# LEGAL BRIEFS

*A periodic summary of judicial decisions affecting accounting and financial services professionals*

DrinkerBiddle

## Third Circuit Finds Market Price More Probative Than Experts in Establishing Valuation of Subsidiary at Time of Spin Out

The Third Circuit Court of Appeals recently upheld the dismissal of a suit by the shareholders and creditors of Vlasic Foods International, Inc., a former Campbell Soup subsidiary that had been "spun out" of the parent. The case, *VFB, LLC v. Campbell Soup Co.* (March 30, 2007), upholds the broad discretion of trial courts to determine valuation issues in the context of corporate transactions and, more specifically, gives great weight to market capitalization as a measure of value.

The plaintiff, VFB, was created in the wake of Vlasic Foods' bankruptcy to prosecute the claims of Vlasic's shareholders and creditors against Campbell, Vlasic's former parent. The claims arose out of a March 1998 "leveraged spin" transaction in which Vlasic was formed to own certain businesses in Campbell's Specialty Foods Division, which Campbell viewed as underperforming. The transaction basically involved Campbell's incorporation of a new wholly owned subsidiary (Vlasic), the subsidiary's assumption of bank debt to purchase the Division for $500 million, and then Campbell's issuance of stock in the subsidiary to Campbell shareholders as an in-kind dividend. Vlasic's life was short lived and it filed for bankruptcy in 2001. In SEC filings as early as June 1998, it was disclosed that the pre-transaction operating results of the Specialty Foods Division had been inflated to increase short term earnings. Over the next two years, the reduced earnings forecast, the burden of the acquisition debt and declining food sales all contributed to Vlasic's failure. Between 1999 and May 2001, Vlasic sold off

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On January 1, 2007, Drinker Biddle & Reath LLP and Gardner Carton & Douglas LLP merged to form one of the 70 largest law firms in the United States, with more than 630 lawyers located in 12 cities nationwide. The firm is known as Drinker Biddle & Reath LLP. In Illinois and Wisconsin, the firm will do business as Drinker Biddle Gardner Carton for a transitional period.

the former Specialty Foods Division for some $115 million less than it had paid in 1998.

VFB sued Campbell alleging that the original purchase price was inflated and, therefore, the "spin out" was a fraudulent transfer as to Vlasic's shareholders and creditors. VFB also claimed that Campbell breached a fiduciary duty to the future creditors of Vlasic. The district court rejected both arguments and VFB appealed.

The Court of Appeals reprised the testimony before the district court, including the expert testimony on the issues of Vlasic's valuation at the time of the transaction. VFB had presented testimony from three different experts that, under a market approach or a discounted cash flow analysis, Vlasic had a value substantially less than the purchase price on the date of the "spin out" transaction. The district court viewed these opinions as "hindsight evaluations" that did not reflect the assumptions made by the public markets as of the time of the spin and for months thereafter. The district court emphasized that the market capitalization of Vlasic as of March 1998 was approximately $1.6 billion and it did not drop below $1.1 billion until 1999, even though by that time the market knew about Vlasic's inflated pre-spin earnings.

As the appeals court put it, "nobody claims that [Vlasic's] fortunes were improving, so the market's valuation of [Vlasic] as solvent in FY 1999 was strong evidence that [Vlasic] was solvent at the time of the spin, and therefore received reasonably equivalent value for its $500 million." Rejecting VFB's argument that the district court had improperly disregarded its experts' valuations, the circuit court stated: "Absent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'"

The Third Circuit also rejected VFB's claim that Campbell had aided and abetted a breach of the Vlasic directors' duty of loyalty to the subsidiary when they approved the spin transaction. VFB's argument rested on the fact that the Vlasic directors were simultaneously directors of Campbell. The appeals court found that, because Campbell was the sole shareholder of Vlasic, there was only one substantive interest to be protected and, thus, "it makes no sense to impose a duty on the director of a solvent, wholly owned subsidiary to be loyal to the subsidiary *as against the parent company*." The appeals court noted that the situation would be different if the subsidiary were not wholly owned or if the subsidiary were insolvent at the time of the transaction. In those cases, the directors would have duties to act fairly toward minority shareholders and creditors, respectively.

If you would like a copy of the *VFB* decision, please contact Vince Gentile at Vincent.Gentile@dbr.com.

