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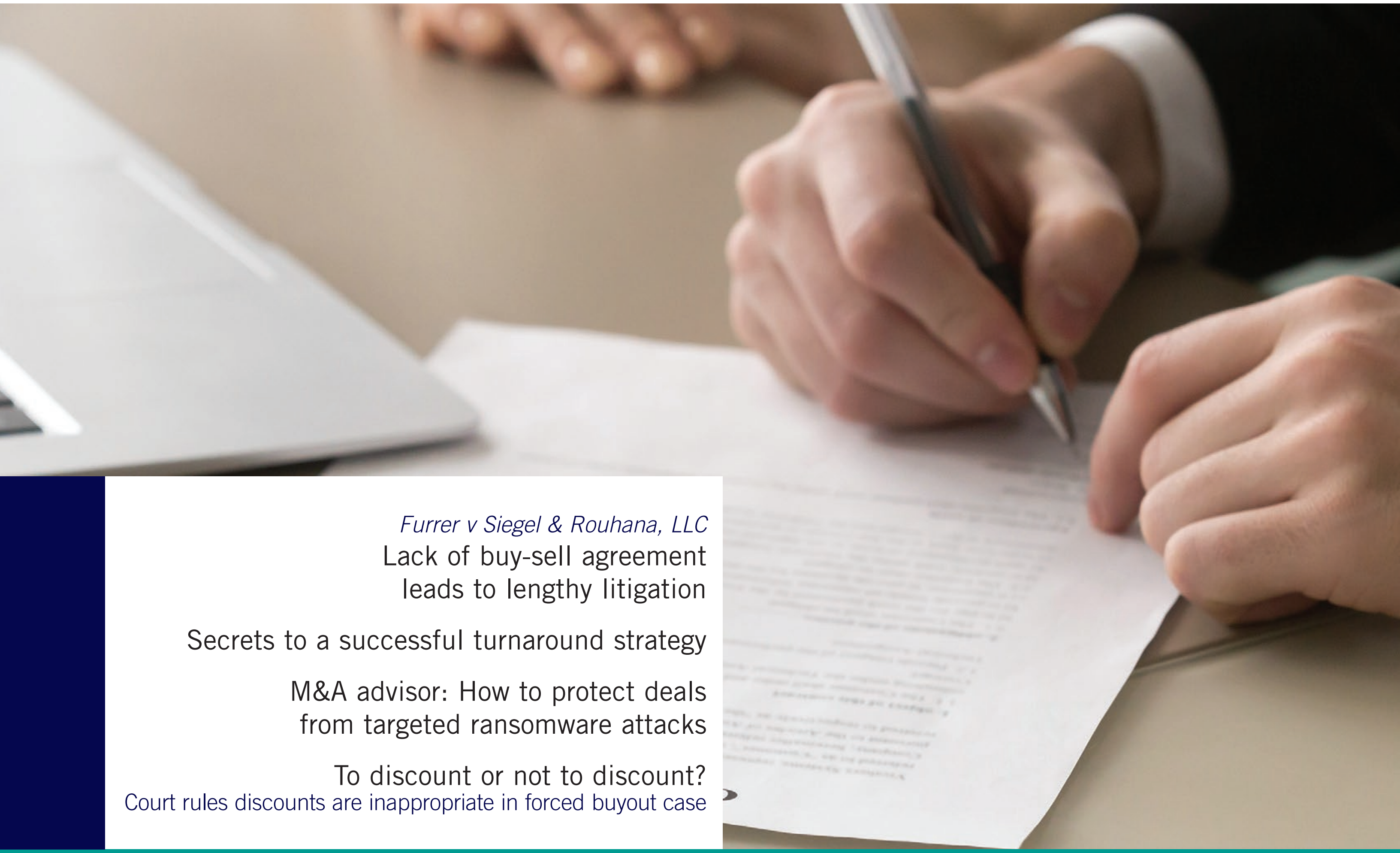
LITIGATION SUPPORT



Furrer v Siegel & Rouhana, LLC

Lack of buy-sell agreement leads to lengthy litigation

A law firm without an operating or buy-sell agreement wound up in a protracted court battle when an owner withdrew after the other owners discovered he had mishandled cases and clients. The case is a powerful illustration of how costly disputes can be preempted with an effective buy-sell agreement.

