

The Accountant/Attorney Liability Reporter

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Fair Value Opinion Engagements

By John B. Connarton, Jr., P.C.

WHETHER THE ISSUE IS PREPARING FINANCIAL STATEMENTS OR raising capital, accurate valuations, which are credible and well substantiated, are a necessity. Credible asset valuations accelerate and drive informed decisions in all market conditions. Referring to prevailing market prices to determine an asset's value might work for some assets, while not for others where a market is illiquid. Difficulties also arise since depressed market values don't necessarily reflect the intrinsic value of the company's assets. Companies need accurate valuations to ensure the financial statement numbers are defensible. Raising capital needs support for future cash flow projections. Negotiating lending terms needs verification of financial ratios.

Assessing a company's fair value requires that the valuator go back to the basics and analyze a company's fundamentals. Cash flow projections must be examined as well as management's track record, the extent of the company's tangible and intangible assets and intellectual property, historical and anticipated rates of return and potential competitive advantages. Such a fair value opinion must be based upon industry standard valuation methodology. In short, such an evaluation must include:

- An assessment of the management team
- An assessment of the science, technology and products of the company
- An analysis of the company's business model in the current market environment
- A summary of key risk factors and future potential
- Implications of further strategic development
- Analysis of the value drivers for successful development
- All assumptions used for the valuation

Reliability of such a fair value opinion would be expected also to require that the calculation of the company's value be made using multiple, different, accepted methods.

Preparing a fair value opinion of a particular biotech product requires similar rigorousness and a detailed calculation of a risk adjusted net present value for the company as licensor and any potential licensees. Such a valuation must also be

based upon industry standard valuation methodology which may also be required to apply to various clinical development stages. Various scenarios must be analyzed including the possible use of Monte Carlo assumption techniques. The analysis must also include both current value indicators as well as forecasts of the future value of the product following a successful completion of various development stages.

In recent years, the accounting industry has been called upon to become increasingly more involved in the preparation of fair value opinions. Since, as indicated above, these services can be complicated and carry substantial risk, it is suggested that any engagement letter for such services as well as any fair value opinion itself include a list of assumptions and limiting conditions which might apply to the engagement. In 2007, the AICPA issued the *Statement on Standards for Valuation Services No. 1 (SSVS No. 1)* which attempted to set forth standards for the completion of various types of fair value opinion engagements. SSVS No. 1 became effective for all engagements for such services accepted on or after January 1, 2008. Attached as part of SSVS No.1 was an illustrative list of assumptions and limiting conditions that could be used for inclusion in both the engagement letter and the issued opinion for most, if not all, types of fair value engagements. They are as follows:

1. The conclusion of value arrived at herein is valid only for the stated purpose as of the date of the valuation.

2. Financial statements and other related information provided by [ABC Company] or its representatives, in the course of this engagement, have been accepted without any verification as fully and correctly reflecting the enterprise's business conditions and operating results for the respective periods, except as specifically noted herein. [Valuation Firm] has not audited, reviewed, or compiled the financial information provided to us and, accordingly, we express no audit opinion or any other form of assurance on this information.

3. Public information and industry and statistical information have been obtained from sources we believe to be reliable. However, we make no representation as to the accuracy or completeness of such information and have performed no procedures to corroborate the information.

4. We do not provide assurance on the achievability of the results forecasted by [ABC Company] because events and circumstances frequently do not occur as expected; differences between actual and expected results may be material; and achievement of the forecasted results is dependent on actions, plans and assumptions of management.

5. The conclusion of value arrived at herein is based on the assumption that the current level of management expertise and effectiveness would continue to be maintained, and that the character and integrity of the enterprise through any sale, reorganization, exchange, or diminution of the owners' participation would not be materially or significantly changed.

6. This report and the conclusion of value arrived at herein are for the exclusive use of our client for the sole and specific purposes as noted herein. They may not be used for any other purpose or by any other party for any purpose. Furthermore the report and conclusion of value are not intended by the author and should not be construed by the reader to be investment advice in any manner whatsoever. The conclusion of value represents the considered opinion of [Valuation Firm], based on information furnished to them by [ABC Company] and other sources.

