# Zivetz, Schwartz & Saltsman CPAs

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## Trademark Claims Include Reasonable Royalty and Disgorgement of Profits

***Bellagio Jewelry, Inc. v. Croton Watch Co.*, 2008 WL 3905895 (C.D. Calif.)(Aug. 20, 2008)**

The owner of a boutique watch business, "Bellagio Jewelry," successfully registered the Bellagio® trademark. In 2005, he entered into a two-year exclusive licensing agreement with Avalon jewelers to sell a guaranteed minimum of Bellagio watches at a 7% royalty rate. In early 2006, Avalon negotiated with ShopNBC to sell the watches. The network sold thirty-nine watches in six minutes at approximately $1,800 per watch.

Six months later, Avalon discovered that a large, well-known watch company (Croton), with over $20 million in annual sales, had marketed its own line of Bellagio watches on ShopNBC for nearly five years. In August 2006, Bellagio sent Croton a cease and desist letter, notifying it of the registered Bellagio trademark. It also filed a formal complaint, alleging trademark infringement, but Croton continued to sell its Bellagio watches on ShopNBC and placed enough pressure on the network that it cut off negotiations with Avalon, which in turn forced Avalon not to renew its licensing agreement with Bellagio. At trial, Bellagio sought to recover nearly $240,000 in lost profits from Croton, as well as what Croton made on the Bellagio line, worth over $1.1 million.

**Disgorgement of profits is equitable remedy.** The federal district court agreed that "but for Croton's infringement and control over ShopNBC, Avalon would have renewed its licensing agreement with [Bellagio]." At trial, Bellagio's expert proved lost profits amounting to $238,833. This sum was equal to the present value of two years of guaranteed royalty payments, the minimum that Bellagio would have received if Avalon had renewed the licensing agreement. The court found this a "conservative and reasonable" estimate of damages, and awarded it in full.

The defendant (Croton) contested any disgorgement of profits, claiming first that this would constitute a double recovery. But the court disagreed. Under applicable law, Bellagio was entitled to a portion of profits as an equitable remedy (and punitive measure) for any "willful" infringement, which occurred after Croton received actual notice in the cease and desist letter.

However, the majority of the requested damages related to the defendant's sale of watches prior to receiving notice, and these were not recoverable. After reviewing the evidence, the court decided that the defendant made $78,313 in profits from Bellagio watch sales after receiving notice of the trademark infringement, and awarded this amount, for a total recovery of $317,146 on the plaintiff's original claims.

## Tax Court Rejects Appraisal of Donated Stock for Incorrect Premise of Value

***Bergquist v. Comm'r*, 131 T.C. No. 2 (July 22, 2008)**

Stockholders in University Anesthesiologists (UA), a medical services corporation, provided services to the Oregon Health & Science University Hospital (OHSU), which decided to consolidate all of its providers into a single, tax-exempt corporation under IRC §501(c) (3). OHSU targeted July 1, 2001 to close the deal.

The UA shareholders gathered at a meeting and discussed donating their stock to the new entity. The move would allow them to claim "huge" charitable deductions, according to company reps, so majority agreed. They retained a national valuation group, which appraised the stock at $401.79 per share, or up to $175,000 in charitable deductions for each donating shareholder.

Delays in qualifying for an ERISA-exempt pension plan moved the closing to January 1, 2002. The new OHSU Medical Group (OHSUMG) accepted the UA donation of shares as a "professional courtesy," but booked their value at $0. Pro forma cash flows prepared in September 2001 supported this and showed that UA retained no residual value for the

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new entity. At a second meeting, UA gave its former shareholders copies of the appraisal reflecting the $401.79 per share value and told them not to consult their own tax advisers, lest they "attract [the IRS's] attention." All but two took charitable deductions for their donated stock, per the appraised value, and the IRS assessed substantial deficiencies.

**Going concern premise makes 'dramatic difference.'** At trial, the Tax Court attributed the "dramatic difference" between the parties' appraised values to their different premises of value. The taxpayers' expert valued UA as a going concern, because as of the valuation date of September 2001, consolidation was still uncertain. The government's approval of an ERISA-exempt pension plan was a "necessary condition for the consolidation," the taxpayers argued, offering the original appraisal of $401.79 per share as well as a second appraisal valuing UA stock between $323 and $326 per share.

