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Court takes more expansive view of goodwill in divorce case

Goodwill continues to fuel debate in divorce cases involving professionals such as attorneys and physicians. In a recent Arizona case, *Walsh v. Walsh*, the court of appeals reversed the family court's ruling limiting a law firm partner's goodwill to the amount he would receive under a stock redemption agreement.

FAMILY COURT VALUES INTEREST

During divorce proceedings between Cheryl and E. Jeffrey Walsh, the parties disagreed about the value of the attorney husband's intangible professional (or personal) goodwill. The husband claimed that his interest in the law firm should be $140,000 — the stock redemption value pursuant to the firm's stockholder's agreement. His expert testified that, while the husband had professional goodwill, the only realizable benefit from his employment as of the date of divorce was the $140,000 redemption value.

The court acknowledged that, when goodwill has no immediate cash value, the court must apply its own judgment and discretion.

The wife's expert applied a capitalization-of-earnings valuation approach and examined documents related to the husband's tax returns, historical income performance, earnings sustainability, reputation and client loyalty. Based on these factors, and giving little weight to the stockholder's agreement, the expert valued the husband's professional practice at about $1.3 million.

The family court agreed with the husband's expert and found that his interest in the firm (including goodwill) and the value of his law practice were limited to $140,000. The wife appealed, contending that the lower court shouldn't have limited the husband's professional goodwill as an attorney to his stock redemption interest in his firm.

APPELLATE COURT SIDES WITH WIFE

The appellate court began by explaining that future earning capacity isn't goodwill per se. However, goodwill may exist when future earning capacity has been enhanced because reputation leads to probable future patronage from existing and potential clients. Like other Arizona professionals, attorneys face evaluation of their professional goodwill as a community asset under the state's divorce law.

To determine the existence and extent of goodwill, the court said it may consider as "determinative factors" (commonly known as the *Wisner* factors) the practitioner's:

- Age,
- Health,
- Past earning power,
- Reputation in the community for judgment, skill and knowledge, and
- Comparative professional success.

The terms of an attorney's partnership agreement might also be considered when determining the value of goodwill in a divorce context — but only as a single factor. "Partnership agreements," the appellate court noted, "are designed to deal with particular aspects of the business, and simply do not address the considerations involved in valuation for a marital dissolution."

The court of appeals faulted the family court for failing to consider the husband's professional goodwill beyond his stock redemption interest in the firm. The court pointed out that it had previously rejected the lower court's approach of requiring goodwill to be realizable — something that can be bought or sold on the open market — as had other courts.

The court acknowledged that, when goodwill has no immediate cash value, the court must apply its own judgment and discretion in making a determination. The determination isn't limited to corporate documents setting a shareholder's interest in the company's assets. Rather, the court can use the *Wisner* factors and expert testimony to help guide its examination of enhanced future earning capacity.

IMPORTANT DISTINCTION

The court of appeals concluded that the family court had conflated the firm's net assets, which *were* subject to the stockholder's agreement, with the husband's own goodwill. It also decided that he possessed goodwill beyond the amount the family court had designated.

The appellate court emphasized, however, that its ruling shouldn't be interpreted as equating future earning capacity with goodwill. Future earning capacity may be evidence of goodwill, but the earning capacity isn't itself a divisible community asset.

IS PROFESSIONAL GOODWILL COMMUNITY PROPERTY?

The husband in *Walsh v. Walsh* (see main article) alternatively argued that professional goodwill is separate from "enterprise goodwill" and not divisible marital property. The Arizona court of appeals acknowledged that some states hold that professional goodwill may not constitute marital property. In Arizona, however, the court said that consideration of the *Wisner* factors demonstrates that the state does in fact consider qualities that are attributable to the individual in determining community property values.

The husband further argued that professional goodwill is already realized through future earnings and accounted for in spousal maintenance. The court disagreed, comparing the divisible component of professional goodwill with an interest in pension rights — value is generated (at least in part) during the marriage, and will be realized later. Courts must, however, ensure that they don't divide as community property future earnings that are based solely on post-divorce efforts.

How to spot and stop expense account cheating

Suppose that one of your clients recently caught an employee falsifying an expense report. The client fired the individual, but because the fraudulent amount was relatively small, the business decided not to prosecute. As far as your client is concerned, the case is closed.

Unfortunately, the same conditions that make it possible for one employee to cheat may enable others to submit false expense reports. And even small amounts can add up to big losses when several employees and multiple reports are involved.

EMPLOYEE INGENUITY

There are as many ways to cheat on an expense account as there are employees willing to cheat. One of the most common methods is to mischaracterize expenses — using legitimate receipts for nonbusiness-related activities. If Sarah treats her friend Jennifer to a birthday dinner, for example, that generates an actual receipt, but it shouldn't show up on Sarah's expense account.