7. Neither all nor any part of the contents of this report (especially the conclusion of value, the identity of any valuation specialist(s), or the firm with which such valuation specialists are connected or any reference to any of their professional designations) should be disseminated to the public through advertising media, public relations, news media, sales media, mail, direct transmittal, or any other means of communication without the prior written consent and approval of [Valuation Firm].

8. Future services regarding the subject matter of this report, including, but not limited to testimony or attendance in court, shall not be required of [Valuation Firm] unless previous arrangements have been made in writing.

9. [Valuation Firm] is not an environmental consultant or auditor, and it takes no responsibility for any actual or potential environmental liabilities. Any person entitled to rely on this report, wishing to know whether such liabilities exist, or the scope and their effect on the value of the property, is encouraged to obtain a professional environmental assessment. [Valuation Firm] does not conduct or provide environmental assessments and has not performed one for the subject property.

10. [Valuation Firm] has not determined independently whether [ABC Company] is subject to any present or future liability relating to environmental matters (including, but not limited to CERCLA/Superfund liability) nor the scope of any such liabilities. [Valuation Firm]'s valuation takes no such liabilities into account, except as they have been reported to [Valuation Firm] by [ABC Company] or by an environmental consultant working for [ABC Company], and then only to the extent that the liability was reported to us in an actual or estimated dollar amount. Such matters, if any, are noted in the report. To the extent such information has been reported to us, [Valuation Firm] has relied on it without verification and offers no warranty or representation as to its accuracy or completeness.

11. [*Valuation Firm*] has not made a specific compliance survey or analysis of the subject property to determine whether it is subject to, or in compliance with, the American Disabilities Act of 1990, and this valuation does not consider the effect, if any, of noncompliance.

12. [Sample wording for use if the jurisdictional exception is invoked.] The conclusion of value (or the calculated value) in this report deviates from the Statement on Standards for Valuation Services as a result of published governmental, judicial, or accounting authority.

13. No change of any item in this appraisal report shall be made by anyone other than [*Valuation Firm*], and we shall have no responsibility for any such unauthorized change.

14. Unless otherwise stated, no effort has been made to determine the possible effect, if any, on the subject business due to future Federal, state, or local legislation, including any environmental or ecological matters or interpretations thereof.

15. If prospective financial information approved by management has been used in our work, we have not examined or compiled the prospective financial information and therefore, do not express an audit opinion or any other form of assurance on the prospective financial information or the related assumptions. Events and circumstances frequently do not occur as expected and there will usually be differences between prospective financial information and actual results, and those differences may be material.

16. We have conducted interviews with the current management of [*ABC Company*] concerning the past, present, and prospective operating results of the company.

17. Except as noted, we have relied on the representations of the owners, management, and other third parties concerning the value and useful condition of all equipment, real estate, investments used in the business, and any other assets or liabilities, except as specifically stated to the contrary in this report. We have not attempted to confirm whether or not all assets of the business are free and clear of liens and encumbrances or that the entity has good title to all assets. ■

Auditor's Obligation to Third Parties

By Nathaniel Paty and Cheryl Waterhouse

THE CONTOURS OF AUDITOR LIABILITY WAS RECENTLY SOLIDIFIED by the Texas Supreme Court case of *Grant Thornton LLP v. Prospect High Income Fund*, which reaffirmed that accountants can only be held liable for negligently supplying information used by third parties if the information is supplied "to a *known* party for a *known* purpose." A "known party" must be a member of the "limited class" that an accountant directly supplies information to, and the accountant must intend that the known third party rely on the information. The standard for fraud liability is even higher: an accountant must have "intent to deceive" the recipient of the information. For both negligent misrepresentation and fraud, the recipient must "show actual and justifiable reliance" on the information in order to make a successful claim.

The plaintiffs in *Grant Thornton*, bond and hedge funds (the "Funds"), bought bonds from Epic Resorts, LLC ("Epic"), a vacation timeshare operator, over a five year period. Epic began selling high yield bonds on the open market in 1998. Grant Thornton, LLP ("GT") was retained in 1999 to audit Epic's financial statements, as mandated by the SEC. Upon conducting its first audit of Epic, GT discovered that Epic's U.S. Trust escrow account fell short of the required minimum amount; Epic's explanation was that U.S. Trust allowed them to use more than two accounts to meet its responsibilities and that the combined balance of the two consistently exceeded the required minimum. Apparently satisfied, GT issued a report verifying the accuracy of Epic's financial statements.