Misconduct prompts member withdrawal

The owner who brought the case was one of five attorneys in a limited liability company (LLC) that had neither a written nor an oral operating agreement. He held a 26.5% interest in the firm. Each LLC member received $10,000 per month in "guaranteed payments." They agreed that income from legal services fees would be aggregated regardless of what individual members generated. The aggregate fees would be distributed as quarterly profits according to each member's ownership percentage in the firm.

> The plaintiff's withdrawal changed him from a *member* with an economic interest to an *assignee* of that interest.

In January 2017, the members discovered a $3,000 personal check the plaintiff wrote to a client from his personal bank account. An adjuster subsequently found that there was no known settlement in the client's case and the last noted activity had been in 2010. The plaintiff admitted that he'd "self-settled" the case with his own money to preempt a complaint from the client about the delay in resolving the claim. Malpractice counsel advised the firm that he'd committed fraud against the client, so the other members asked him to leave. The plaintiff withdrew from the LLC and was eventually suspended from practicing law indefinitely.

Remaining owners see a pattern

The four remaining members unearthed a pattern of problems involving the plaintiff after his departure. In one instance, the firm's malpractice insurance company settled a claim involving the plaintiff for almost $600,000. Notably, though the firm didn't dissolve after the plaintiff's withdrawal, it didn't purchase

Build a better buy-sell agreement

A buy-sell agreement is generally advisable, but it doesn't necessarily ensure a smooth transition when an owner leaves a business. Disputes often arise over the value of a departing owner's business interest — especially if the agreement relies on a formula to establish the amount.

Predetermined buy-sell agreement formulas tend to be oversimplified and backward-looking. For example, a formula might base value on a multiple of past earnings, ignoring critical factors such as the business's risk premium, future growth, prevailing economic conditions, and other factors that may require professional judgment and analysis. The result? It may not accurately capture current market value.

A more reliable approach is to include a clause in the agreement which requires a full independent valuation. Such a valuation determines an objective, unbiased fair market value of the subject interest. An agreement could provide for hiring a joint valuation expert, or it might require that both sides retain their own experts. If the experts' conclusions vary by, say, more than 10%, a third expert could be required to settle the difference. The agreement also should specify who will pay the valuation fees — the buyer, the seller or the company.

his interest. The LLC made distributions only to the remaining members for 2017, 2018 and 2019.

Two years after his departure, in January 2019, the former member sued the firm, seeking compensation for his ownership interest. He claimed that the fair value of his interest was 26.5% of the total value of the firm's current assets on his withdrawal date, less current liabilities — with no discounts for lack of control or marketability.

Courts come to different conclusions

Because the firm didn't have an operating or buy-sell agreement, the courts turned to Maryland's LLC law. That statute defines "economic interest" as a "member's share of profits and losses … and the right to receive distributions."

The trial court found that the plaintiff had an ongoing economic interest in the firm's post-withdrawal profits, losses and distribution. It then concluded that he was entitled to 26.5% of the firm's profits in 2017, before he lost his license — about $85,000.

The Court of Special Appeals of Maryland disagreed. It concluded that the plaintiff's withdrawal changed him from a *member* with an economic interest (that is, a current right to share in the LLC's profits, losses and distributions) to an *assignee* of that interest (with no membership interest in post-withdrawal profits, losses and distributions). As such, he had the right to share only in the LLC's assets, liabilities, profits, losses and distributions that existed on the withdrawal date — what the plaintiff originally sought, before the trial court weighed in.

The appeals court said that the trial court's interpretation of the LLC law would give the withdrawn member a "perpetual share" in the profits of a firm to which he has since contributed nothing. The court noted, too, that his professional misconduct resulted in indefinite suspension of his right to practice law, as well as civil claims against the law firm. It also highlighted the ethical problems related to fee-sharing with a non-attorney.

Preempt the risk

The appellate court acknowledged the "bare bones" rights and procedures governing withdrawal provided to LLCs under the state statute. But it pointed out that LLC members who want more certainty or different rights and procedures can adopt an operating agreement that lays out more specific terms. Having failed to do so, the court said, the parties couldn't now complain about the consequences of that decision. ■

Secrets to a successful turnaround strategy

The COVID-19 pandemic took a toll on many businesses, from restaurants and boutiques to entertainment venues and hotels. However, companies that were able to hunker down and save cash during the economic downturn may be in a position to buy competitors that are in financial distress — and revitalize them.

