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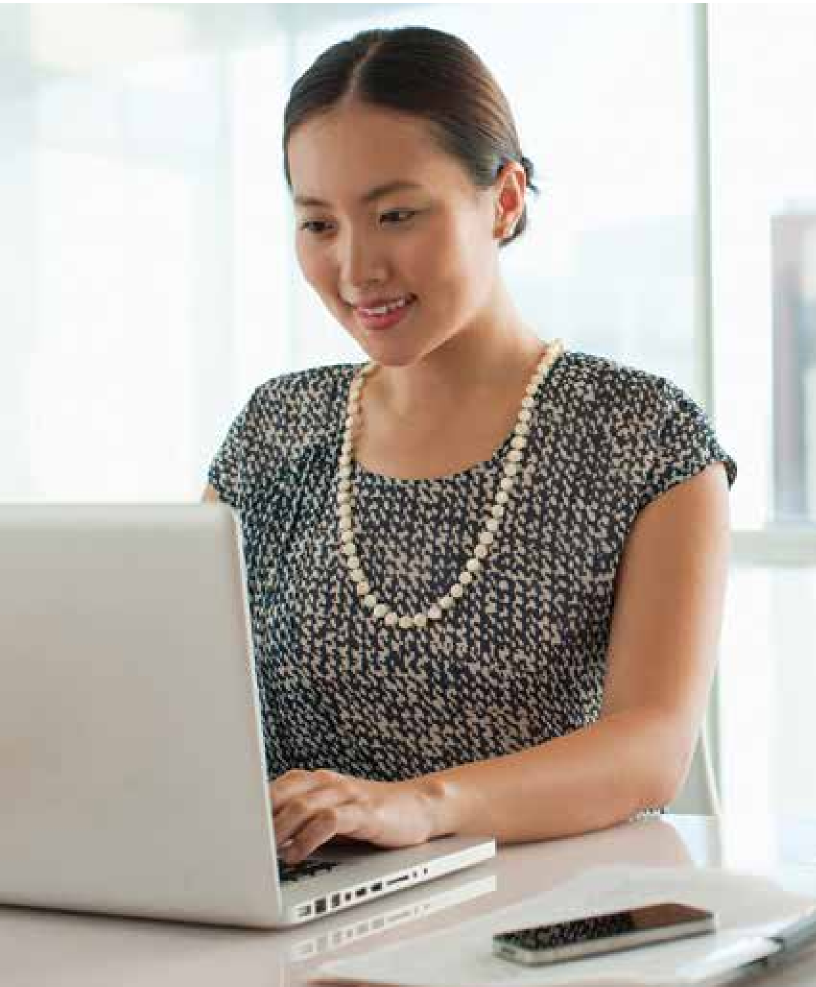
ADVOCATE'S EDGE



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AI rises to the forefront in law firm operations

Artificial intelligence (AI) is revolutionizing a diverse range of industries. The legal industry — with its volumes of available data — is no exception. Even the American Bar Association (ABA) has explicitly recognized the growing role for AI in the practice of law.

Is your firm up to date on these technologies? If not, you risk potentially falling behind more sophisticated clients and competitors.

ABA recognition

In August 2019, the ABA's House of Delegates approved Resolution 112, which urges courts and attorneys to address the emerging ethical and legal issues related to the usage of AI in the practice of law. The report recommending adoption of the resolution says AI will fundamentally transform the practice of law in coming years.

The report also stresses the importance of understanding how AI can be used in law practices. It suggests that, in the next few years, the use of AI will shadow the use of email, becoming indispensable to the practice of law. The report also notes that, as more business leaders embrace AI, they naturally will expect their outside counsel to follow suit.

Benefits for attorneys

Examples of ways that attorneys currently use AI to improve productivity and provide better legal services include:

- Electronic discovery / predictive coding,
- Litigation analysis / predictive analysis,
- Contract management,
- Due diligence reviews,
- "Wrong doing" detection,
- Legal research, and
- Detection of deception in the courtroom.

AI also enables several forms of analytics, including descriptive (identifying trends and analyzing behavior), predictive (forecasting the behavior of, for example, judges or expert witnesses based on past behavior) and prescriptive (providing advice on such decisions such as whether to settle or go to trial).