In late 2000, Epic's primary lender refused to renew its credit arrangement. Despite the loss of credit facilities which Epic's president would later testify were crucial to its existence, in April of 2001, GT issued a report indicating there were sufficient escrow moneys, and the Funds, who had knowledge of the non-renewal, increased their holdings of Epic bonds. Epic soon defaulted on an interest payment, triggering the Funds to increase their Epic holdings even further before forcing the company into bankruptcy. The Funds sued GT shortly thereafter, alleging, among other claims, fraud and negligent misrepresentation. The Texas trial court granted summary judgment to GT, but the appeals court reversed on some claims, including those for fraud and negligent misrepresentation, and GT petitioned the Supreme Court of Texas.

The Texas Supreme Court then unequivocally rejected the idea that auditors have an obligation to provide accurate accounting information to anyone who reads and relies on their reports. The Court's holding was divided into three parts. First, the Court determined that the Funds did not justifiably rely on GT's audit reports because they continued to purchase Epic bonds after they learned of the non-renewal of Epic's credit facility. Second, the Court ruled that the Funds could not have relied on a 1999 "negative assurance statement" issued by GT because they never received or reviewed it,

and they could not substitute the reliance of escrow agent U.S. Trust (who received the statement) for their own without also being bound by U.S. Trust's knowledge, or lack thereof. Finally, the Court rejected the idea that an investor could recover for the speculative diminished value of a security from one who wrongfully induced the investor to continue holding the stock (a so-called "holder claim") in the absence of direct communication, at a bare minimum.

The other major jurisdictions seem to have followed the approach generally taken by the Texas Supreme Court towards third party liability for accountants. The leading New York case is *Credit Alliance Corp. v. Arthur Anderson & Co.* In that case, which was relied upon by the *Grant Thornton* court, the New York Court of Appeals held that for accountants to be liable in negligence to third parties they must know that the information will be used for an intended purpose in furtherance of which a known party relies, and there must be some conduct "which evinces the accountants' understanding" of a link to that party. California has adopted a similar approach, explicitly limiting liability to the "limited group of persons for whose benefit and guidance [the professional] intends to supply the information," who rely on the information "in a transaction" as intended. Restatement (Second) of Torts § 552 (1997). Most other states, including Massachusetts, also follow the Restatement. However, accountants should be wary of gaining comfort from the fact that most states generally restrict the flow of third party liability, because seemingly minor differences can have huge ramifications. For example, as the *Grant Thornton* court noted, California, New York, and Massachusetts have all recognized holder claims.

While the Texas court decided not to expand the scope of third party liability, the *Grant Thornton* decision makes it clear that third party liability is still a very real threat. Third parties who have "justifiably relied" on audit reports that were directly provided to them may still bring successful claims for fraud and/or negligent misrepresentation. However, the court noted that justifiable reliance is unwarranted where there are "red flags" of which the investor was aware.

Although it is clear that a successful third party claimant in Texas must be a member of the “limited class” of persons for whom the information was intended to be supplied, the *Grant Thornton* court noted that it “may have been true” that some of the Funds were members of such a class, and in fact only one of the Funds failed to meet the test. Were it not for the brazen attempts of the Funds to monetize their knowledge of Epic’s misfortunes by escalating their bond purchases, the outcome of *Grant Thornton* may well have been the opposite. Auditors should perhaps pay attention to institutional investors who increase their holdings of an audited company’s debt instruments to disproportionate levels, as this may be a sign that those investors are aware of trouble brewing beneath the surface that even the prudent auditor may have missed. In general, accountants should use increased caution when auditing companies with a small base of institutional investor-bondholders, because fewer investors means a more limited potential class, and, in any event, large institutional investors may have the kind of access to management that could make the “known party” distinction moot.

Grant Thornton also leaves the door open to “holder claims” against accountants by expressly deferring a decision on “whether a holder claim involving more specific and direct communications is actionable under Texas law.” The U.S. Supreme Court succinctly summarized the problems that holder claims present for potential defendants: “[A] putative plaintiff, who neither purchases nor sells securities but sues

instead for intangible economic injury . . . is more likely to be seeking a largely conjectural and speculative recovery.” It is troubling that Texas and other states have left this door open despite the Supreme Court’s decision to close it for certain federal actions. There is not much that the accounting profession can do at this time to guard against the speculative avenue to holder claim liability, other than perhaps to file *amici curiae* briefs when plaintiffs who sue accountants and other professionals try to recover damages for holder claims.

