of a 26-attorney law firm. He was 50 years old. They had two sons, ages 22 and 17.

The trial court used the capitalization of earnings approach to arrive at a value of $2.6 million for defendant's interest in his law firm and awarded 50 percent to the wife. In arriving at a value of defendant's law license, the trial court determined the value of the "bare license," that is, the value of the license in the hands of the average licensee, by calculating the difference between (1) the present value of the remaining average lifetime earnings of a law firm associate in 1992 who was admitted to the bar in 1974, practicing law in a locality with a population of more than 1 million, and (2) that of an employed white male in the same locality with a bachelor's degree. Based upon that difference, it calculated the present value of the enhanced earnings resulting from the acquisition of a law degree by an average white male in a large city, to amount to $330,239. To this total the trial court applied a 50 percent "coverture fraction," to account for the portion of law school that defendant completed prior to the marriage.

Enhanced Potential

The trial court also took into account the enhanced earning potential created by the license in the hands of this particular licensee. To avoid duplication, it removed from consideration that portion of defendant's expected lifetime compensation that was already considered in calculating the goodwill portion of the value of defendant's share of the law practice.

As was done in Wadsworth, and to avoid a double count, it deducted the income used in determining the present value of the practice from the calculation of future enhanced earning capacity. The First Department noted that the trial court had

already used defendant's "excess earnings," i.e., his earnings beyond reasonable compensation of $294,860, to calculate the value of his interest in the practice.

Thus, the trial court's calculation of the defendant's enhanced earning potential, for purposes of valuing his law license, was properly based on the difference between the remaining earnings of $294,860 per year and the median income of an average attorney in a law firm who was admitted to the bar in 1974, which was $94,021. The difference was projected forward to obtain a lifetime earnings figure, which was then tax-impacted, after which a mortality figure was applied, and finally the total was reduced to its present value with a 3 percent "true interest" rate.

This calculation brought the trial court to a figure of $1.5 million for the second component of the license. It then reduced that figure by 7 percent, or $104,030, to reflect the pre-marital separate property component of that figure, leaving the "license" contemplated by McsSparron available for distribution as a marital asset worth $1.5 million.

In declining to award plaintiff any share of defendant's license, the trial court was mindful of McSparron's admonition against "duplication in the form of maintenance awards that are premised on earnings derived from professional licenses" and relied upon the holding in Wadsworth that "the court is obliged to reduce the value of the enhanced earnings by the amount awarded in maintenance." It found that, given the substantial maintenance and other distributions to plaintiff, any additional distribution based upon the license would be duplicative.

The First Department held that this was error. It noted that property distribution and maintenance should each be considered with a view toward the other and that their purposes should be kept in mind. Equitable distribution is the division of martial property that was acquired by either member of the "economic partnership" during the marriage, and therefore belongs to both spouses. Maintenance is a payment awarded by the court to ensure the support of the non-earner spouse while keeping in mind, to the extent possible and appropriate, the standard of living enjoyed during the marriage.

The court stated that since the dollar value assigned to defendant's law license was computed based upon projected after-tax earnings, a distribution of that asset would already have been tax impacted. To substitute an award of maintenance for a distribution of that asset, which maintenance is then subject to income tax, is tantamount to making plaintiff the victim of double taxation.

Another Option

It concluded that reducing the value of the enhanced earnings by the amount awarded in maintenance, as was done in Wadsworth, was not the only way to

avoid the problem. Another option was for the court to grant a distributive award based upon the enhanced earnings, and then to adjust the payor's other obligations accordingly. It concluded that plaintiff was entitled to 50 percent of the part of defendant's law license that was earned during the marriage, and increased her distributive award by $773,500. It also held that plaintiff was entitled to interest on the unpaid balance of the distributive award.

The trial court awarded plaintiff maintenance in the sum of $15,000 per month, to be reduced to $8,500 per month following the contemplated sale of the marital residence. The appellate court found that its increase in the distributive award did not eliminate plaintiff's need for maintenance. It held that the court "must consider, in particular, the marital standard of living, the extent of the estate possessed by each party and the extent of the earner's remaining stream of actual and potential future income, after deducting the sums already subject to court order."

Here, the defendant's future earnings were expected to exceed $1 million yearly, and he had other resources, the income from which could provide for at least a portion of the maintenance. It also noted that the distributive award was payable in installments, and would not be completely in plaintiff's possession for years to come.

The Appellate Division directed that the maintenance, reduced to $8,500 per month, should begin the month following the date when the distributive award had been paid in full.

Footnotes

FN(1) 87 NY2d 275, 639 NYS2d 265 (1996).

FN(2) 219 AD2d 610 (4th Dept. 1996).

FN(3) AD2d , NYS2d (Ist Dept. 1999).

FN(4) Citing, among other things, Brandes and Weidman, "The Valuing of Law Practices," New York Law Journal, Nov. 22, 1994, at 3.

FN(5) 66 NY2d 576.

FN(6) 137 AD2d 131.

Joel R. Brandes has law offices in Garden City and New York City. He co-authored Law and the Family New York Forms (9 vols.) and Law and the Family (both, published by Westgroup). Bari B. Brandes, a member of The Law Firm of Joel R. Brandes PC, assisted in the preparation of this article.