Chatbots are another AI tool that's taking hold in the legal industry. In 2016, a former Stanford University student made news with the release of a "robot lawyer" called DoNotPay that helps users contest parking tickets. Law firms can develop their own custom bots or other forms of AI that leverage their private data for similar straightforward matters, as well as for such basic tasks as initial client screening and conflict identification.

Applying AI at a law firm

According to the American Bar Association, artificial intelligence (AI) refers to tools that are *trained*, rather than programmed. Specifically, it "involves teaching computers how to perform tasks that typically require human intelligence, such as perception, pattern recognition and decision making."

AI encompasses a variety of different technologies, including:

Machine learning. This is an iterative process by which machines improve their performance of a specific task over time with little or no programming or human intervention. Machine learning can, for example, find relevant case law.

Natural language processing (NLP). NLP applies algorithms to analyze unstructured human language in documents, emails, texts, conversation or other forms. In the legal context, it can dramatically streamline the search for documents responsive to discovery requests.

Robotic process automation (RPA). RPA automates repetitive and time-consuming manual tasks that don't require decision making, using only business rules and structured inputs. It could, for example, draft common legal documents, such as contracts, interrogatories, subpoenas and motions.

What's more, attorneys can use AI to create more-accurate litigation budgets. Data analytics based on past cases and invoices allow them to better understand their likely costs for specific strategies. This is particularly critical for clients that require fixed-fee or other alternative-fee arrangements.

Ethical considerations

The ABA report points out that attorneys must be aware of how they can use AI to deliver client services in accordance with their professional ethics guidance. Several rules affect attorneys' use (or nonuse) of AI, including the:

Duty of competence. In 2012, the ABA expressly added the duty of technology competence to Rule 1.1, requiring attorneys to generally understand the technology available to improve the legal services they provide. As a result, attorneys must have a basic understanding of how AI tools operate, including risks and benefits of specific tools.

Duty to communicate. This includes discussing the decision to use AI with clients and obtaining informed consent before doing so. An attorney also might need to communicate the decision not to use AI if AI could potentially benefit the client. Failure to use AI could implicate the reasonable fees rule, too, if AI could save money.

Duty of confidentiality. AI tools might require attorneys to share client confidences with third-party vendors, so they must take appropriate steps to safeguard that information. Appropriate communication with the client and vendors also is necessary.

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Duty to supervise. This applies to nonlawyers, whether human or nonhuman. Attorneys must supervise the work of AI, including ensuring that the work product is accurate and complete and doesn't risk disclosing confidential information.

The future is now

Attorneys can't afford to ignore AI — ethically or financially. Get on board to remain competitive, but also remember to comply with applicable ethical requirements. Qualified professionals can help you accomplish both aspects effectively. ■

Beware of hidden business income and assets in divorce

When divorcing spouses own a private business interest, dividing up the marital estate can get complicated — even downright ugly. Sometimes the spouse who controls the business feels compelled to downplay profits or hide assets to protect his or her financial interests. That's why it's important to hire an experienced financial expert who knows the common tricks of deception and can bring a healthy dose of professional skepticism to the analysis.

Potential red flags

In divorce cases, experts must determine whether there are any special issues, such as the following:

- Is it a cash business that may have unreported income?
- Does the owner receive special (or excessive) perks or tax write-offs that affect the business's profitability?
- Are the numbers intentionally reported incorrectly to affect the business's value?

Another common problem with smaller businesses is that their owners tend to commingle personal and business funds. A financial expert may need to segregate business assets and expenses from personal items if the owners haven't maintained separate checking accounts, credit cards, loans and lines of credit.

> Sudden changes when a spouse is contemplating divorce may suggest unreported income or overstated expenses.

In addition, experts investigate whether the company has any subsidiaries or is part of any other business ventures. Sometimes, a business owner may be a silent partner in a business where ownership may not be obvious. These ownerships and involvements can substantially affect the value of a business interest.

Income statement analysis

The income statement details revenue received from customers and expenses incurred to generate that revenue. Historical patterns and trends should be evaluated. Deviations — such as excessive write-offs, withheld revenue deposits, a large one-time expense or a decrease in revenue with no related decrease in variable expenses — require investigation.

Experts try to determine the cause of any anomalies. Sudden changes when a spouse is contemplating divorce may suggest unreported income or overstated expenses. But these changes could also be due to external forces, such as the loss of a major salesperson or adverse market conditions.

