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Enterprise goodwill disallowed if based on non-solicitation agreement

***Held v. Held,* 2005 Fla. App. LEXIS 14138 (September 7, 2005).** *Judge Gross.*

The issue in this marital dissolution case was whether the trial court correctly included enterprise goodwill in valuing husband's insurance agency, Joseph Held Company.

Although husband and wife agreed that book value was around $2.9 million, they hotly contested the existence and value of the company's enterprise goodwill above the adjusted book value. The trial court determined that such goodwill was around $7.6 million.

To arrive at its valuation, the court relied mostly upon the testimony of the wife's expert, Jim Gilbert. Central to the court's determination of fair market value, which included enterprise goodwill, was the court's assumption that in any sale of the business, the husband would sign a non-solicitation/non-piracy agreement preventing him from doing business with the Company's existing customers. The court reasoned that the non-solicitation agreement had nothing to do with personal goodwill of the business, but was part of enterprise goodwill.

Holding and rationale

The appellate court found that for the purpose of distinguishing enterprise goodwill from personal goodwill in the valuation of a business, there is no distinction between a "non-solicitation/non-piracy agreement" and a covenant not to compete, because both limit a putative seller's ability to do business with existing clients. The court also noted that a covenant not-to-compete is attributable to the personal reputation of the seller/spouse and not to the enterprise goodwill of the business.

Accordingly, the court reversed and ruled that the trial court impermissibly inserted into enterprise goodwill an aspect of personal goodwill—the value of the husband's personal relationship with the company's 60 clients. The court remanded, directing the trial court to use only the adjusted book value in determining the agency's fair market value.

Sufficient evidence must support valuation date

***Scharfman v. Scharfman,* 2005 N.Y. App. Div. LEXIS 6584 (June 13, 2005).** *Per Curiam.*

In this marital dissolution case, the issue was the appropriate valuation date for the parties' 85 operating entities, which, in turn, owned more than 100 residential rental real estate properties.

The trial had agreed with husband that the valuation date should be the action's commencement date, and had rejected wife's assertion that the valuation date should be the trial date.

Holding and rationale

The appellate court ruled that the trial court had abused its discretion, finding that husband failed to offer evidence in support of his assertion that any change in the value of the properties since the commencement of the action was due solely to his efforts rather than to other factors, including market forces.

Accordingly, the court held that because there were factual disputes involving ownership and management of the properties that needed to be resolved by the court, the selection of a valuation date was premature.

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Fifth Circuit affirms Tax Court's application of § 2036 to FLP assets

Strangi v. Commissioner, **2005 U.S. App. LEXIS 14497 (5th Cir. July 15, 2005).** *Judge Jolly.*

In this last installment of the *Strangi* case, which has been going back and forth between the Tax Court and the Fifth Circuit, the Fifth Circuit affirmed the Tax Court's decision on remand that Strangi had retained enjoyment of the assets he had transferred to **Strangi Family Limited Partnership (SFLP)** and **Stranco, Inc.** through an implied agreement, and, thus, that the transferred assets were properly included in his estate under IRC Section 2036(a) for estate tax purposes. The Fifth Circuit also upheld the Tax Court's determination that the bona fide sale exception to § 2036(a) was inapplicable.

The facts, valuation evidence, original Tax Court ruling,[1] first appellate opinion,[2] and the Tax Court's ruling on remand[3] are set forth, respectively, in the January 2001, August 2002, and July 2003 issues of the *BVUpdate.*

Implied agreement

The benefits retained by Strangi included periodic payments made prior to Strangi's death on his behalf, his continued use of the transferred house, and the post-death payment of various debts and expenses. The Tax Court concluded that Strangi and the other shareholders of Stranco, i.e., the Strangi children, had an implicit agreement by which Strangi would retain the enjoyment of his property after the transfer to SFLP.

The Tax Court found that SFLP's distribution of over $100,000 to pay for funeral expenses, estate administration expenses, specific bequests and various personal debts that Strangi had incurred provided strong circumstantial evidence of an understanding between Strangi and his children that "partnership" assets would be used to meet Strangi's expenses. The Fifth Circuit agreed, noting that the "possession or enjoyment" of one's assets is the assurance that they will be available to pay various debts and expenses upon one's death, which is what Strangi received.

The Tax Court also found "highly probative" Strangi's "continued physical possession of his residence after its transfer to SFLP." The Estate argued that SFLP charged Strangi rent on the home. Although the rent charge was recorded in SFLP's books in 1994, the Estate made no actual payments until 1997. The Fifth Circuit found that even assuming that the belated rent payment was not a post hoc attempt to recast Strangi's use of the house, such a deferral, in itself, provided a substantial economic benefit. Therefore, it concluded that the Tax Court did not err in considering Strangi's continued occupancy of his home as evidence of an implied agreement.

Finally, the Fifth Circuit concluded that the Tax Court did not err in finding an implied agreement based on evidence that Strangi lacked liquid assets—other than $762—but had $17,000 in monthly expenses; the court believed some arrangement to meet his expenses must have been made. As the court said:

> In sum, upon creation of SFLP, Strangi retained assets barely sufficient to meet his own living expenses assuming he was never required to pay rent, estate administration costs, outstanding personal debts, funeral expenses, or taxes. At the same time, Strangi began receiving substantial monthly payments out of SFLP's coffers. Given these circumstances, we cannot say that the Tax Court clearly erred in holding that Strangi and his children had some implicit understanding by which Strangi would continue to use his assets as needed, and therefore retain "possession or enjoyment" within the meaning of § 2036(a)(1).