## Court Rejects Challenge to Expert Testimony on Extent of "Lost" Market Due to Defendant's Breach of Contract

New Jersey's Appellate Division recently affirmed the trial court's rulings on the plaintiff's expert damages testimony in a case involving breach of an international distribution agreement. In *Andes Trading De Mexico, S.A. de C.V. v. Church & Dwight Co.* (March 12, 2007), the appeals court had to review the testimony of plaintiff's experts in support of its calculation of lost profits damages from the defendant's breach of a five-year exclusive distribution agreement covering defendant's consumer products in Mexico. Defendant terminated that agreement only six months after it was entered when defendant acquired another consumer products company that had a pre-existing Mexican distributor. A jury found defendant liable for breach of the agreement and awarded $15,000,000 in damages.

Defendant moved to set aside the damage award, claiming that the jury had been improperly tainted by the plaintiff's expert testimony and by plaintiff's lawyer's argument during summation. Two experts had testified for the plaintiff. Andrew Safir testified to relevant market conditions in Mexico, opining that the average seller of "branded" consumer products could reasonably expect to capture 5% of the Mexican retail market. Under this assumption, Safir testified that defendant's potential retail sales during the contract period would have been approximately $500,000,000. Despite defendant's objections that Safir's testimony was irrelevant, speculative and prejudicial, the court allowed the testimony as background to help the jury assess the credibility of plaintiff's other damages expert, Walter Bratic. Bratic had testified to a much smaller retail market share of defendant's products (0.36%), and had calculated that plaintiff's total retail sales during the contract period would have been $37,000,000. Bratic's opinion translated into lost profits of $9,800,000. In summation, plaintiff's lawyer introduced a chart that extrapolated Bratic's lost profits damage figure, assuming the greater market share that Safir had estimated, and invited the jury to "do the arithmetic" in calculating an appropriate damage award. The trial court denied defendant's motions to set aside the judgment for a new trial but it reduced the verdict to $9,800,000.

On appeal, the Appellate Division rejected most of defendant's challenges to the plaintiff's expert testimony. The appeals court noted that the trial judge had wide latitude in allowing expert testimony and that her decisions could not be disturbed absent a clear abuse of discretion. The Appellate Division stated that given the short pre-termination history of plaintiff's operations under the five-year distribution agreement, the trial court properly allowed Safir's testimony to assist the jury in evaluating Bratic's later projection about defendant's market penetration. The appeals court also rejected the arguments that Safir's testimony had improperly bolstered Bratic's opinion, had misled the jury, was too speculative and was unduly prejudicial. Rebuffing defendant's challenges to Bratic's testimony as well, the appellate court noted that defendant's own expert had accepted the same premises that defendant now claimed were unsupported.

The Appellate Division, however, did find error in the trial court's refusal to issue a curative instruction to the jury about counsel's damages chart and his argument in summation. The court noted that Bratic did not support any damages that would have resulted from a higher market share, and that there was no support in the record for counsel's assertion that lost profits would increase in direct proportion to greater market share. Even though it found that the trial court's error could have produced an unjust result, the Appellate Division concluded that the trial court had rectified the problem by remitting the verdict to $9,800,000, the maximum amount of damages supported by Bratic's testimony.

If you would like a copy of the *Andes Trading* decision, please contact Karen Denys at Karen.Denys@dbr.com.

## Court Dismisses Negligence Claim That Tax Preparer Failed to Advise Spouse of Potential Liability for Husband's Tax Obligations

In *Daunno v. Crincoli* (Jan. 22, 2007), New Jersey's Appellate Division rejected an interesting claim for negligence against a tax preparer. The case arose from the following facts:

Plaintiff Camille Daunno's husband, Ted, engaged defendant, Crincoli, to prepare delinquent personal tax returns for the couple and business tax returns for Ted's law practice for tax years 1991 through 1996. During the five-year period at issue, Camille earned little or no income herself and would have only been required to file a return for 1995 (when she earned less than $10,000). Other than signing the personal return, Camille had no involvement in the preparation of the tax returns. Camille never met or communicated with Crincoli, nor did she provide Crincoli with any information needed to prepare the returns. Crincoli's communications were solely with Ted. Ted provided Crincoli with all of the information needed to prepare the returns, including erroneous information that the marital home was jointly owned with Camille. Based on the information provided by Ted, Crincoli advised Ted that the couple would save approximately $55,000 in taxes by filing a joint return. Crincoli then prepared the joint returns and filed same after they were signed by both Ted and Camille.