Perhaps the most alarming aspect of *Grant Thornton* is that it leaves the door wide open for third parties to satisfy the “justifiable reliance” element of a fraud or negligent misrepresentation claim via escrow agents and/or other dual agents of both the investor and the company. When “there is a dual agent, operating with the consent and knowledge of both principals, the agent’s knowledge is imputed to its principals.” The potential for liability through this loophole is significant, because it means that the knowledge and reasonable reliance of a debt-issuing company’s escrow agent could theoretically be imputed to all purchasers of the company’s bonds, despite the fact that the escrow agent is privy to knowledge (such as that contained in GT’s negative assurance statement) that is withheld from the general investing public. Auditors should thus pay closer attention to non-public reports supplied to escrow agents and other dual agents, and attempt to ensure that a reputable agent is chosen. ■

Accountant Compensation Dispute Governed By State Law When Not Specified in Agreement

By Justin M. Jagher

A **N AGREEMENT BETWEEN AN ACCOUNTING FIRM AND ITS PARTNER** can be used against a firm when the provisions are not clearly defined. A Florida Court of Appeals determined that, in an accountant compensation dispute, the state's attorney fee statute governing "unpaid wages" applied where the agreement was silent on that issue.

In *BDO Seidman, LLP v. Bee*, 24 So.3d 1278 (2010), a former partner of a New York limited liability accounting partnership filed a lawsuit to confirm an arbitration award of more than \$4 million in compensation and to be granted substantial attorneys fees incurred in obtaining that award. The former partner, Bee, had been a Florida partner at BDO Seidman, LLP ("BDO"), an international accounting firm, since July 1984. On October 19, 2003, he and BDO executed a three-page letter agreement, which was referred to by both parties as the "Understanding." The Understanding guaranteed Bee an amount for the then-fiscal year and for the next four fiscal years, including a \$900,000 partnership bonus to be paid for the fiscal year ending June 30, 2004. The Understanding did not terminate Bee's status as a partner, and the amounts to be paid through June 30, 2004 were characterized in the Understanding as "allocations of Partnership profits... based on a per unit value, as determined in accordance with the Partnership Agreement" and the bonus was paid at the same time as normally paid to BDO partners. The Understanding established annual guaranteed earnings and a guaranteed annual minimum bonus, ending on June 30, 2008. The Understanding further specified that Bee would be compensated for all amounts due Bee if BDO terminated Bee without cause before November 2, 2006. The Understanding also contained an arbitration clause for disputes. Neither the Understanding nor the partnership agreement included any provision for the recovery of attorneys' fees and costs by a prevailing party in the event of a dispute.

In November 2004, BDO informed Bee that it was terminating Bee's partnership interest for cause and "rescinding" the Understanding. Bee filed an arbitration claim in Florida against BDO. The panel found for Bee, awarding him \$404,150 for the unpaid balance of the June 30, 2004 \$900,000 bonus; \$3,498,436, which was the present value of the remaining guaranteed compensation Bee was entitled to per the Understanding; and \$57,802 for the American Arbitration Association's costs and expenses.

The arbitration panel made several rulings important to the Florida Court of Appeals' decision. The arbitration panel determined that it did not have jurisdiction to rule on the partnership agreement, that the Understanding was governed by Florida law and that the firm's termination of Bee was a breach of the Understanding. The arbitration panel ruled that it would not determine prevailing party and attorney's fees and costs, deciding instead those issues would be judicially decided.

In June 2006, Bee filed a lawsuit against BDO in Miami-Dade circuit court seeking confirmation of the arbitration award and an award by the court for attorney's fees and costs under Florida statutes. Pursuant to Florida statute § 448.08, the court confirmed the award for "unpaid wages" and awarded Bee \$286,655.50 for Bee's attorney's fees. BDO appealed.