The IRS expert applied a liquidation premise of value, maintaining that UA was "very likely" to cease operations after the consolidation. Using UA's balance sheet to determine the book value of its assets and liabilities, he made appropriate adjustments and valued total assets at nearly $3.66 million, minus total liabilities of $2.20 million, leaving a net equity value of $1.46 million. Based on M&A and restricted stock studies, he also applied a 35% lack of control discount and a 45% lack of marketability discount to UA's equity value, resulting in a final fair market value of $521,373, or between $35 and $37 per voting share.

**Taxpayers' selection was 'self-serving.'** The court dismissed the petitioners' "going concern" premise of value. "OHSUMG's ability to offer a governmental plan clearly was not a major requirement for the planned consolidation but simply a potential benefit." In fact, when OHSUMG could not qualify for a governmental pension, it implemented an ERISA-compliant plan, to become effective in time for the consolidation. The taxpayers' arguments were self-serving, the court said, and their appraisal "conveniently" failed to explain the basis for their selection of a going concern premise of value. Further, they failed to point out any significant flaws in the IRS appraisal, and the court adopted its discounted value of UA shares, without any further adjustment.

Finally, the court found taxpayers liable for the 40% accuracy-related penalties pursuant to IRC §6662 (h). (The penalty applies when a "gross valuation misstatement" results in the taxpayers claiming a value 400% or more of the "correct value"). The good faith exception—for relying on a "qualified appraisal" by a "qualified appraiser" after due investigation of the stock's value—did not apply. Taxpayers "cannot blindly rely on advice from advisers, [or] on an appraisal." In this case, the doctors were well educated and aware of the new company's decision to book their donated shares at zero. That, plus the warning not to consult tax advisors, should have "put [them] on notice as to the inaccuracy of the claimed donations."

## Expert Evidence Helps Decide Partnership 'Divorce'

***Schuetzle v. Lineberger*, 2008 WL 2406825 (Wash.) (June 16, 2008) (unpublished)**

Like divorce cases, partnership dissolutions are often costly and conflicted. And in both settings, one party's qualified valuation professional can help decide the outcome—especially when the opposing party opts not to retain an expert.

**Expert concludes club worth over $1 million**. Two married couples formed a partnership to run an athletic club. After six years in operation, the majority owners (60% partnership interest) terminated the 40% owners. The minority partners sued for a dissolution and accounting of the partnership, and the court held a valuation hearing. The minority partners presented a valuation expert, who used the combined income, market, and asset approaches to conclude that the club was worth nearly $1.08 million. He also calculated $93,510 in unpaid distributions to the minority partners.

By contrast, the majority partners did not retain an expert appraiser or offer an alternate valuation. Rather, the couple's husband simply testified that the expert's value conclusions were "much too high" for "various reasons," including increased competition from other health clubs.

Not surprisingly, the trial court credited the expert's testimony, with a couple of exceptions. It rejected an adjustment to the club's income based on "minimally adequate staffing," as well as his optimistic view that the club would rebound from the increased competition and a stagnant growth rate. To reflect these concerns, the trial court discounted the expert's value by 25%, arriving at a final value of $807,000. The minority partners' 40% share amounted to $322,800, plus unpaid distributions. The majority partners appealed.

**Hard to argue without alternative valuation evidence**. In an unpublished decision, the Washington Court of Appeals reviewed the trial court's conclusions. Although the court didn't discuss the valuation evidence in much detail, it found the trial judge acted reasonably in accepting the expert evidence as a starting point—

especially given the lack of a credible, alternative valuation from the opposing side. It was also within the judge's discretion to make appropriate adjustments, including the blanket 25% discount. "The trial court took the weaknesses of [the expert's] valuation into account and discounted his final calculation," the higher court held, in confirming the valuation conclusion as well as the unpaid distributions.

## Does Buy-Sell Contract Trump Statutory Shareholder Remedies?

***Kortum v. Johnson*, 2008 WL 3931544 (N.D.)(Aug. 28, 2008)**

When a closely held, private professional practice terminates the employment of a minority shareholder, there is often a clash between the "at will" doctrine of employment law and the broad equitable remedies offered by a state's shareholder oppression statutes. *Another key issue:* Can a buy-sell agreement preempt the conflict by limiting the minority shareholder's rights upon termination to a nominal sum?

**Doctors value practice at $5.** In setting up their medical clinic, five physicians each contributed $25,000 and received 5,000 shares in return; they later contributed another $50,000 apiece to cover expenses, after which they shared equally in profits, lab fees and overhead contributions. Their operating agreement provided that if shareholders "voluntarily or involuntarily" terminate their employment, "for any reason whatsoever," they are to sell their shares at $0.04 per share (or $1.00 for $25,000). The shareholders also agreed to review the stock price at the annual meetings, and if unable to agree, then the sale of any share would be at book value.

