Corporate Lawsuits Are Business Expenses (But Some Are Personal)

by Robert W. Wood

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In this article, Wood examines the Fifth Circuit's recent decision in *Cavanaugh*, illustrating that some corporate lawsuits are too personal to qualify for deductible business expense treatment, even when the company is named as a defendant.

This discussion is not intended as legal advice.

The code does not specifically allow deductions for damages or settlement payments. Yet payments of settlements or judgments related to a business are usually deductible as business expenses under section 162.[1] One of the few exceptions is the so-called Weinstein provision added in late 2017, prohibiting deductions for settlements and legal expenses in confidential sexual harassment or abuse cases.[2] For the most part, however, lawsuits are an assumed cost of doing business.

However, what is a legitimate business expense, and are any lawsuits off limits? What qualifies as a business expense may be a legal question, but in most respects, it is factual. In the context of lawsuits, the origin of the claim test is meant to resolve the issue. However, that test has never been easy to apply. And as *Cavanaugh*[3] makes clear, some suits, even if the company is a named defendant, don't qualify for business expense treatment.

Cleaning Up

The events in *Cavanaugh* go back to 2002, but a 2019 Fifth Circuit decision gives it renewed interest.[4] Jani-King International Inc. is a successful janitorial services franchiser founded by James Cavanaugh Jr., its longtime CEO and sole shareholder. In 2005 and 2006 (the years that ended up in Tax Court), the company paid Cavanaugh at least $1 million in annual compensation, plus profits of $7 million in 2005 and $16 million in 2006.

In 2002 Cavanaugh and three others went to the Caribbean over Thanksgiving weekend. The only non-Jani-King employee on the trip was Cavanaugh's 27-year-old girlfriend, Colony Robinson. The two others were Cavanaugh's

[1] *See, e.g.*, *Kornhauser v. United States*, 276 U.S. 145 (1928) (holding that the taxpayer may currently deduct amounts paid in defense of a suit against him by his former law partner); *Federation Bank and Trust Co. v. Commissioner*, 27 T.C. 960 (1957), *aff'd*, 256 F.2d 764 (2d Cir. 1958) (allowing the taxpayer to deduct amounts paid in settlement of legal proceedings charging the taxpayer with mismanagement in the liquidation of assets); Rev. Rul. 79-208, 1979-2 C.B. 79 (permitting the taxpayer to deduct payments to settle a lawsuit and obtain a release from claims under a franchise agreement).

[2] Section 162(q), added by the Tax Cuts and Jobs Act. *See* Robert W. Wood, "Taxing Sexual Harassment Settlements and Legal Fees in a New Era," *Tax Notes*, Jan. 22, 2018, p. 545.

[3] *Cavanaugh v. Commissioner*, T.C. Memo. 2012-324, *aff'd per curiam*, No. 18-60299 (5th Cir. 2019).

[4] *Cavanaugh*, No. 18-60299.

bodyguard, Ronald "Rock" Walker, and Erika Fortner. The trip was for pleasure and not to conduct or further Jani-King business. After ingesting large amounts of cocaine, Robinson went into cardiac arrest and died.

Robinson's mother sued Cavanaugh and Jani-King for wrongful negligence, assault and battery, conspiracy, and wrongful death. She claimed that Jani-King contributed to her daughter's death by the action of its employees. She claimed that Cavanaugh, Walker, and Fortner were acting within the course and scope of their employment when they provided her daughter the cocaine.

Jani-King paid $2.3 million to settle the case and deducted it on its 2005 and 2006 tax returns. Cavanaugh contributed $250,000 to the settlement, which Jani-King reimbursed and also deducted. The IRS denied the deductions arguing that no part of the settlement was deductible as a business expense. The Tax Court agreed with the IRS.

The company was named in the suit and had to defend itself. There were even facts suggesting a corporate response to this tragic situation. Jani-King's board called a special meeting in September 2004. Cavanaugh insisted that the case was frivolous but expressed willingness to contribute $250,000 to settle. He recused himself from the meeting to allow the rest of the board to discuss it.

