

LAW UPDATE

From the Editor's Corner



Seth I. Rubin

The RMF Corporate and Securities Law Update is designed to give you an overview of important topics facing the business world today. This issue focuses on critical considerations for business owners who

are selling or looking to sell a business: how to protect the confidentiality of a deal and how to maximize your selling price through the use of an earnout. This issue also provides a discussion of the pros and cons of majority voting for directors. We encourage you to e-mail us with your questions so we can devote future columns to the issues you deem critical in our field. I hope to hear from you at 516.663.6691 or srubin@rmfpc.com

Can You Keep A Secret? Maintaining Confidentiality While Selling Your Business

by Irvin Brum Esq.



Irvin Brum

Selling a business can be an emotionally trying time, fraught with demons both real and imagined. Near the top of the nightmare list is the fear that information about an impending sale will be leaked prematurely to employees and business partners, jeopardizing long-standing relationships and causing defections that can both kill a deal and seriously damage the business itself. Of equal concern to business owners is the risk that critical information shared with potential buyers during the due diligence process will be used for competitive advantage if the transaction fails to close.

While a well drafted confidentiality agreement can be effective in maintaining the confidentiality of a proposed sale, there are a number of steps that business owners can take to reduce the likelihood of an inadvertent disclosure. First, buyers should be pre-screened so as to limit the number of suitors to those most likely to make a serious offer. Using an investment bank or business broker can greatly assist in qualifying potential buyers while reducing dependence on employees in the due diligence and negotiation process. Second, to the extent that non-management employees are needed to facilitate the sale, their loyalty and discretion can be significantly enhanced by appropriate compensation arrangements that help allay their concerns about the future while aligning their interests with those of the business owners. Finally, because many buyers including public companies and private equity funds typically require that the companies they buy have audited financial statements, forward-thinking owners will start having their financial statements audited well before the first buyer walks through the door. This will help facilitate a sale without raising questions among employees who might otherwise suddenly witness a number of unfamiliar faces appearing at the company poring through the company's books and records for no obvious reason.

While a seller may succeed for a time in keeping knowledge of the sale private, sooner or later, employees, customers and suppliers will need to be notified. A wide variety of factors will influence the timing of the disclosure, including whether the buyer insists on contacting key employees, customers and suppliers as part of its due diligence investigation, the existence of anti-assignment or change in control provisions in significant contracts, the need to negotiate with other third-party constituencies (e.g., unions and lenders), the extent of sale rumors in the company and the industry, and whether and when federal securities laws will require the buyer to publicly disclose the transaction.

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Smart Counsel. Straight Talk.

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From a seller's perspective, the goal is almost always to delay the disclosure until the buyer is "locked in" with a binding contract. But a cautious buyer that has not been given the opportunity to contact key employees, customers and suppliers before the contract is signed may condition its obligation to close the acquisition on its ability to retain these relationships after the closing for its own benefit. The issue of who bears the risk of lost relationships after the deal is announced is often hotly negotiated between buyers and sellers.

To protect the confidentiality of proprietary information, information can and should be disclosed in stages with more sensitive information not shared until late in the process. For example, although a buyer may at some point be entitled to know the seller's gross profit margins for specific customers, there may be no reason to disclose the actual names of those customers until the closing. Poorly advised and inexperienced sellers often divulge more information too early in the sale process than is needed.

Sellers, of course, rely most heavily on confidentiality agreements to protect their interests. From a seller's perspective, this agreement should describe confidential information in the broadest possible terms and apply to all information provided in any format – i.e. oral, written, digital or otherwise. Among the issues to be negotiated are the length of time the agreement will remain in effect, whether a buyer must obtain separate confidentiality agreements from its agents and advisors before sharing seller's confidential information, and how to ensure the return or destruction of information when a transaction fails to close.

Unfortunately, sellers trying to economize on legal fees often either accept a buyer's "standard form" or use a form previously used by seller in another context. Sellers without the benefit of experienced M&A counsel risk irreparable harm as proprietary information is lost to those who will use it for their competitive advantage. Such sellers also lose the opportunity of negotiating for less common but sometimes necessary protection – e.g., restrictions on the suitor's ability to hire seller's employees if the deal does not close. In a recent sale transaction involving direct competitors, we successfully negotiated on behalf of the seller for the inclusion of a "standstill" provision that required the potential buyer to pay seller if, at any time during the negotiations or six months after negotiations terminated, seller lost a key customer to the buyer, whether or not the loss resulted from the misuse of confidential information.

While the sale of a business will always involve challenges and risks, advance planning, careful thought and professional advice can mitigate those associated with confidentiality and prevent a successful business from becoming damaged goods.

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The Voice of Shareholders in the Director Election Process

by Barry R. Carus, Esq.



Barry R. Carus

Business Corporation Act (the "Model Act").

One of the most significant corporate governance topics affecting public companies across the country is the issue of moving from plurality voting to majority voting in electing directors. The American Bar Association Committee on Corporate Governance a drafting provisions on the election of directors, official comments and an explanatory report on this topic, which could result in changes to the Model

The Model Act has always championed plurality voting for the election of directors and it is the standard used under most state corporate laws (including Delaware). Plurality voting involves the election of directors at a shareholders meeting by the receipt of the most votes. Accordingly, the action by which shareholders withhold their votes is rendered purely symbolic.

“Plurality voting involves the election of directors at a shareholders meeting by the receipt of the most votes.”

Shareholder activist and other groups believe that plurality voting is a fundamental flaw in U.S. corporate governance since it often renders the vote of shareholders in director elections meaningless. The heightened attention being paid to majority voting has resulted in the New York Stock Exchange reviewing its discretionary broker voting process (known as the "broker vote rule" which allows brokers to vote shares held in street name for directors unless brokers receive contrary voting instructions, which could ultimately lead to its elimination or curtailment.