BDO maintained that the dispute should be governed by

New York law, Bee was a partner or co-owner and not an employee, and that the purpose of § 448.08, considering it focused on unpaid wages, was to remedy inequalities between laborers and their employers, not to resolve differences between white-collar parties, particularly a professional partner desiring millions of dollars from an LLP. The Appellate Court acknowledged BDO's argument that this was a partnership dispute, about partnership profits, and that the dispute should be governed by New York law, as specified in the partnership agreement. The Appellate Court also acknowledged BDO's argument that "partners are ordinarily considered co-owners of their partnership rather than employees."

However, the arbitrators had ruled that the "Understanding" BDO entered into with Bee was a distinct agreement from the BDO partnership agreement. That determination was

not subject to judicial review. The Appellate Court also examined the caption and the introductory sentence in the "Understanding", which referred to Bee's "employment" by BDO. Giving effect to the arbitrators' findings, the Appellate Court ruled that, pursuant to the "Understanding" entered into by the parties, and Florida laws, the unpaid amounts should be characterized as "wages" and the trial court properly employed § 448.08.

The impact of this ruling is that accounting firms should take extra care when entering into contracts, even those with their own partners. Agreements should be clear and not unnecessarily subject to reliance on statutory interpretation for scenarios that could arise if not addressed in the agreement. Rather, properly crafted agreements can provide an opportunity for the parties to pre-emptively resolve any potential ambiguities should a conflict occur. ■

Auditor Obtains Dismissal of Claims by Shareholder Where Assets Invested with Bernie Madoff

By Daniel C. Poteet

A RECENT CASE IS INDICATIVE OF SOME OF THE PROCEDURAL DEFENSES that may be available to auditors with respect to claims brought by Madoff victims. It also demonstrates reluctance on the part of a court to allow a plaintiff to, in essence, repackage a negligence or malpractice-based claim into a viable count for fraud.

The case, *Stephenson v. Citco Group Limited, Citco Fund Services BV, and Pricewaterhousecoopers, LLP*, 2010 WL 1244007 (S.D.N.Y), arises out of a complaint filed against the defendants by a limited partner investor ("Plaintiff") to a fund, Greenwich Sentry ("Greenwich"), that invested substantially all of the fund assets with Bernie Madoff Investment Securities ("BMIS"). The Plaintiff, who had invested a large sum with Greenwich, which was a feeder fund for BMIS, ultimately lost everything after the Madoff Ponzi scheme was uncovered. The Plaintiff brought claims against the Greenwich administrators ("Citco") and outside auditor

Pricewaterhousecoopers ("PWC"), based on various theories of breach of contract, malpractice, and/or fraud.

The Court ultimately granted motions to dismiss all counts based on a variety of theories that the Plaintiff's pleadings were insufficient. The Court ruled that certain of the counts were barred because they were derivative of claims belonging to Greenwich for purposes of standing, were pre-empted by New York State's Martin Act, or, with respect to the fraud counts against PWC, were insufficiently pleaded.

The Plaintiff in this case had invested \$60 million in Greenwich, which subsequently invested that sum with BMIS, and was unable to recoup any of the investment when the BMIS Ponzi scheme came to light. The Citco entities provided a variety of fund administration services, and PWC audited Greenwich from 2006 through 2008. In performing its audits, PWC received complete access to Greenwich's records and issued unqualified audit reports addressed to the "Partners of Greenwich Sentry, L.P." PWC's audit reports attested to the accuracy of Greenwich's financial statements. The Plaintiff claimed to have decided to invest in Greenwich in early 2008 because of both Citco's approval as an administrator and PWC's approval as an auditor. In December of 2008, after learning of the Madoff fraud, the Plaintiff was unable to withdraw any of its investment in Greenwich.

The Plaintiff claimed that there were numerous "red flags" surrounding BMIS that should have placed PWC and Citco on notice of the Madoff Ponzi scheme. The red flags cited by the Plaintiff include the totality of control that BMIS maintained over trades, that BMIS' trade methods should have triggered suspicion because of their increased transaction costs, that BMIS' refusal to permit due diligence reviews or performance audits of manual trades was suspicious, that cash and position reconciliations between Greenwich and BMIS should have revealed material discrepancies, that various of BMIS' securities lending practices would have uncovered irrational behavior, that BMIS' results were much better than firms using purportedly similar strategies, and that the BMIS independent auditor was not well-known nor properly certified.

