When Business Owners Disagree and Separate

By Scott I. Unger, JD and Vincent J. Love, CPA/CFF, CFE

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Closely held companies—including CPA firms—are susceptible to internal disagreements between their owners that sometimes lead to a "business divorce." A business divorce is a legal proceeding in which two or more business partners sever their business relationship, generally in a closely held private business entity. CPAs need to understand the legal and ethical implications associated with a business divorce, both as it affects their clients and their relationship with those clients. Furthermore, if it is an accounting firm that is going through a business divorce, the partners and members of the firm must understand the legal and ethical issues involved and, more importantly, the steps that can be taken to minimize any disruption.

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Because state law establishes the procedures for the proper formation of closely held companies, generally the law of the state of incorporation or formation will govern the legal ramifications of any disruption to the entity's structure, including, but not limited to, the means and methodology for triggering and handling a business divorce. The controlling law will often vary from state to state. Further complicating things, the type of corporate entity (e.g., corporation versus limited liability corporation) can also affect the rules governing the company's legal affairs. A corporate divorce is accomplished through voluntary dissolution, involuntary dissolution, disassociation, and shareholder oppression statutes.

When a Business Goes Through a Business Divorce

Voluntary dissolution. A voluntary dissolution is ordinarily effected through a vote of the board of directors, shareholders, or members who have the authority to dissolve the entity. A voluntary dissolution likely does not create many ethical issues for a CPA representing the soon-to-be dissolved company and its owners because the owners are agreeing to part ways amicably. Of course, even in the most amicable situations, issues may arise that can cause disputes among the parties unless previously covered in the agreement between all of the stakeholders:

- The realizable value of the assets and liabilities that can be different than the recorded value;
- The treatment of unrecorded liabilities or assets (i.e., intangible assets, possible litigation); and
- The right of any of parties to customer/supplier relationships, among other possible disagreements.

An outside accountant can greatly assist a client, if appropriate and covered by a properly worded consulting engagement letter, by initially suggesting that the organization consider all of the business valuation issues that could occur in a withdrawal or dissolution and including their resolution in the entity's bylaws or wherever appropriate. Of course, this needs to be done in conjunction with legal counsel.

An accountant/auditor can also assist in determining the value of the entity at the date of withdrawal/dissolution. However, this service should be covered in a separate engagement letter that includes damages limitation and indemnification provisions. It is strongly suggested that the letter include a mediation and or arbitration clause and that the accountant's attorney review the engagement letter before it is presented for execution. In addition, an accountant needs to consider the professional standards and ethics code in delivering this service. It is important to recognize who the client is and that the work is accomplished within the principles of due care, objectivity, and integrity. Remember, even

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though the dissolution is voluntary, often disputes will arise when one of the parties disagrees with a calculation that adversely affects that party's interests.

Involuntary dissolution. Unfortunately, the owners of closely held companies often cannot come to an agreement to divorce voluntarily. One party often sues the other to withdraw or have a party expelled from, or dissolve, the enterprise. In such cases, it is necessary for the parties to seek judicial intervention to cause an involuntary dissolution.

As previously stated, involuntary dissolution varies from state to state. Delaware law provides the fewest options for seeking an involuntary dissolution. The only Delaware statute that expressly empowers courts to dissolve a Delaware corporation is section 273 of the General Corporation Law of the State of Delaware (DGCL). That statute has been used sparingly by Delaware courts to dissolve a corporation in cases where there is a deadlock, fraud, or bad faith. By contrast, New York and New Jersey law empowers courts to involuntarily dissolve a corporation in cases where it has been demonstrated that there is: deadlock, illegal or fraudulent activities by one owner that affects the other, or oppressive behavior. Typically, however, before dissolution is ordered, parties will resolve their differences by agreeing to a buyout.