No bona fide sale exception

Section 2036(a) provides an exception for any transfer of property that is a "bona fide sale for an adequate and full consideration in money or money's worth." The Tax Court held that Strangi's transfer of assets to SFLP lacked a substantial non-tax purpose, and, that, therefore, the bona fide sale exception did not apply.

The Fifth Circuit again found that the Tax Court's ruling was not clearly erroneous. The appellate court found that none of the five non-tax rationales proffered by the Estate were supported by the evidence.

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Fifth Circuit affirms Tax Court's application of § 2036 to FLP assets

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These rationales were: (1) deterring potential tort litigation by Strangi's former housekeeper; (2) deterring a potential will contest (3) persuading a corporate executor to decline to serve; (4) creating a joint investment vehicle for the partners; and (5) permitting centralized, active management of working interests owned by Strangi.

The Fifth Circuit emphasized that it was receiving the case after a full trial on the merits, and that the Tax Court had presented a litany of circumstantial evidence to support its conclusions. Because it was bound to review the Tax Court only for clear error, the Fifth Circuit could not disturb the Tax Court's findings of fact unless it was convinced that the Tax Court had made a mistake. Finding no clear mistakes, the court affirmed.

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[1] Estate of Strangi v. Commissioner, 115 T.C. No. 35 (U.S. Tax Ct. Nov. 30, 2000).
[2] Gulig v. Commissioner, 2002 U.S. App. LEXIS 11920 (5th Cir. June 17, 2002).
[3] Estate of Strangi v. Commissioner, T.C. Memo 2003-145 (U.S. Tax Ct. May 20, 2003).

Anti-competitive breach of contract supports both lost business value and lost profits damages

***Vehicular Technologies Corp. v. Titan Wheel International, Inc.,* 2005 Cal. App. Unpub. LEXIS 5392 (June 22, 2005).** *Judge Armstrong.*

In this breach of contract action, the issues pertained to the appropriate measure of contract damages.

Vehicular Technologies (Vehicular) sued **Titan Wheel International, Inc.** and **Dyneer Corporation dba Tractech** (Tractech) for breach of contract and other causes of action. Before Vehicular started selling the Lock-Right automotive locker (an automotive locker is a device that can be put on car or truck axles to add traction for difficult driving conditions, such as off-road driving), Tractech dominated the locker market with a device called the Detroit Locker. The Lock-Right was a superior product in every way. It was just as durable as the Detroit Locker, but much cheaper, and it also worked better and was much easier to install.

Allegedly, Tractech CEO Ralph McGee contacted Vehicular, ostensibly to discuss a licensing or other business arrangement between the two companies. During the negotiations, McGee requested confidential manufacturing and business information, promising not to use it except for purposes of the negotiation. McGee also promised not to copy the Lock-Right (and concealed the fact that Tractech was already doing just that) or to sell a Lock-Right copy. In reliance on McGee's promise, Vehicular divulged confidential information on all aspects of its business, including materials, manufacturing techniques, production costs, sales, and profits.

McGee's promise not to copy and his promise not to use confidential information were knowingly false. Trachtech put out a locker identical to the Lock-Right, the EZ Locker, with the goal of "burying" Vehicular through misleading marketing and price undercutting; Trachtech succeeded. Ultimately, another company acquired all of Vehicular's operations, including its products, patents, inventory, designs, and trademarks.

Lost profits

At trial Vehicular presented proof on lost profits as well as on lost business value. On damages, Vehicular presented evidence about its sales, growth, projected growth and sales, profits, debts, and business and financial plans from 1993 to the buy-out in 2002. Damages expert **Marc Margulis** testified that (as a minimum, based on modest estimates) Vehicular lost $8.5 million in profits on the Lock-Right and $12.8 million in profits on the Performance Locker (another locker it had developed). He calculated these figures by estimating the number of sales Vehicular could have expected, capping those sales at a conservative number, determining Vehicular's cost per unit and its actual sales. Margulis testified that the profits were lower than would have been expected because competition from the EZ Locker caused confusion in the marketplace and forced Vehicular to lower its prices, so that Vehicular had less money "to be out there with advertising, with promotion" or for research and

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Anti-competitive breach of contract supports both lost business value and lost profits damages

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development, and was left "undercapitalized to achieve its goals."

Lost business value

He also opined that the value of the business on sale was diminished by about $17 million, $4 million of which was attributable to the Lock-Right and $13 million of which was attributable to the Performance Locker. A jury found in Vehicular's favor and awarded $16.3 million. 29

Holding and rationale

On appeal, Trachtech challenged the damages as insupportably high, and also argued that the lost business value damages were improper, but the appellate court disagreed. Tractech's theory of Vehicular's damages was that loss of sales due to disparaging advertising had to be ignored, so that the only sales Vehicular lost were the sales Tractech made ($2.89 million at most). The court rejected this argument as an oversimplification, given that Trachtech did not want to sell EZ Lockers, but instead was protecting its flagship product, the Detroit Locker.

The court also rejected Trachtech's argument that to the extent that the jury awarded damages for lost business value, those damages were duplicative of the lost profits damages. The court found persuasive Margulis' testimony that "a valuation of a business is by definition all about the future," and that Vehicular would have had over $20 million in lost profits and $17 million at the time of the sale. The court found that this was substantial evidence that the damages were not duplicative, but would actually compensate Vehicular for the harm caused by Tractech's torts.

Finally, the court found Margulis's testimony was not speculative, but was based on Vehicular's financial records and reliable projections.

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