Requesting multiple reimbursements is riskier, but just as simple. If Sarah wants her company to pay for Jennifer's birthday dinner twice, she copies the receipt and turns it in on another expense report. Worse, she may attempt to be paid once for the bill, once for the receipt and once for the credit card statement.

Some employees simply overstate their expenses by doctoring supporting paperwork — for example, by changing a 3 to an 8 or a 1 to a 4 on a receipt. Then, there are cheats who invent expenses. All David needs to do is ask a cab driver for an extra receipt, fill it out and turn it in for reimbursement.

These and other small expense account infractions can add up to outrageous sums. In one case, a top salesperson who traveled extensively for business was found to have defrauded his company of $30,000 over the course of three years by adopting a liberal definition of allowable business expenses.

ENFORCEMENT IS KEY

In most cases, expense account fraud can be averted if companies implement fraud control policies and procedures and then *enforce* them. Too often, companies establish policies but fail to make sure they're followed correctly.

Once a company has an expense report policy in place, it should communicate it. Sarah needs to know she can't take friends to dinner on the company dime and David needs to understand that only business-related cab trips are reimbursable. This prevents misunderstandings and makes punishing infractions, when they occur, easier.

Also, managers should keep abreast of employee business travel plans and other activities that might trigger expense reports. If Doug is based in Cleveland but submits a bill for a dinner in San Diego, his supervisor should have known about the trip before it happened. The supervisor should review every expense turned in, and require original receipts for everything. If a photocopied receipt is necessary — and sometimes it is — the supervisor should inspect it carefully for signs of tampering.

Some employees overstate their expenses by doctoring supporting paperwork.

While expense tracking software can't substitute for hands-on expense account reviews, it can help spot inconsistencies that develop over time. These programs make it easy to see if someone's expenses have soared in recent months or are noticeably higher than those of others in the same department.

A confidential fraud-reporting hotline is also a good idea. It encourages anonymous reports of misdoings and signals that the company is serious about eliminating fraud.

BE REASONABLE

At the same time, businesses need to take care that their antifraud policies are reasonable. If the official definition of reimbursable expenses is excessively narrow, some employees may be more inclined to lie on their expense accounts to make up for out-of-pocket expenditures.

Also, everyone in an organization must be held to the same standards. The CEO can't be immune from scrutiny — especially because a CEO who cheats on an expense account may be perpetrating other forms of fraud, including falsifying financial records.

SYSTEMIC PROBLEMS

If a business contacts you about suspected expense account cheating, help the client understand that the incident may not be isolated. Enlist a fraud expert to investigate the claim and possibly to review the company's expense reporting policies and internal controls.

Tax Court rejects charitable deduction

Conservation easements require strict substantiation rules

The Internal Revenue Code allows taxpayers to take a charitable deduction for a qualified conservation contribution. But satisfying the requirements for that deduction without solid expert input is difficult, as the taxpayer in *Scheidelman v. Commissioner* learned.

TAXPAYER SEEKS DEDUCTION

Huda Scheidelman donated a façade conservation easement on her brownstone row house in Brooklyn's historic Fort Greene neighborhood to the National Architectural Trust (NAT). The easement:

- Prohibited Scheidelman from altering the façade without the NAT's permission,
- Required Scheidelman to maintain the façade and the rest of the structure,
- Gave the NAT the right to inspect and to require Scheidelman to cure any violations of her obligations, and
- Ran with the land in perpetuity.

Scheidelman obtained an appraisal of the easement from Michael Drazner, an expert on a NAT list of qualified appraisers. He used the before-and-after method, deducting the value of the building with the easement from the value of the building without it. He reached the former amount by applying an 11.33% discount to "before" value, based on consideration of the range of value that the IRS has historically found to be acceptable as well as historical precedents. Drazner ultimately valued the easement at $115,000.

Scheidelman claimed that amount as a deduction on her tax return, and the IRS challenged it. The IRS argued that the appraisal wasn't a "qualified appraisal" under the applicable tax regulations because it failed to state the method and basis of valuation.

The Tax Court upheld the disallowances, but the Second Circuit Court of Appeals vacated and remanded the case. It held that the appraisal met the minimal "qualified appraisal" requirements but noted that the Tax Court didn't have to find the appraisal persuasive or allow any deduction for the donated easement.