Shortly before Ted's death, Camille discovered that Ted had failed to pay the taxes. When attempting to sell the marital home, Camille learned that tax liens had been placed on the property to secure Ted's business liability for federal withholding tax, interest and penalties. Camille ultimately filed for bankruptcy and settled the federal and state tax liabilities. Camille then sued Crincoli and his firm for accounting malpractice, asserting that he had failed to advise her that, by filing a joint tax return, she could be exposed to personal liability for taxes, interest and penalties relating to her husband's business – liabilities that she would not have borne had she filed separately.

At trial, Camille's accounting expert testified that Crincoli had deviated from accepted accounting practices by failing to explain the risks of filing a joint return to both spouses. The expert conceded, however, that these "accepted practices" did not derive from standards set by the AICPA or the IRS, but rather were based upon his "personal" standards. In contrast, Crincoli's expert testified that Crincoli had acted properly and should not have been expected to investigate the accuracy of the information provided by the husband or to discover that the marital home was held in the wife's name. The expert testified further that it was not uncommon for one spouse to act as the agent for the other in communicating with a tax preparer.

After a four-day trial, the trial judge dismissed the complaint and entered judgment in the amount of $6,000 (the outstanding accounting fees) in favor of Crincoli. On appeal, the Appellate Division affirmed the lower court's ruling. The appeals court agreed with the trial court's ruling that Camille's expert was not credible, and that the standard of care set forth by Crincoli's expert should govern. The appeals court also noted, that even if Crincoli had been negligent, that his negligence was not the proximate cause of Camille's damages; she did not present any evidence that, had she been informed of the risks of filing jointly, she would have acted differently.

While both the trial and appeals courts ultimately sided with the tax preparer in *Daunno*, accountants and tax preparers should consider providing a standard written disclosure to their clients making clear that they are relying on the information supplied to them by the clients themselves and that they are undertaking no duty to conduct an independent investigation to confirm the accuracy or completeness of that information.

If you would like a copy of the *Daunno* decision, please contact Susan Kleiner at Susan.Kleiner@dbr.com.

## Computer Abuse Can Lead to Stiff Penalties

In one of the few published cases dealing with New Jersey's Computer Related Offenses Act, N.J.S.A. 2A:38A-1 *et seq.* ("CROA"), *Fairway Dodge, Inc. v. Decker Dodge, Inc.* (App. Div. June 12, 2006), New Jersey's Appellate Division recently affirmed a verdict against two employees who gained unauthorized access to their employer's computer system and transferred confidential customer information to their new employer and a verdict against the employees' new company because it found the employees were acting as its agents.

The case arose out of the sale of the Fairway Dodge dealership in Bergen County. When the dealership was sold to Ronald Sumner in 1995, the seller's daughter, Kate Fair, along with several other employees, left Fairway Dodge and joined a competitor, Decker Dodge, Inc. ("DDI").

After her departure, Fair and her husband, Timothy Morgan (who was still a Fairway employee), entered Fairway's premises after business hours and attempted to make a back-up tape of Fairway's computer system. Their first attempt was unsuccessful but the following day, Morgan returned and successfully transferred the information. The back-up tape contained Fairway's confidential customer names and addresses, sales lists, and the complete sales and service history of vehicles and automotive parts. Morgan did not have the permission of either Sumner or Fair's mother (who still owned the dealership at that time) to make the back-up tape.

Morgan gave the tape to Reynolds & Reynolds Company, a data processing firm that had been hired by DDI to upgrade its computer system. Reynolds, mistakenly believing that Fair owned both Fairway and DDI, downloaded the back-up tape onto DDI's computer system. At Reynold's request, Fair provided a consent letter on Fairway stationary, stating: "This letter gives Reynolds & Reynolds Company permission to go into Fairway Dodge's system to run specifications."

