

## VALUE ADDED™ Fall, 2002

Superior Courts of Pennsylvania & New Jersey  
Consider Value of Law Firms

Two recent cases considered the value of an interest in a law firm. In *Lewis J. Capozzi, Jr. v. Latsha & Capozzi, P.C., et al*, 2002 PA Super 102, ([http://www.courts.state.pa.us/OpPosting/Superior/out/a07045\\_02.PDF](http://www.courts.state.pa.us/OpPosting/Superior/out/a07045_02.PDF)), the Pennsylvania Superior Court considered whether an oral agreement among stockholders of a law firm to value the stock of the departing shareholder who competes with the firm after withdrawal at the amount of his initial capital contribution was appropriate.

*Latsha & Capozzi, P.C.* was founded by the petitioner and another in 1994. Both partners contributed \$5,000 for their stock. The firm's revenue grew from \$300,000 in 1994 to \$2.6 million in 1996.

The partners entered into an oral agreement, which valued their stock at the amount of their initial capital contribution, \$5,000, should the departing shareholder compete upon his withdrawal. In 1997, Capozzi, holding a 37.5 percent interest in the corporation, withdrew and began competing. He brought suit against the corporation, claiming the valuation agreement was an unenforceable agreement. The Court agreed and the corporation appealed.

On appeal, the Superior Court affirmed the trial court. It stated, "We hold that a forfeiture for competition clause is enforceable in Pennsylvania for lawyers. The clause, must still, however, meet the applicable standard for restrictive covenants. Our courts have held that a restrictive covenant (1) must be ancillary to the main purpose of a lawful transaction, (2) reasonably necessary, (3) supported by consideration, and (4) application must be limited as to duration of time and territory." The Superior Court found that the oral agreement violated the second and fourth prong of that analysis. It found the forfeiture clause unreasonable in light of the growth and revenue of the firm. It further noted that since the oral agreement was not limited in either time or territory, it was unenforceable. The Court ruled Capozzi was entitled to a trial to determine the value of his stock as of the date of his departure.

In *Neslon v. Craner et al*, No. SOM-L-1098-01 (N.J. Super. Somerset County April 5, 2002, the New Jersey's Superior Court, Somerset County, considered whether the value for stock in a law firm, as set forth in the firm's shareholders agreement, should be enforced against a shareholder who committed a breach of fiduciary responsibility.

Nelson held a 25 percent interest in the law firm. This stock was subject to a shareholder's agreement. Under the agreement, the redemption price of the stock during the life or at the death of a shareholder was the value of the firm's tangible and intangible (including goodwill) assets as a going concern. The agreement called for the stock to be valued annually, but in the event a valuation was not performed, the most recent valuation which occurred under the shareholders' agreement, would control. The stock was last valued under the shareholders' agreement in 1988 at \$24,000 per share. The firm purchased life insurance on the shareholders to cover the repurchase of the stock in the event of death.

In 2000, the firm discovered that Nelson had fraudulently been making payments to himself from the firm's trust account. The firm and Nelson then disassociated. Nelson set up a competing practice, bringing with him many of the firm's former clients. The firm then sent Nelson \$31,027.91, an amount representing Nelson's share of the book value of the firm's assets. Thereafter, Nelson brought suit against the firm.

Nelson claimed the firm breached the shareholders' agreement by failing to purchase his interest in the firm. He claimed the firm owed him \$600,000 for his interest based on the \$24,000 per share valuation set forth in the agreement. The firm argued that the amount set forth in agreement was solely for death benefits because redemption was to be funded with life insurance.

The Superior Court agreed in part with Nelson. Looking to the shareholders' agreement, it found that the agreement clearly valued the stock at \$24,000 per share. With regard to the firm's argument, it found that "the Court thus concludes that, while it may appear that the shareholders did not adequately make provision for payment of a stock redemption except in the case of the stockholder's death, this lack of

foresight does not excuse defendants from the duty to pay to which they contracted." However, it permitted an offset of redemption price by the amount already remitted to Nelson.