DENIED AGAIN

The Second Circuit directed the Tax Court to determine on remand whether the taxpayer satisfied her burden of proving the easement's fair market value (FMV). The Tax Court began with Drazner's appraisal. It faulted his report for deriving the 11.33% discount not from reliable market data or specific attributes of Scheidelman's property, but from his analysis of what the courts and IRS had allowed in prior cases. The court held that the report wasn't based on sufficient facts or data and wasn't the product of a reliable methodology.

The court also examined the evidence presented by Michael Ehrmann, who testified in court for the taxpayer. It found that the information he relied on came from the NAT. His report didn't accurately describe the easement but instead was a summary of his knowledge about the NAT easement program. Moreover, he relied on outdated information rather than contemporaneous inspection and used alleged comparables from outside the property's area. Ehrmann's testimony, the court said, "had all the earmarks of overzealous advocacy in support of NAT's marketing program."

The testimony of the IRS's experts struck the court as much more persuasive. The first expert considered the easement terms, zoning laws and the real estate market in the neighborhood, among other factors, and concluded that an easement wouldn't materially affect the value of Scheidelman's property.

Another IRS expert took a different approach, based on condemnation techniques (used when governments take property by eminent domain). The expert also determined that the easement didn't materially affect the property's FMV. The court, therefore, held that the easement had no value for charitable contribution purposes.

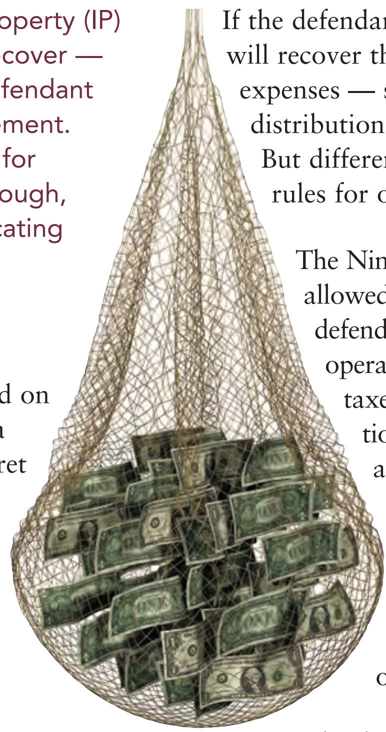
BEYOND QUALIFICATIONS

Expert qualifications are important. But, as the Tax Court observed, expert opinions that disregard relevant facts affecting valuation, or that excessively exaggerate value, are rejected by courts — even when they come from qualified appraisers. ◗

IP litigation

Making the case for (or against) disgorgement of profits

In certain types of intellectual property (IP) cases, plaintiffs are entitled to recover — or disgorge — the profits the defendant reaped as a result of the infringement. Determining the proper amount for those profits can prove tricky, though, especially when it comes to allocating expenses and revenues.



ATTRACTIVE REMEDY

Instead of pursuing damages based on its own lost profits, a plaintiff in a trademark, copyright or trade secret case can opt to pursue the equitable remedy of disgorgement of defendants' profits. Defendants' profits tend to outpace plaintiffs' lost profits, making disgorgement an attractive remedy for many companies.

Patent holders generally pursue lost profits *or* reasonable royalties — not both. The exception is with design patents, such as when Apple sought $2 billion for a disgorgement of Samsung's profits from products that infringed Apple design patents. The federal patent law allows design patent holders to recover disgorgement without any apportionment of profits based on patented and nonpatented features in the infringing product, which isn't true with other types of IP.

BURDENS OF PROOF

A plaintiff that seeks disgorgement is only required to establish gross sales revenue attributable to the infringement. The burden then shifts to the defendant to prove any appropriate deductions for expenses and profit allocation. If the defendant fails to do so, the plaintiff will recover the gross revenue amount. Direct expenses — such as product, marketing and distribution costs — usually are deductible. But different jurisdictions have different rules for other types of expenses.

The Ninth Circuit Court of Appeals has allowed deductions for a portion of a defendant's general expenses, including operating expenses and federal income taxes, if they're material to the generation of the revenue. Some courts don't allow the deduction of overhead — which can be incurred in support of both infringing and noninfringing activities — while others allow overhead deductions that can be attributed to the production or sale of the infringing product.

The defendant in such cases generally also has the burden of demonstrating the degree to which infringing and noninfringing activities contribute to the gross revenue. Such apportionment can be particularly difficult when, for example, infringing material is used in a book that's largely original material or an infringed trademark is used on a product that also benefited from strong distribution channels or pricing strategies.

ARM YOURSELF WITH ANALYSIS

Whether you're representing the plaintiff or defendant in a case involving disgorgement of profits, come prepared with thorough documentation and analysis. Your financial expert witness must be able to speak authoritatively to both claimed gross revenues and claimed costs and apportionment.