When evaluating expenses, experts often focus on the amounts paid to owners and other related parties. These may include payments for compensation, benefits, rent, management fees, and company vehicles and other perks. The owner-spouse also might try to flush personal expenses through the business. Examples include nonbusiness meals and travel expenses, the cost of home renovations and attorneys' fees for services unrelated to the business (such as fees related to divorce proceedings).

Eyes on the balance sheet

A dishonest controlling shareholder could try to hide assets (for example, in an offshore account) or transfer them to a related party for less than market value. Inventory is particularly susceptible to manipulation, depending on the method used to value it. For example, a construction company could alter its percentage-of-completion estimates to make the company look less profitable. Or a retailer could write off excessive amounts for theft or damaged goods.

Notes payable to shareholders can be legitimate business transactions. But they also may be used to conceal income being distributed to the controlling shareholder. For instance, an owner of a company might stop taking a paycheck to affect alimony calculations. Instead, the company would report payments to the owner-spouse as a "shareholder loan."

Experts look under the equity section of the balance sheet for any changes in the company's ownership after the parties filed for divorce. They also search for suspicious withdrawals or distributions from capital accounts. Controlling owners may sometimes attempt to transfer ownership of a business interest to deprive their spouses of a portion of the asset or a portion of the business's income. These transfers typically involve related parties, such as close friends or business associates, at below-market prices.

Need help?

Examining financial issues with professional skepticism will help fortify your expert's conclusions. The results of the investigation may lead to adjustments to reported numbers that affect the division of marital assets, the value of businesses and support calculations. Discuss any concerns or special issues with your expert. ■

4 common payroll fraud schemes

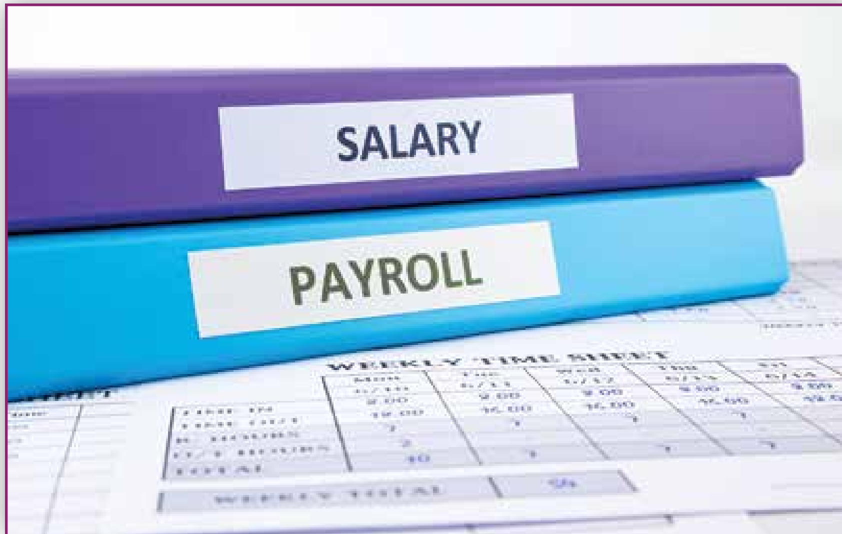
Dishonest employees may test the waters with payroll scams before they attempt bigger, bolder fraud ploys. In hindsight, these crimes may seem easy to catch. But weak internal controls can cause them to go on for months — or even years. In fact, the average duration of payroll scams was nearly three years, according to the Association of Certified Fraud Examiners. Knowing how these crimes are committed is the first step to lowering a company's risk. Following are four common schemes.

1. Doctored hours

Probably the oldest and most straightforward payroll fraud scheme is lying about the number of hours worked. Hourly employees may misrepresent their time on the job and falsify their compensation rates — for example, when they claim they're owed overtime pay.

In companies that use manually prepared timecards, an employee may forge a supervisor's signature or collude with a manager and agree to split the proceeds of the fraud. In companies that use automated systems, employees may rely on co-workers or a supervisor to enter timecards when the employee isn't at work.

Although the process of cheating is more difficult for them, salaried employees can also arrange to receive compensation they don't deserve. These



frauds require access to personnel files and the ability to change pay rates.