However, the Tax Court noted that Cavanaugh was one of only four directors, and as sole shareholder had the power to remove any director for any reason. The company's lawyers warned that juries were unpredictable and that Jani-King's reputation could be soiled by protracted litigation and publicity. The directors also worried that Jani-King franchisees would sue if they thought the wrongful death suit would hurt their *own* businesses.

Ordinary and Necessary?

Corporations and prominent individuals are commonly sued, and settling to avoid a potentially enormous payout is often justifiable to protect a business from scandal. Nevertheless, the IRS argued that no amount of worry over business assets and reputation could convert payments for the death of the boss's girlfriend into a corporate business expense. Of course, section 162 is broad, with "ordinary and necessary" given unusual meanings.

Payments are necessary if they are appropriate and helpful. Payments can be ordinary even if they are sporadic. However, the origin of the claim test enunciated by the Supreme Court in *Gilmore*[5] requires one to look at the genesis of a suit. Cavanaugh argued that *Gilmore* was inapplicable because Jani-King was a business corporation engaged solely in business activities and was named in the suit.

The correct analysis, he argued, was in *Kopp's*.[6] There, the son of a lumber company president crashed a company car and seriously injured another driver. The injured driver sued the son, the company president, and the company. The company settled and deducted its share of the settlement and legal fees.

The Fourth Circuit upheld the deductions because the company was named in the suit and bore direct exposure. The Tax Court has even cited *Kopp's* for the proposition that a corporation engaged exclusively in business activities is not bound by *Gilmore*.[7] However, the Tax Court stated that naming a company as a defendant does not alone make legal fees or settlement costs deductible business expenses.

Origin of the Claim

In *Gilmore*, a husband argued that legal fees from his divorce were ordinary and necessary business expenses because he had to shield his business from his former wife's community property claims. The Supreme Court held that deductibility hinges on whether the claim arises in connection with the taxpayer's profit-seeking activities. The consequences to the taxpayer from a failure to defeat the claim were not enough.[8]

However, in several Tax Court cases, the court has tried to consider all facts and circumstances.[9] In *Cavanaugh*, the Tax Court said it could consider

[5] *See United States v. Gilmore*, 372 U.S. 39, 49 (1963).

[6] *Kopp's Co. Inc. v. United States*, 636 F.2d 59 (4th Cir. 1980).

[7] *See Synanon Church v. Commissioner*, T.C. Memo. 1989-270; *Northwestern Indiana Telephone Co. v. Commissioner*, T.C. Memo. 1996-168, *aff'd*, 127 F.3d 643 (7th Cir. 1997).

[8] *Gilmore*, 372 U.S. at 48.

[9] *See Boagni v. Commissioner*, 59 T.C. 708 (1973); *Guill v. Commissioner*, 112 T.C. 325, 329 (1999).

all the facts but that under *Gilmore*, it couldn't consider the harm the suit might have caused Jani-King's reputation. Thus, the deductibility of Jani-King's portion of the settlement and its legal fees turned on identifying the claim and determining whether its origin lay in Jani-King's business.

Cavanaugh argued that its origin was the mother's contention that Jani-King killed her daughter by negligently allowing its employees to provide illegal drugs to her. The IRS argued that the origin of the claim was Robinson's death. The Tax Court had a third view of the origin of the claim, observing that Robinson's death alone could not make Jani-King liable.

Examining the mother's allegations about Cavanaugh, Walker, and Fortner as employees of Jani-King, the Tax Court asked whether the three employees undertook business or personal activities during the trip. The suit alleged that they gave Robinson the drugs that killed her. Finding that the origin of the mother's claim lay in the conduct of the Jani-King employees did not make the payments deductible.

The court said it also had to determine whether the conduct in question arose from Jani-King's profit-seeking activities. The parties had stipulated that the trip involved no business conduct, and the IRS claimed that that should end the case. Yet Cavanaugh argued that tort claims against company employees are rampant in business today, making them proximately related to undertaking business operations.