Turnaround acquisitions can yield sizable long-term rewards. But acquiring a troubled target can also pose greater risks than buying a financially sound business. Fortunately, a business valuation advisor can help reduce such risks.

Find hidden gems

Prospective turnaround targets may have untapped value-building opportunities — such as untried territories, poor leadership and outdated strategic plans — that a buyer can tap into. However, those opportunities will need to provide enough financial benefits to offset acquisition risks. If the deal will be financed, the lender may also want to verify that the potential deal is financially sound. In addition, a distressed business may have undisclosed or hidden assets which may have synergistic value.

Buyers need to comprehend their target company's core business — specifically, its profit drivers and roadblocks. Without a clear understanding of this, the company's financial statements and financial condition are likely to be misjudged, ultimately resulting in an ineffective course of rehabilitative action. That's why many successful turnarounds are conducted by corporate buyers in the same industry or private equity funds that specialize in a particular sector.

Kick the tires

Due diligence is a critical part of any acquisition, but it's the make-or-break stage of a turnaround deal. Due diligence can help pinpoint the source of the target's distress (such as maturing products, excessive costs or overwhelming debt) to determine what, if any, corrective measures can be taken. The success of a deal also may be hampered by unreported liabilities — such as pending legal actions or tax investigations — beyond those reported on the financial statements.

Due diligence can unearth unreported sources of potential value, such as tax breaks or proprietary technologies, too. Benchmarking the company's performance with its industry peers' can help reveal where the potential for profit lies.

Devise a plan

Turnaround plans may include cost-cutting measures, asset sales and debt restructurings. So, before the deal closes, the buyer must assess which products drive revenue growth and which costs hinder profitability. Does it make sense to divest the business of unprofitable products, services, subsidiaries, divisions or real estate? Can staff be cut to save costs?

It's also important to decide who will serve as the chief restructuring officer (CRO). Independent outside CRO candidates not only offer fresh ideas and experience, but also add credibility to the company's turnaround plan. CRO is a *temporary* position that leads the rest of management on the road to recovery. The CRO's initial priority is creating daily cash budgets. By taking control of cash disbursements, the CRO alleviates the imminent crisis, enabling the management team to chart a short-term action plan.

Implementing a long-term cash-management plan is also critical. Each line item of the acquisition's weekly or daily receipts and disbursements can be managed according to profit and loss projections, changes in working capital, and major debt and capital expenditures. A strong cash-management plan, along with a thorough evaluation of accounting controls and procedures, can help identify lost revenue opportunities, such as unbilled services. The buyer may even be able to pinpoint costs that can be reduced — or eliminated altogether.

Track results

Turnaround plans require continuous monitoring and occasional tweaks. If the company's accounting systems don't accurately list all assets and liabilities and capture all transactions in a timely manner, it's impossible to track progress and fully pursue growth opportunities or respond to potential problems.

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One troubled manufacturing company, for example, wasn't tracking future purchase commitments. After the company was acquired, the new owner prepared and circulated among managers a comprehensive commitment and contingency report that helped senior management renegotiate terms of the customer agreements.

Ready, set, buy

Turning a financially distressed company around is a tall order. A valuation professional can help develop a strategic plan to enhance revenue growth, improve cash flow and build long-term value. ■

M&A advisor: How to protect deals from targeted ransomware attacks

After a three-year lull, merger and acquisition (M&A) volume is expected to rebound to pre-pandemic levels in 2023, according to a recent survey by Citizens Bank. The survey also found that sellers are increasingly seeking guidance from financial professionals to maximize purchase prices. However, there's a new reason for sellers to seek outside advice — to lower the risk of ransomware attacks.

Key findings

Citizens Bank surveyed private equity firms and C-suite executives of U.S. middle-market companies with between $50 million and $1 billion in annual revenue. The results were published in the report, "Citizens 2023 M&A Outlook: Optimism cuts through the headwinds."