The defendants' motion to dismiss argued that the Plaintiff lacked standing because his claims were properly brought in Greenwich's name, not the Plaintiff's as a Greenwich shareholder. The Court applied Delaware law as the law of the fund's state of incorporation, and found that the counts alleging breach of fiduciary duty and aiding and abetting breach of fiduciary were derivative, and therefore that the Plaintiff lacked standing to bring the counts. The Court reasoned that because the Plaintiff's injuries were

not distinguishable from similar injuries to Greenwich, the fiduciary duty-based claims were derivative under Delaware Law. The Court used similar reasoning to find the breach of contract counts to be derivative as well, given that, even if the Plaintiff could establish that it was a third party beneficiary of Greenwich's contracts with Citco and PWC, the Plaintiff could not establish a separate injury that is independent of those contracts.

With respect to the counts alleging negligence, gross negligence, and fraud, the Court acknowledged that, while those counts involve direct claims, the New York Martin Act preempts all but the fraud count. The Martin Act empowers the New York Attorney General to enforce its provisions, and the Court noted that the Martin Act is generally intended to provide broad remedial measures to prevent fraudulent securities practices. The Court goes on to note that the New York Court of Appeals has found no private cause of action under the Martin Act, and that the Martin Act preempts common law claims within its purview. Because the Martin Act does not extend to circumstances involving intent to defraud, only the fraud count survives the Martin Act preemption.

PWC was also able to obtain dismissal of the fraud count because the Court found that the Plaintiff's count did not plead fraud with the degree of specificity required under the Federal Rules of Civil Procedure. The Court interpreted the Federal Rules to require that "mere conclusory statements" or "threadbare recitals of elements of a cause of action" are not sufficient pleadings to meet the Federal Rules' requirement. The Court recognized the additional requirement that the allegations must also "plausibly suggest an entitlement to relief." Applying that standard in conjunction with New York's elements of fraud, the Court stated that the Plaintiff would have to allege either the motive and opportunity or facts constituting "strong circumstantial evidence of conscious misbehavior or recklessness." The Court found insufficient allegations to substantiate the motive and opportunity aspect because it found it improbable that PWC would risk its business reputation merely to maintain a client relationship with Greenwich.

The Court then also disposed of several allegations of specific conduct by PWC in the following manner: it ruled that 1) failure to follow Generally Accepted Accounting Practices ("GAAP") is insufficient to demonstrate the requisite circumstantial evidence; 2) relying on prior case law, failure to investigate internal controls and accounting practices at Greenwich does not constitute recklessness; and 3) that ignoring the presence of the "red flags" was not sufficient without plausible allegations explaining how PWC would have known about the "red flags."

This case provides some guidance for accountants seeking to avoid and/or defend themselves from suits by investors who have lost money on their investments and seek deep pockets to get reimbursed. The case also points out that, even when "red flags" are present, the accountant needs to have been aware of such red flags or the court must find that the accountant should have been aware of those red flags for the accountant to be held liable. ■

Protecting Your Business Interests: Non-Competition and Other Restrictive Covenants

By Chris Whitten and Cheryl A. Waterhouse

ACCOUNTING FIRMS, LIKE OTHER PROFESSIONAL FIRMS, OFTEN ENTER into agreements with principals, or key employees, which contain restrictive covenants. Non-competition, non-solicitation and non-disclosure provisions are examples of agreements designed to protect a firm's business interests and its investment in personnel, customer relations and confidential business information. These agreements are only good if they can be enforced, however. In most cases, such covenants may be upheld if the covenants meet certain standards such as 1) they are reasonable in balancing the employer's interests and the employee's interest in employment, 2) they are supported by consideration, 3) they do not violate public policy by being in restraint of trade, 4) they protect legitimate business interests and 5) they are reasonable in duration and geographical limits. There are some states which limit the enforceability of restrictive covenants, however, while others, such as California, generally do not enforce non-competition agreements.