If a majority voting standard were adopted, it would give shareholders a stronger voice in the director election process, since a nominee for director would generally be required to receive the affirmative vote of a majority of the total votes cast for and against such nominee in the election. Under a majority voting

standard, withheld, votes with respect to the election of directors become significant as they can result in the failure of a nominee to receive the needed majority vote.

Majority voting can lead to a series of unintended consequences, including:

- The possibility of a failed election (where one or more directors does not achieve the required vote).
- Failure to elect a certain group of directors could lead to a “change of control” under various corporate documents such as employment agreements, credit agreements and leases.
- Impact of failure to elect certain directors on ability of corporation to comply with the requirements of Sarbanes-Oxley, and SEC and NYSE rules – e.g., rules requiring listed companies to have a majority of independent directors, and certain committees consisting of all independent directors.
- Impact of proposed NYSE rule changes on elections – a committee of the NYSE has been formed to review the continued existence of the broker vote rule. As a practical matter, broker votes are generally cast in favor of the corporation’s proposed slate of directors. Accordingly, if this rule is eliminated, there could be a significant impact on the proportion of votes “For” and “Withheld” from nominees for director.

Thoughtful planning must be undertaken prior to implementing majority voting or a compromise form thereof (e.g., some companies have adopted compromise voting policies such as a “majority withheld” policy in which director nominees (in an uncontested election) receiving a greater number of withheld votes than votes for are required to tender their resignations) to ensure the ongoing proper functioning of the board. The implementation of majority voting could intensify the challenge of recruiting qualified, independent directors due to the perceived negative stigma directors could face in receiving a negative vote.

In order to fulfill their obligations to shareholders, all public company boards should have substantive discussions regard corporate governance issues, including majority voting for election of directors. Before adopting majority voting for election of directors, corporations should carefully consider all of the pros and cons of such adoption as this particular corporate governance issue will continue to evolve throughout 2006 and thereafter.

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Earnouts: The Valuation Bridge

by Seth I. Rubin, Esq. and Michael I. Schnipper, Esq.

Picture this scenario: you’ve worked your entire adult life building up the value of your business and you’re ready to execute your exit strategy – a sale to another company that will enable you to retire comfortably. But, there’s a catch in the deal. The buyer is expressing doubts about the projected earnings of your company despite all of your charts showing a clear upward path in earnings well into the future. How can you bridge the gap between the buyer’s concerns and your own certainty about the future performance of your business? Simple, the buyer says, let’s use an earnout.

An earnout provision provides a seller with a higher purchase price – over a designated period of time – provided the seller achieves certain agreed upon targets. An earnout is designed to alleviate a buyer’s concern about overpaying for a business and a seller’s reasonable desire to be paid for the anticipated future value of the company being sold. As a result, an earnout can be useful in effectively bridging the gap between a willing buyer and a willing seller who have a disagreement as to the true value of the business being sold.

So, how can a seller protect himself with an earnout and still have the opportunity to maximize his sale price? First, a seller must have realistic guidelines in mind and understand how each piece of an earnout will be calculated post-closing. A good suggestion is to keep the earnout simple. Sellers are well advised to keep earnout percentages low (i.e., maximize the amount of up-front cash) and the length of time short. The longer the earnout period, the more performance becomes a reflection of new management and less a valuation as of the closing.

Second, understand that earnouts are fully negotiable. While a buyer may desire an all-or-nothing provision, a seller can often successfully argue for a sliding scale of payments dependent on the level of achievement. It is perfectly logical to argue that if you achieve 90% of target X, you should get something for your efforts instead of being shut out completely. A seller should also argue for catch-up provisions that take into account the possibility of a bad fiscal quarter and provide an opportunity to the seller to counter the effects of a bad quarter with the results of a good one. Earnout requirements and methods of calculations must be precisely defined to avoid confusion.

Earnouts can be based on a variety of targets including gross revenue, EBITDA, new clients generated or anything else on which the parties can agree. It is imperative that a seller understands that an earnout will require a seller to work for

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The strength of Ruskin Moscou Faltischek's resources greatly enhances what we can accomplish for our clients – to not only solve problems, but to create opportunities. We take pride in going beyond what is expected from most law firms. The invaluable contacts and relationships we have nurtured in the business community and our multidisciplinary approach heighten our value-added services.

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someone else post-closing. Although the seller should negotiate control over the entity being sold post-closing (i.e., a management position), the seller must recognize that he will no longer have absolute control.

An earnout should require a seller to work to achieve the earnout goals while also minimizing the ways in which a buyer could manipulate the numbers that are involved in the earnout calculations. As a result, specific limits must be placed on a buyer's operations. For example, while a buyer may wish to integrate a portion of the business it just bought, a seller may rightfully argue that the earnout cannot be properly determined if such integration occurs. Accounting issues must be analyzed pre-closing as companies often adopt generally accepted accounting principles (GAAP) without considering the ambiguities within GAAP. To protect against undesirable maneuvering by a buyer, a seller should insist on audit rights in connection with the earnout calculation, which allow a seller representative or an independent third party to review the numbers before they are deemed final.

Parties considering the use of an earnout must proceed with caution. In order to properly structure an earnout that recognizes the needs of both parties, the buyer and seller must have a full understanding of the business being sold and the accounting issues involved. The terms of the earnout must be clearly defined and carefully negotiated, with all ambiguities settled pre-closing. Only then can the earnout be used as a tool for a fair bridging of the gap between buyer and seller.

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