An accountant representing the disagreeing owners will need to reference the ethics code to determine, among other things, who the client is. If possible, it is strongly suggested that if an accounting firm will represent both parties, it should obtain a letter from each party that allows it to act in such a manner and also contains strong indemnification and arbitration clauses. Often, one or the other party will not agree to the use of the entity's accounting firm in resolving the dispute. If this is the case, the accounting firm needs to determine who was the client—usually, the entity—at the time of the dispute, and is best advised to represent neither party in the dispute and to instead suggest that the parties select another firm to represent them in the dispute. An accounting firm should then seek legal advice and follow the professional standards and ethics code in dealing with the firms selected by the parties. This is a very delicate situation for any CPA firm, and it should reference the ethics code related to confidentiality among the other principles and act with integrity and objectivity.

When a CPA Firm Goes Through a Business Divorce

Voluntary dissolution. A voluntary dissolution of a CPA firm is likely to create valuation and ethical issues relating to the individual accountants. Accounting firms usually use the cash basis for making distribution of earnings to the stakeholder; that is, the cash basis in conformity with the firm's tax return basis. In a voluntary dissolution, provision can be made to distribute the accrual earnings as received after the dissolution, according to a prescribed

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allocation. Determining who is designated to be in charge of the collection of the receivable, however, can be problematic, especially when clients are also individually assigned to the parties in the resolution. Clients, of course, are the largest unrecorded asset of a professional services firm. The party responsible for the collection of the receivable can favor those clients it retains and pursue collection from those it does not retain. While this behavior is not in accordance with the ethical principle of integrity and the party so acting would have breached that principle, it has been observed and undoubtedly will continue to occur.

Many of the valuation issues discussed in the dissolution of a business entity are also appropriate in the dissolution of a professional organization. A good way to preclude these issues from occurring is to cover them in the agreement establishing the firm. It is critical to engage a lawyer familiar with business divorce to prepare or review the agreement. Furthermore, firms should consider including a clause in the agreement requiring negotiation, mediation, and arbitration to resolve disputes.

Important provisions for the agreement also include addressing who retains a given client relationship. Battles over who has the rights to the client relationship often lead to claims of an ethical violation involving the rights to the client's working paper files and client confidentiality. Of course, a client has the right to remain with the party of its choice. This situation can be addressed in the agreement by a nonsolicitation clause coupled with an indemnification clause for all clients going with one or the other party outside of the agreement. The indemnification must be reasonable.

Involuntary dissolution. If a CPA firm is the subject of litigation seeking a voluntary dissolution that ends with either a settlement or the involuntary dissolution of the firm, the accountants will be confronted with the same ethical issues related to client retention and confidentiality of client information as mentioned above.

Disassociation is another method of forcing the separation between a limited liability company (a form of entity often used by accounting firms) and one or more of its members. As with corporations, there are voluntary and involuntary disassociations. The term "disassociation" means that the individual is no longer a member of the LLC. An involuntary disassociation may be effectuated by the vote of the other members in accordance with the parties' operating agreement or upon demonstrating to the court that the member has engaged in activities that are fraudulent, repugnant, or in violation of the operating agreement. The accountant for an entity with a dissociated member would have the same issues previously discussed for other business entities. Moreover, a CPA firm that

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disassociates a member for fraud, illegality, or violations of the firm's operating agreement should follow the same advice.

Maintaining Integrity

Often, business divorce cases end with one party buying out the other party. Valuation often is one of the central issues in the case. CPAs representing the entity can find themselves in the middle of the owners' dispute. When it is the accounting firm itself, the individual members can find themselves in legal and ethical disputes involving clients and client information. Legal advice from an attorney who is familiar with these types of disputes is essential. Proper preparation combined with preventive measures will save a CPA firm from needless expenses and go a long way in creating better client and former member relationships. Any CPA involved in a business divorce would do well to remember the wise words included in the AICPA Code of Professional Conduct:

Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance or in the face of conflicting opinions, a member should test decisions and deeds by asking: 'Am I doing what a person of integrity would do? Have I retained my integrity?' (0.300.040.04)

Scott I. Unger, JD, *is a shareholder in Stark & Stark, Lawrenceville, N.J.*
Vincent J. Love, CPA/CFF, CFE, *is the managing director of VJL Consulting, LLC, Bradenton, Fla. He is also a member of The CPA Journal Editorial Advisory Board.*

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