The Tax Court made a point of noting cases in which personal conduct gave rise to business expense deductions:

- *Kopp's* (costs of suit were deductible by the corporation because the case involved negligently entrusted corporate property);[10]
- *Dolese* (divorce costs were deductible because the wife enjoined a business of the husband's paving company);[11]
- *Guill* (costs of a suit against an affiliated insurance carrier were deductible because they entirely related to the plaintiff's insurance business);[12]
- *O'Malley* (costs of defending a bribery charge were deductible because they related to attempts by a trucking business to influence trucking deregulation legislation);[13]
- *Hauge* (costs of defending a suit brought for conspiracy to defraud were deductible because the case implicated ongoing business operations);[14] and
- *Naporano Iron and Metal Co.* (costs of a suit resulting from a fight on company property during business hours were deductible by the corporation).[15]

Notably, each case involved a company's profit-seeking business or the actual conduct of a profit-seeking business. Fatally, Cavanaugh had stipulated that no business was done on the trip. Even if Jani-King employees gave Robinson the drugs that killed her, Cavanaugh did not show how those actions arose from or furthered the business.

If the Jani-King employees had been attending a conference or had given Robinson drugs at Jani-King's offices during business hours, the analysis might be different. But here, the employees were not engaged in profit-seeking activities and were far from any company property. The Tax Court found the legal fees and settlement payments not to be deductible business expenses.

Appeal

On appeal, Cavanaugh argued that *Gilmore* did not address a situation in which a corporation is directly named in the suit. Relying primarily on *Kopp's*,[16] Cavanaugh argued that the corporation's direct exposure to a judgment was pivotal. However, like the Tax Court, the Fifth Circuit

[10] *Kopp's*, 636 F.2d at 61.

[11] *Dolese v. United States*, 605 F.2d 1146, 1151-1152 (10th Cir. 1979).

[12] *Guill*, 112 T.C. at 329-330.

[13] *O'Malley v. Commissioner*, 91 T.C. 352, 362-364 (1988).

[14] *Hauge v. Commissioner*, T.C. Memo. 2005-276, at *7.

[15] *Naporano Iron and Metal Co. v. United States*, 6 Cl. Ct. 422, 431-432 (1984).

[16] *Kopp's*, 636 F.2d 59.

agreed with the IRS that the origin of the claim test still applied.

Cavanaugh could cite cases outside the Fifth Circuit in which the potential consequences to the business were indeed viewed as enough. But the Fifth Circuit was not convinced. The court declined to follow what it called scarce out-of-circuit cases that distinguished *Gilmore*'s origin of the claim test when the taxpayer corporation is named in the underlying suit.[17] Those cases directly conflicted with *Gilmore*, which the Fifth Circuit found was binding.

Notably, however, the appeals court did leave a window for the *Kopp's* line of cases. There, said the Fifth Circuit, the corporations showed that the litigation directly threatened or inhibited their ability to engage in profit-seeking activities.[18] Here, simply being named in the suit was insufficient to prove that Jani-King's expenses were deductible.

The Tax Court had found that the origin of the claim was that Robinson was allegedly provided cocaine by Jani-King employees, and that providing cocaine does not arise from, further, or use property directly employed in Jani-King's franchising business. Cavanaugh did argue that Jani-King engaged only in profit-seeking activities, so its employees' actions (alleged to have been within the course and scope of their employment) *must* have arisen from profit-seeking activities.

Of course, Cavanaugh did not argue that providing cocaine to Robinson was done with a profit-seeking motive. He also did not argue that the alleged actions arose from or were proximately related to any Jani-King business activity. Thus, the Tax Court found that the Jani-King employees' alleged actions were not profit seeking, and the Fifth Circuit concluded that the finding was not clearly erroneous.

Cavanaugh argued that the suit was founded on a theory of *respondeat superior*, so the nexus with the business was an allegation that the employees were acting within the course and scope of their employment. However, the Fifth Circuit said the origin of the claim was the employees' providing cocaine, not their employment by Jani-King. The settlement payment and related legal fees could not be deducted.