Sumner quickly learned of the unauthorized copying and filed a lawsuit against DDI, Fair, Morgan and Reynolds, seeking injunctive relief and damages. Several other DDI employees were later added as defendants. The lawsuit alleged, among other things, unlawful interference with Fairway's business, breach of the employees' duties of loyalty to Fairway and violations of CROA as a result of the unlawful transferring of Fairway's confidential customer information. The trial court issued a preliminary injunction and the parties agreed to a consent order, which required DDI to delete Fairway's confidential data from its computer system and to refrain from soliciting customers whose names DDI acquired from the back-up tape. At trial, the jury returned a verdict in favor of Fairway, awarding approximately $2 million in compensatory damages, $130,000 in punitive damages under CROA, $525,678 in attorneys' fees and costs, $16,429 in costs of investigation, and $853,000 in pre-judgment interest.

Defendants appealed, contesting, among other things, their liability under CROA. Fair and Morgan argued that they could not be liable because they only copied information from Fairway's computer system. They contended that they did not assume ownership of the information or deprive Fairway of its use of the information. The Appellate Division rejected this argument, holding that defendants can be liable under CROA if they purposely or knowingly, and without authorization, access or attempt to access a computer system or if they purposely or knowingly access a computer system and recklessly obtain any data. By their own admissions, Fair and Morgan access Fairway's computer system without authorization and obtained data. The Appellate Division explained further that because CROA is not limited to proprietary or confidential information, it made no difference that Fair and Morgan had only obtained publicly available data.

The Appellate Division rejected other arguments by Fair and Morgan. Specifically, the Appellate Division held that: (1) neither Fair's status as an officer, her mother's status as owner, nor Morgan's status as an employee of Fairway authorized them to take information from Fairway's computer system; (2) the fact that Fair still had keys to the dealership did not justify them entering the premises to access the computer system after business hours; (3) the fact that the purchase agreement did not contain a provision that Fair would maintain the goodwill of Fairway did not permit Fair to commit tortious acts; and (4) the unauthorized copying of Fairway's customer information impaired Fairway's ability to sell vehicles, services and parts, resulting in lost revenue,

thereby establishing damages as required under CROA.

DDI and the other former Fairway employees similarly contested liability under CROA. They argued that they could not have violated CROA because the statute only applies to "actors" who actually access, alter, damage, take or destroy computer information. The Appellate Division agreed in part and reversed the judgments against the other former Fairway employees. The Appellate Division, however, affirmed the judgment against DDI finding that Fair was acting as DDI's agent.

The development of case law interpreting CROA is still in the early stages. *Fairway Dodge* serves as an important guidepost for how New Jersey courts will interpret the boundaries of CROA and define the types of conduct that will lead to civil liability.

If you would like a copy of the *Fairway Dodge* decision, please contact Vince Gentile at Vincent.Gentile@dbr.com.

## Professional Service Firms Are on the Hook for Employees' Acts Performed "Within the Scope of Their Employment"

A professional service firm's liability for its partner's acts hinges on a key question: was the partner acting within the scope of her employment? If so, the firm will have *respondeat superior* (also called "vicarious") liability for the partner's wrongful or negligent acts, making it – or its insurer – responsible for the resulting damages. New Jersey's Appellate Division recently applied this principle in a legal malpractice case, *Moorehead v. Luhn* (January 22, 2007), and affirmed the trial court's ruling that a defendant law firm was liable for some of its partner's wrongful acts, but not those that were performed outside of the scope of the partner's employment and for the partner's benefit alone.

In *Moorehead*, a former client, Moorehead, sued his attorney, Luhn, for legal malpractice. He also sought damages from Luhn's law firm, the Courter firm, under the common law theory of *respondeat superior* and New Jersey's Professional Service Corporation Act, N.J.S.A. 14A:17-1, *et seq.* ("PSCA"). While tort liability must normally be based on personal fault, an employer can have *respondeat superior* liability for its employees' wrongful or negligent acts committed within the scope of their employment. Similarly, the PSCA makes a professional service corporation liable for its shareholders' negligent or wrongful acts committed while "engaged on behalf of the corporation in the rendering of professional services." (Emphasis added.)

Moorehead's claims arose from two transactions. First, he sought damages for Luhn's default on $199,000 in interest-free, unsecured loans that Moorehead had made to Luhn without independent counsel or proper documentation. Second, he sought to recover monies that Luhn had aggressively solicited from Moorehead in connection with one of his other client's restaurant franchise without advising Moorehead to obtain separate counsel or disclosing the restaurateur's past business failures. Based on the limited information Luhn provided, Moorehead invested almost $200,000, which he lost when the franchise failed.