A recent decision illustrates the issues courts consider in ruling on the enforceability of such provisions. In the case of *McCann v. Barton*, the Eighth Circuit Court of Appeals upheld a restrictive covenant against former employees of a CPA firm who formed a new firm and sent out letters requesting the prior firm's clients to join them at their new firm and solicited four of the prior firm's employees. The Court, applying Missouri law, ruled against the former employees, who had successfully persuaded more than 120 clients to move to their new firm and successfully recruited employees from the prior firm. The Court awarded the prior firm approximately \$1.4 million in liquidated damages and entered a preliminary injunction, prohibiting the former employees from causing further harm to their prior firm.

The Court enjoined the former employees from 1) soliciting, directly or indirectly, the prior firm's clients and employees, 2) seeking to perform any additional attest services for the former firm's clients and 3) using confidential business information from the former firm. The Court also ordered the former employees to provide access for a forensic computer expert to the new firm's computers as well as the home computers of the former employees and the new firm's employees.

The Court based its rulings on restrictive covenants in Stockholder's Agreements the former employees signed. The former employees had been with a previous CPA firm that merged with the former firm that commenced this case. As

part of the merger, the former employees had received shares which the firm agreed to repurchase upon the termination of employment if the employees agreed they would not solicit the firm's clients or employees for two years or use the firm's confidential information at any time.

Finding that the restrictive covenants and the liquidated damages provision were enforceable under state law, the Court considered the arguments of former employees and found them unpersuasive. Acknowledgment by the former employees in the agreements that the restrictions are enforceable and necessary to protect the firm's business interests was held to be sufficient consideration. The Court also ruled that restrictive covenants in close corporation shareholder agreements are enforceable. The firm's client contact list was held to be a legitimate protectable interest. The scope of the covenants, including a two year duration and customer restriction rather than geographical restriction was held to be reasonable. In addition, the liquidated damages provision, indicating the measure of damages upon breach of the agreement, was held enforceable because it was reasonable and the harm would otherwise be difficult to accurately measure.

As stated above, state law controls how and whether restrictive covenants are enforced. Although restrictive covenants allow employers to more freely share proprietary information with employees, for the good of the employer and the employees, some states look less favorably on the ability of employers to impose barriers to employees' seeking other employment or competing with prior employers.

In California, non-competition agreements are invalid even if narrowly drawn, unless they fall within certain statutory exceptions. Exceptions include noncompetition agreements in the sale or dissolution of corporations, partnerships, or limited liability corporations. In a case involving an accounting firm, *Edwards v. Arthur Anderson LLP*, the California Supreme Court noted that an employee violates public policy if it conditions employment on an employee's signing of an unenforceable non-competition agreement.

With regard to liquidated damages provisions, California has more liberal rules. In services contracts, liquidated damages

provisions are enforceable where determining actual damages is impracticable or extremely difficult. Liquidated damages provisions are valid unless the damages are not a fair representation of the harm sustained, and may be construed as a penalty.

In *BDO Seidman v. Hirsberg*, the Court of Appeals of New York discussed the New York standards for both noncompetition agreements and liquidated damages provisions. "[A] restrictive covenant will only be subject to specific enforcement to the extent that it is reasonable in time and area, necessary to protect the employer's legitimate business interests, not harmful to the general public and not unreasonably burdensome to the employee." The Court also noted that "[w]ith agreements not to compete between professionals, however, we have given greater weight to the employer in restricting competition within a confined geographical area." The Court rationalized this use in situations where the parties provide unique or extraordinary services. In addition, liquidated damages are held valid if the amount is a reasonable measure of the anticipated probable harm.

Florida has a statute allowing noncompetition agreements "so long as such contracts are reasonable in time, area, and line of business" A provision for liquidated damages in Florida is enforceable if "it is valid as one for liquidated damages and not as a penalty"

Noncompetition agreements are, for the most part, enforceable, in most states. The reasonableness doctrine advanced by most districts requires that the agreement not be unduly restrictive in time, location, or line of business. That is why, in *McCann*, the court upheld the noncompetition agreement of two years with no geographical restriction. Similarly, some jurisdictions are more lenient with geographical restrictions to prevent competition for extremely specialized work in a small area, as it would be unfair to the business of both parties. Therefore, in signing or crafting a noncompetition agreement, the red flags are (1) excessive duration, (2) strict geographical restrictions, in combination with (3) a generalized practice. A strong noncompetition agreement is one which is reasonable with regard to geographical restriction or duration, and involves specialized, professional work. ■

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The Accountant/Attorney Liability Reporter

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