After three years in operation, the clinic terminated one of the doctor/shareholders, and offered her $1.00 in return for her stock. She refused, and sued the shareholders for breach of fiduciary duty and for the statutory fair value of her stock. The shareholders asked the court to enforce the buy-sell provisions. The trial court found that, according to the operating agreement, the doctor was an "at will" employee and had bargained away any rights to shareholder oppression remedies. It dismissed her complaint and ordered the corporation to pay her $1.00.

**Owner/employee has different expectations.** On appeal, the doctor argued that she was unfairly deprived of her entire investment in the practice, her continued earnings and employment and her patient base and accounts receivable—all for $1.00. She claimed entitlement to her pro-rata share of the medical corporation as a going concern. The shareholders reasserted their prior arguments, that she agreed to the repurchase of her shares at the contract terms and could acquire no greater rights simply by virtue of her minority shareholder status.

The appellate court agreed that the doctor was an at-will employee, adding that "within many closely held enterprises, it is not as easy to separate out the employment relationship from the ownership relationship." In these cases, the inquiry is whether the minority shareholder had a reasonable expectation of continued employment. Accordingly, the corporation's shareholders owed the doctor a fiduciary duty as a shareholder and a shareholder/employee. The trial court, in concluding the opposite, had relied on cases in which employees acquired nominal ownership as part of their compensation. In this case, the doctor helped form and capitalize the corporation; she made the same contributions and received the same shares as the other members. The buy-sell agreement did not relieve the shareholders of their statutory duties, and the trial court should have determined whether their conduct toward the owner/employee was unfairly prejudicial.

The court remanded the case for findings as to whether the doctor had reasonable expectations of continued employment. Signing such a restrictive buy-sell agreement could be some evidence that she did not. Still, other factors (such as whether a shareholder's salary constituted de facto dividends and whether procuring employment was a significant reason for investing in the business) could support an alternate finding. If the shareholders acted unfairly, then she would be entitled to relief under the shareholder oppression statutes and the trial court would have broad discretion to fashion an equitable remedy. If the court found no unfair prejudice, then the buy-sell price of $0.04 per-share would apply, or $200 for a total ownership of 5,000 shares.

## 10 Tips to Protect Expert-Attorney Communications

The vast majority of courts now adopt a "pro-discovery" stance regarding the disclosure requirements for a party's testifying expert as codified in Rule 26(2)(b) of the applicable rules of civil procedure (state and federal). An attorney's provision of information to an expert may be afforded some protection, under either the attorney-client privilege or the work product doctrine. However, a safer assumption to make—right from the beginning

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of a litigation matter—is that *any* correspondence or communication between the attorney(s) and expert(s) may be discoverable as information forming the basis of the expert's opinion.

This general rule is broad enough to include discussions between attorneys and experts, emails, notes, voice mail messages and other recorded conversations. Consequently, attorneys and their experts—including financial analysts, business appraisers, and economic damages experts—should:

1. Remember that an expert's entire file may receive very limited protection from disclosure.
2. Keep away from any discussion or exchange of documents that will allow an opposing party to question your independence in arriving at opinions.
3. Avoid any risk of waiving any protections (attorney-client privilege, work product doctrine) that might otherwise apply in all communications.
4. Be prepared in advance for such questions; depositions often provide fertile ground for delving into an expert's communications with an attorney.
5. Know that any pre-engagement communications may also be discoverable. Because of this, engagement letters should convey the facts of a case without any "spin." Indeed, both the expert's and the attorney's engagement letter should remain as neutral as possible.
6. Make sure attorneys understand that they should ever provide documents or information that they would not want the opposing party to see during discovery.
7. Take care not to make handwritten notations on any hard copy drafts or send notes by email; draft reports can be discovery minefields. In addition, discussions regarding the drafts should not be written.
8. Understand that all expert communications are subject to discovery. This is particularly important in cases where multiple experts will be working on a single report. Again, key is to avoid written communications whenever possible.
9. Alert attorneys of your prior publications and be prepared to handle aggressive questions at deposition and trial. Expert disclosures often require a list of prior publications and opposing counsel can use these materials to impeach the expert.
10. Discuss compliance to all the aforementioned provisions, especially given the recent amendments to the Federal Rules of Civil Procedure, regarding preservation of electronically stored evidence.

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Zivetz, Schwartz & Saltsman CPAs
11900 W. Olympic Bl., # 650
Los Angeles, CA 90064-1151
www.zsscpa.com

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