After Moorehead filed suit, Luhn filed for bankruptcy protection, effectively staying Moorehead's claims and dashing any meaningful chance of enforcing a judgment against him. The bankruptcy court, however, allowed claims against Luhn that were "covered by legal malpractice insurance" to proceed. After a non-jury trial, the judge found Luhn liable for $199,000 plus interest on the loans claim, and for $198,340 on the business investment claim, but only held the Courter firm to be vicariously liable on the latter. Both the Courter firm and Moorehead appealed.

On appeal, the Courter firm argued that it could not be held vicariously liable on the business investment claim because, in seeking Moorehead's investment in the restaurant business, Luhn was acting outside the scope of his employment. The Appellate Division disagreed. It reasoned that Luhn simultaneously represented both Moorehead and the restauranteur, despite an obvious conflict of interest, because he "did not want to lose, for himself and the Courter firm, the prospect of significant future business if the restaurant venture was a success and additional franchises were opened . . . ." The appeals court found that evidence of Luhn's sharp practices, which were designed to increase the prospects of this future business, supported the trial judge's conclusion.

Moorehead argued on appeal that the Courter firm should have been held liable not only on the business investment claim, but on the loans claim, as well, because Luhn acted within the scope of his employment when he prepared documents for some of the loans that failed to adequately protect Moorehead's interests. In resolving the issue, the Appellate Division considered whether or not Luhn's conduct (1) was the kind of work he was employed to perform; (2) was performed substantially within the firm's authorized time and space; and (3) was "actuated, at least in part, by a purpose to serve the master." The Appellate Division agreed with the trial judge that the loans were taken, and the documents prepared, for Luhn's benefit alone. In this regard, it noted that Luhn took the loans to meet his own personal ends and

did so "in a manner so as to conceal the same from his employer."

As the *Moorehead* case illustrates, the "scope of employment" analysis can make or break a professional negligence case. To a plaintiff, its outcome likely means the difference between full recovery and a hollow judgment. Likewise, to the professional service firm, it can mean the difference between serious financial consequences and a no-cause verdict.

If you would like a copy of the *Moorehead* decision, please contact Eric Moran at Eric.Moran@dbr.com.

## Taxpayer Found Entitled to an Evidentiary Hearing in IRS Summons Enforcement Proceeding

In a recent IRS summons enforcement case, *United States of America v. Trenk* (January 22, 2007), the United States District Court for the District of New Jersey ruled that a taxpayer had the right to an evidentiary hearing to produce evidence as to his lack of possession defense.

In *U.S. v. Trenk*, the IRS issued a summons to Steven Trenk, the president of Gold Crown Insurance, seeking records and testimony relating to an investigation it was conducting into an alleged tax avoidance scheme between Gold Crown and one of its subsidiaries. Trenk objected to the summons. To support his objection, Trenk submitted an affidavit in which he swore that (1) he did not possess or control the records requested in the summons and (2) the summons constituted an impermissible "second inspection" because the government had already received the documents from Gold Crown's accountants. The IRS moved to enforce the summons. In support of its motion, the IRS submitted a declaration of one of its agents stating that the records had not previously been produced. In addition, the IRS argued that Trenk needed to do more than make a general assertion that he did not have the documents and that, given Trenk's position as president of Gold Crown, the court could presume his possession of the requested records.

The district court ruled that the IRS had met the four-fold preliminary showing required for enforcement of the summons: (1) that the investigation was being conducted for a legitimate purpose; (2) that the inquiry was relevant to such purpose; (3) that the information sought was not already in the IRS's possession; and (4) that the administrative steps required by the tax code had been followed, including prior notice to the taxpayer. Ordinarily, such a showing would be enough to permit enforcement of the summons. The district court noted, however, that the taxpayer's sworn statement that he did not possess or control the records meant that an evidentiary hearing was required to determine the possession or control issue as well as the "second inspection" issue. Critical to the district court's reasoning was the fact that, if the summons were enforced on the IRS's showing, the taxpayer would not be allowed to raise his defenses in a later civil contempt proceeding over his non-compliance.

If you would like a copy of the *Trenk* decision, please contact John Mitchell at John.Mitchell@dbr.com.

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