Indemnity Payment

There was also an indemnity payment involved in the tax dispute. Cavanaugh had personally contributed $250,000 to the settlement, which Jani-King reimbursed and then deducted. Jani-King claimed that its bylaws required it to reimburse Cavanaugh, making the payment deductible. The Tax Court read Jani-King's bylaws not to require indemnity, but to require it only when the person became involved in the controversy by reason of being a director, officer, or employee.

Even then, Cavanaugh would be entitled to indemnity if he was "wholly successful" in his defense. Partial success would make indemnification discretionary. Cavanaugh proved neither element, making the indemnity authorities simply irrelevant to the Tax Court. Notably, voluntary payments can sometimes be deductible when made to protect or promote a business.[19]

However, those voluntary payments could be deducted only when the company showed that the person for whom it was paying was unable to pay. Here, Cavanaugh was quite able to pay and had paid all the litigation costs and expenses. Thus, the Tax Court held that even the reimbursed $250,000 was not deductible.

Cavanaugh disputed this on appeal, arguing that the reimbursement was in Jani-King's best interests, that the corporation's bylaws made indemnification obligatory, and that Jani-King's primary motives for reimbursement were to protect its business and uphold its corporate obligations. The Fifth Circuit agreed with the Tax

[17] *See Kopp's*, 636 F.2d at 60-61; *Dolese*, 605 F.2d 1146. Each concentrates on the consequences of the litigation rather than on the underlying claim's origin. *See Kopp's*, 636 F.2d at 61 (focusing on the company's "direct exposure to the risk of a monetary judgment"); *Dolese*, 605 F.2d at 1151-1152 (focusing on the restraining order that arose out of a divorce action). The Fifth Circuit has repeatedly confirmed that it follows *Gilmore*, which has not otherwise been confined to its facts. *See Meade v. Commissioner*, 489 F.2d 161, 164 (5th Cir. 1974); *Marcello*, 380 F.2d 509 (5th Cir. 1967); *see also Northwestern Indiana Telephone Co.*, 127 F.3d 643 (applying *Gilmore* even though the taxpayer corporation was directly named in the underlying litigation).

[18] *See Kopp's*, 636 F.2d at 60; *Dolese*, 605 F.2d at 1149 and 1151-1152; *Naporano Iron & Metal*, 6 Cl. Ct. at 431; *see also IRS v. Heininger*, 320 U.S. 467, 469 (1943) (owner of mail-order false teeth business was deprived of access to the mails by a fraud order). Cavanaugh made no such showing.

[19] *See Lohrke v. Commissioner*, 48 T.C. 679, 684-685 (1967).

Court that the bylaws were clear and that the indemnity here was a matter of the board's discretion.

Cavanaugh argued that the settlement was necessary to protect Jani-King's business, not that the reimbursement payment was necessary. And he had not argued that he was unable to make the payment. The Fifth Circuit concluded that the Tax Court's finding that the suit did not arise in connection with Jani-King's profit-seeking activities was not clearly erroneous. The appeals court affirmed that all the payments were nondeductible.

Conclusion

Legal claims are often made against a company and its employees. As FedEx and Uber lawsuits have made clear, if a company's driver has a traffic accident, the company will probably be sued, even if the driver was an independent contractor. The origin of the claim may be a bad driving record, but whatever the facts, there can be little doubt that the basic activity is related to the business and to the conduct of business activity.

The same is sometimes true in sexual harassment litigation, despite the new nondeductibility of confidential settlements. If a supervisor harasses another employee, the conduct seems personal and outside the supervisor's scope of employment. However, it arises out of a working relationship and usually involves company property, business trips, and business activities.

The sexual harassment situation is a hotbed of employment litigation, and the tax changes that took effect in 2018 will take time to surface in tax disputes. Surely some tax cases will emerge in which companies will deduct legal fees and settlement payments despite some arguable sexual harassment element. Small allocations to those claims may well be tested.

However, outside the sexual harassment arena, *Cavanaugh* is a useful warning. Plainly, companies get sued frequently, and many things are deducted without question. But when the facts are egregious and there is little or no business connection, the fact that the company is named as a defendant may simply not be enough. ■