2. Ghost employees

There's nothing supernatural about ghost employees. In this frequently seen fraud scheme, a fictitious employee (or an actual person who doesn't work for the company) receives regular paychecks.

Usually that person works in accounting under lax supervision and arranges to have the paycheck of the "ghost" deposited into an account set up for the purpose. If the ghost employee is a real person — say, a friend or relative of the perpetrator or a terminated employee — paychecks may go directly to them.

3. Commission fraud

Commission fraud schemes involve falsifying sales so that an employee receives an unearned commission — or a commission at a higher rate than sales numbers warrant. How the perpetrator manipulates sales figures and commission rates varies by industry and the employee's access to employer records.

If an employer pays commissions based on sales captured via a point-of-sale system, the employee may commit fraud simply by entering a fictitious sale. On the other hand, if the sales department must generate invoices, an employee might invent a document trail that includes fake purchase orders, shipping records and invoices. At the same time, the employee may inflate sales and commission rates to boost the amount of payments he or she will receive.

4. Direct deposit redirect schemes

Direct deposit redirect schemes are more likely to be perpetrated by outside parties, rather than employees. In these cases, thieves may send emails to an HR or payroll department staffer that appear to come from the company's CFO or another executive. The email states that the executive wants to change the bank account the company uses to direct deposit employee paychecks. Of course, the new account is under the control of the fraud perpetrator.

> Hourly employees may misrepresent their time on the job and falsify their compensation rates.

These official-looking emails generally request that the account change be made immediately. The criminal hopes to intimidate the recipient into acting quickly, without asking follow-up questions that would expose the scheme.

Staff training

In-house training sessions on common fraud ploys can help deter fraud in two ways. First, they educate managers and frontline workers about potential red flags and how to report suspicious activity. Second, fraud training sends a powerful message to employees that management is serious about fraud prevention. This can help reduce the perceived opportunity for employees to steal from their employers. ■

Doyle v. Commissioner

Taxpayer can't reduce taxable settlement for pain and suffering

Internal Revenue Code Section 104 lays out the proper tax treatment for damages for injuries or illness received as the result of a lawsuit. However, in a recent U.S. Tax Court case, a taxpayer tried to get around the rules by taking what the court described as "some weird deductions" to offset payments for emotional distress.

What was the original dispute?

The case grew out of a wrongful discharge lawsuit. Following his termination, the taxpayer suffered several physical ailments that were the result of emotional distress.

The parties settled that case, with the employer paying $350,000 for the taxpayer's "alleged unpaid wages" and $250,000 for his "alleged emotional distress" in two installments. The employer issued a Form 1099 to the taxpayer for each of the two emotional distress payments.

The taxpayer reported the payments on Schedule C, "Profit or Loss from Business," of his 2010 and 2011 federal income tax returns. In 2010, he offset the entire payment with deductions for "legal and professional services" and "personal injury." The 2011 payment was offset by a $125,000 deduction for "pain and suffering." After an audit, the IRS issued a notice of deficiency.

What did the Tax Court decide?

The taxpayer asserted that the emotional distress payments were excludable from income under Sec. 104. But, as the Tax Court noted, that provision excludes only damages "on account of personal physical injuries or physical sickness." In a settlement situation, the court considers the nature of the settled claim to determine if exclusion is appropriate.

The settlement agreement with the taxpayer made clear that the payments at issue were for emotional distress damages. Under Sec. 104, though, emotional distress isn't a physical injury or sickness. Moreover, the court said, case law dictates that emotional distress includes resulting symptoms, such as insomnia, headaches and stomach problems.

The court therefore concluded that the payments weren't excludable from income under Sec. 104. Accordingly, any "unusual deductions" the taxpayer took to offset them were disallowed.

How can taxpayers avoid accuracy-related penalties?

The taxpayer underpaid due to a "substantial understatement of income tax" (generally, an understatement greater than $5,000 or 10% of the required tax). However, he escaped any accuracy-related penalties because the court ruled that he reasonably and in good faith relied on the advice of a CPA. The court explicitly recognized that the line between excludable and includable under Sec. 104 is "a thin one," and that some uncertainty exists regarding when physical manifestations of emotional distress constitute physical injury or sickness. Thus, "even erroneous professional advice about that is good enough to prove reasonable cause." ■

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