M&A volume slumped during the pandemic due to economic uncertainty and concerns about rising prices and interest rates. However, survey participants were cautiously optimistic about M&As in 2023. The survey concludes, "With buyers on the lookout for growth, high-performing sellers could continue to have an edge." It found that 32% of prospective sellers in 2023 plan to hire an outside M&A advisor to help negotiate a higher price. In the 2022 survey, only 18% of sellers expressed an interest in seeking M&A advice from outsiders.

New fraud scheme

Maximizing the purchase price isn't the only reason for a seller to hire an M&A advisor. An emerging fraud scheme has put sellers on the defensive. According to a recent notification from the FBI, ransomware perpetrators are now hacking into the systems of companies negotiating deals and then threatening to release confidential data.

Fraudsters typically gain access to the company's data through trojan malware. After criminals retrieve sensitive, nonpublic information — such as the asking price, financial and personnel records, and confidential emails — they may threaten to go public with it, unless the company pays a ransom. Any information that paints a company and its activities in a bad light can make investors nervous and more likely to derail a transaction. Perpetrators of ransomware attacks understand this, which is probably why the risk of being hacked generally rises when companies engage in M&As.

Prevention tips

It's important for sellers, especially those involved in high-profile deals, to be proactive about preventing and mitigating the effects of a ransomware attack. The FBI recommends that companies:

- Back up critical data regularly,
- Use the cloud or an external storage device to protect backup data,
- Install anti-virus and anti-malware software updates and patches,
- Allow employees to connect their devices only using secure networks,
- Train employees to prevent ransomware attacks, and
- Adopt multifactor authentication and authenticator apps rather than email.

Many companies also implement least-privilege policies and update permission levels when workers change positions or leave the company. If an attack happens, the FBI discourages victims from paying the ransom or negotiating with perpetrators. However, this is a complicated and legally fraught issue. You should involve IT security experts, legal counsel and financial advisors in your decision-making process.

Ask a pro

An ounce of prevention pays off when the deal closes. In addition to getting the books and records in shape, a forensic expert can help fortify the company's defenses against targeted ransomware attacks. And, if an attack does occur, outside experts can help evaluate whether to ignore or meet the hackers demands. ■

To discount or not to discount?

Court rules discounts are inappropriate in forced buyout case

New Jersey law allows adjustments for lack of control and lack of marketability in certain fair value situations. However, the New Jersey Superior Court found that a forced buyout involving a partnership that owns a shopping mall wasn't one of them.

Partners want out

In 1987, a mother and son executed a partnership agreement with the stated purpose "to acquire the land and premises" of a mall "and thereafter hold, lease, manage, and operate the same as a shopping center." Almost 30 years later, several partners who subsequently purchased minority shares submitted a notice of dissociation and withdrawal from the partnership.

> When valuing a dissociated partner's interest, a court can opt to apply discounts, depending on what's fair and equitable.

The dissociated partners had received no distributions while they owned their partnership interests. They advised the partnership that, under state law, it was required to purchase each plaintiff's interest for the fair value as of the withdrawal date.

Trial court decision upheld

A trial court determined that the fair value of each 1% interest in the partnership was $10,246.36 on a controlling, marketable basis. On appeal, the defendants argued that discounts for lack of control and marketability should have been applied to the plaintiffs' interests.

The appellate court conceded that, when valuing a dissociated partner's interest, a court can apply discounts, depending on what's fair and equitable.

According to the defendants, discounts were appropriate in this situation because the plaintiffs had wrongfully dissociated from the partnership.

The appellate court rejected this assertion, pointing out that the partnership agreement didn't expressly prohibit a partner from dissociating. However, the court acknowledged that wrongful dissociation also could happen if a partnership is for a definite term or particular undertaking and the partner withdraws before the term expires or the undertaking is completed. Therefore, the threshold inquiry was whether the partnership was 1) at-will, or 2) established for a definite term or a particular undertaking. The partnership agreement here didn't specify a duration, so the appeal hinged on whether the partnership was formed for a particular undertaking.

The defendants contended that the partnership was intended to last until the mall was sold. But the partnership agreement clearly stated that the partnership's purpose — or undertaking — was to acquire the mall and operate it. Because the agreement didn't mention any purpose, intent or requirement to sell the mall, the court concluded that it was a partnership at-will.

Beyond control and marketability

The propriety of valuation discounts can turn on facts other than an interest's relative marketability and degree of control. Work closely with valuation experts to ensure the case you present supports their decisions. ■