The Superior Court, however, noted the inequity of permitting Nelson to recover the value of his interest as set forth in the shareholders' agreement while taking many of the firm's clients with him to his new practice following his breach of fiduciary duty. It determined that "the value of plaintiff's stock in the corporation must be reduced by that amount that he has benefited by taking clients and viable business opportunities away from the firm. An accounting of plaintiff's new law practice is therefore necessitated so that it can be determined what value plaintiff has taken from his former partners by opening his new practice." The court further determined that any punitive damages awarded resulting from Nelson's breach of fiduciary duty should be offset against the redemption price. The Superior Court ordered the case to proceed with discovery regarding the value of Nelson's practice and the amount of punitive damages.

#### Financing Issues in the M&A World

"Now that money is cheap, why is it so hard to get?" is a common question in the M&A world -- especially among financial buyers. The reality of today's marketplace is: interest rates are low; the economy appears to be improving although this may be suspect because information seems to be changing on a daily basis; and deal flow seems to be picking up, but the quality of the deals may be somewhat average. Many are convinced that the better deals are on the sidelines until sellers can achieve their expectations.

Lenders are also providing insights into the financing of transactions. The same observations discussed here generally apply to refinancing of businesses as well. Recently, lenders are:

- \* More focused on asset-based loans in today's market than on cash flow loans;
- \* Looking more closely at the coverage ratios;
- \* Not willing to take the risks that they once did, thereby making it more difficult to close the deal;
- \* Insisting on outside appraisals of the actual assets they are lending against to further verify the underlying value. These appraisals can dictate the loan amount;
- \* Typically lending at some percentage of orderly liquidation value which further depresses the ability to get a deal done.

If you consider those financial buyers that are insisting on receiving the same returns that were available during the 90's bull market in the context of the current lending environment, you will understand what is happening in the marketplace. So, what are the options for getting a deal done in today's market?

- \* Put more real equity in the deal;
- \* Ask the seller for better terms or to finance more of the deal; and/or
- \* Work with lenders to get more of a stretch piece if cash flow is strong. Some lenders might be able to stretch up to 10% to 15% of an asset-based deal if they are comfortable with the asset quality.

What can we expect going forward? Lending should loosen up because of the availability of money, but probably not at the late 90s and early 2000 levels. Deal flow should also pick up as expectations adjust to the reality of the current marketplace. Equity groups and lenders have funds available to invest. If sellers can come to terms with the current reality, equilibrium will return to the marketplace and deals can get done.

#### Divorce Engagements and Valuation Terms

Most advisors to divorcing parties know the importance of early involvement by a qualified valuation professional. Defining the engagement and understanding the requirements of the work product is crucial. Unfortunately, there may be a lack of understanding as to what a "valuation" is. In fact, depending on the circumstances of a given situation, there are different products and services that may fit the need. Report documentation, analytical procedures and assumptions, and fee structure can be greatly affected by the nature of the chosen product or service. For the purpose of this article, we will focus on "limited appraisals" and "valuations or full appraisals."

**Limited Appraisal.** A limited appraisal is "the act or process of determining the value of a business, business ownership interest, security, or intangible asset with limitations in analyses, procedures, or scope."\* Limited appraisals can substantiate value, but are not typically called a "valuation." Because in

many cases limited appraisals do not require an on-site inspection, extensive industry and market research, or detailed documentation, they can save time and expense. However, limited appraisals can be elevated to a valuation (or full appraisal) when formality and completeness is needed for the Court or in response to the scope of an opposing expert's work.

Valuation (Full Appraisal). A valuation is "the act or process of determining the value of a business, business ownership interest, security, or intangible asset."\* A valuation requires, among other things, an onsite visit with company management, extensive industry and economic research, and collection and analysis of all information expected to be relevant to the valuation.

The valuation process involves defining the engagement, collecting and analyzing financial and business information, researching relevant valuation data, developing the valuation, and communicating the result via an agreed upon level of documentation and/or testimony. We encourage divorce attorneys to be rigorous in selecting valuation experts. Educated consumers of valuation services enhance the quality of service ultimately delivered to the client. If you have any questions about the services we provide, please do not hesitate to call us.

\*International Glossary of Business Valuation Terms, 2001. AICPA, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and the Institute of Business Appraisers.

Date of Distribution is Appropriate Valuation Date

In *Mary Nagle v. Gary Nagle*, 2002 PA Super 155 filed on May 16, 2002 ([http://www.courts.state.pa.us/OpPosting/Superior/out/a03021\\_02.PDF](http://www.courts.state.pa.us/OpPosting/Superior/out/a03021_02.PDF)), the Pennsylvania Superior Court considered the appropriate valuation date for a closely held business in a divorce action.

Mary and James Nagle, Gary's parents, were married in 1942. In 1971, James started a used truck parts business. In 1972, James and Mary separated. Shortly after the separation, James incorporated the business. In 1988, James gifted each of his two sons a 10 percent interest in the corporation. Mary Nagle filed for divorce in 1994. In early 1995, James transferred the remaining interest in the business to Gary, who had been employed in a managerial role, for no consideration. Mary alleged that the business was marital property, and James fraudulently transferred the business to Gary.

The family court agreed and joined Gary to the divorce action. It found that the business was incorporated using marital property. It further found that the incorporation and the transfer of the controlling interest to her son was an attempt to frustrate her interest in the business. The family court, over the objection of Gary and James, valued the business as of the date of distribution and awarded that amount to the marital estate. In doing so, it imposed a constructive trust on the 80 percent interest transferred to Gary and ordered Gary to pay his parents the value of the stock. Gary appealed.

On appeal, Gary challenged the lower court's selection of the valuation date. He argued that a more appropriate valuation date would have been the date of separation because the business grew as a result of his and his father's post separation efforts. The Superior Court disagreed. It noted that the lower court has the discretion of setting the valuation date that "best effectuates economic justice between the parties." It stated, "The distribution date is a preferred date for valuing assets for purposes of equitable distribution and since the business clearly was capable of being valued as of the date of distribution, there is no need for that preference to be disregarded."

Corporate Reform Update: Sarbanes-Oxley Act

With much fanfare, Congress passed and the President recently signed the Sarbanes-Oxley Act of 2002. The new securities legislation intends to curb weaknesses in laws, regulations, and oversight believed to have contributed to the recent spate of less than admirable disclosures of corporate accounting and governance shortcomings. Accountants and accounting firms bear the brunt of the legislation, as about half of the bill is devoted to the new Accounting Oversight Board and auditor independence issues.

The Accounting Oversight Board is given seemingly broad authority to adopt standards governing attestation procedures, audit quality control, and auditor ethics, responsibilities formerly performed by committees of the American Institute of Certified Public Accountants. However, the Accounting Oversight

Board can incorporate standards previously adopted by other professional organizations into its rules.

The auditor independence regulations stiffen the rules adopted by the SEC in 2001, as indicated in the following chart that compares the new securities act to the SEC's rules. The most significant new limitations on non-audit services appear concentrated in the areas of systems design and implementation and internal audit services. Accounting firms apparently escaped a requirement to rotate clients every few years. Instead, the firm must replace the engagement partner after five years.

Sections of the legislation concerning corporate officers focus more on exacting new or tougher penalties for malfeasance, rather than creating large-scale revisions for accounting firms. CEOs and CFOs must certify financial statements in a form paralleling a standard audit opinion; that is, the company's financial statements "present fairly, in all material respects" its financial position and results of operations. In addition, Section 1001 of the Act recommends that the federal income tax return of a corporation be signed by the CEO of such corporation, which may subject the CEO to other potential tax penalties if a fraudulent tax return is filed.

Given the recent events concerning noted public companies, many people are nervous. This corporate responsibility legislation is an attempt to calm the markets. We note that the vast majority of firms and people that are addressed by this Act are reputable and concerned with what is best for their clients and their employees.

#### Comparison of Public Company Accounting Reform Act of Act of 2002 to SEC Auditor Independence Rules

	Statute	SEC
Rules		
Bookkeeping Services Impairs Independence	Prohibited	
Systems Design & Implementation Impairs Independence if auditor is in the position of making managerial decisions	Prohibited	
Appraisal of Valuation Services Impairs Independence	Prohibited	
Fairness Opinions Impairs Independence	Prohibited	
Actuarial Services not Impairs Independence, except for some insurance company matters	Prohibited	Does
Internal Audit Services Impairs Independence is audit firm performs more than 40% of internal audit work	Prohibited	
Management Functions Impairs Independence	Prohibited	
Human Resources/Recruiting Impairs Independence	Prohibited	
Broker/Dealer, Underwriting Services Impairs Independence	Prohibited	
Corporate Finance Consulting not Impair Independence in certain circumstances	Prohibited	May
Legal Services Impairs Independence	Prohibited	
Expert Services Not Impair Independence	Prohibited	Does

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