GUIDING CLIENTS TO SUCCESS

- **maxIT**
  - Represented shareholders in connection with the sale of a shared service company.

- **CareMore**
  - Represented an asset management company in its sale to a private equity firm.

- **Emerg-C**
  - Represented an energy company in its acquisition of a competitor.

- **ACME**
  - Represented a manufacturer in its acquisition of a competitor.

- **Pierce**
  - Represented a manufacturer in its acquisition of a competitor.

- **I-800-DENTIST**
  - Represented a dental provider in its acquisition of a competitor.

- **reaction**
  - Represented a software company in its acquisition of a competitor.

- **FIFTH STREET**
  - Represented a private equity firm in its investment in a technology company.

- **MATRIX**
  - Represented a healthcare provider in its acquisition of a competitor.

- **PICS**
  - Represented a software company in its acquisition of a competitor.

- **QuickStart**
  - Represented a business services company in its acquisition of a competitor.

- **booker**
  - Represented a software company in its acquisition of a competitor.

- **SCNRG**
  - Represented a renewable energy company in its acquisition of a competitor.

- **Health Essentials**
  - Represented a healthcare company in its acquisition of a competitor.

- **CyberCoders**
  - Represented a technology company in its acquisition of a competitor.

- **INTERFACE**
  - Represented a technology company in its acquisition of a competitor.

- **Arum**
  - Represented a technology company in its acquisition of a competitor.

- **L.L. Foods**
  - Represented a food company in its acquisition of a competitor.

- **Sunwest Bank**
  - Represented a financial services company in its acquisition of a competitor.

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Recently reported high-profile data breaches have brought considerable public attention to cybersecurity issues, as well as an awareness of the importance of protecting a company’s data – whether it be a company’s proprietary information or its customers’ data. Any company that falls victim to a data breach or theft can suffer damage to its reputation, government fines and penalties, remediation costs and monetary damages from resulting litigation. Often, buyers underestimate or do not appreciate the importance of cybersecurity issues when conducting due diligence in M&A transactions. A prior data breach can have a significant impact on the valuation of the seller’s business, and therefore both buyers and sellers should carefully assess the risks surrounding the seller’s data management and cybersecurity practices. For these reasons, buyers should make data management and cybersecurity review a key part of due diligence in M&A transactions. If the deal involves a public company target, data management and cybersecurity due diligence is all the more imperative because such deals generally lack indemnification provisions. The following are some important areas to focus on when conducting due diligence on data-driven businesses.

Data Risk and Compliance Obligations. An effective due diligence process should analyze what types of data the company possesses and maintains, as well as where and from whom the company obtains the data and with whom it shares that data. Currently, 47 states have some type of data security law, some of which impose significant obligations on companies that obtain certain types of data from designated persons resident within their state. Therefore, the due diligence process also should identify each state law that is applicable to the company and the type of data it collects and maintains, and the company’s prior and ongoing compliance with such laws.

Third-Party Vendors. All vendors and service providers to the company should be thoroughly reviewed to ensure that such vendors and suppliers are capable of protecting the information and data with which they are entrusted. Additionally, some state data security laws require companies to have a written contract with each vendor and supplier that obligates the vendor or supplier to implement and maintain appropriate security measures for certain types of personal information, all of which should be carefully reviewed.

Employee Risk Assessment. Employee handbooks, policies and materials should be thoroughly reviewed to ensure that all of the company’s legal remedies for data theft by employees have been preserved, such as the company’s rights under the Computer Fraud and Abuse Act. The company’s policies regarding employees’ rights to use their own devices at work also should be reviewed to ensure that employees do not retain any expectations of privacy regarding company information maintained on such devices. Finally, the company’s past practices with respect to enforcing its data security policies should be examined for consistency with respect to enforcement and employee discipline.

When evaluating a potential acquisition target, it is important to retain experienced legal counsel that understands and appreciates the significant cybersecurity risks that companies face. A thorough due diligence process designed to identify these risks and quantify potential liabilities prior to consummating an acquisition can help avoid significant and unexpected future liabilities.

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t is official: The current M&A market rivals the height of the 2007 market and makes it compelling for business owners to consider an exit. Many private businesses in Orange County are S corporations because owners can limit their liability and enjoy one level of tax on income. However, California does impose a 1.5 percent tax on S corporation profits. Buyers also favor S corporations over C corporations because they can acquire the stock and make a joint election with the seller to treat the transaction as an asset purchase for income tax purposes only pursuant to section 338(h)(10) of the Internal Revenue Code – often referred to as the “338 Election.” This gives the buyer a stepped-up basis in the purchased assets which provides future income tax benefits.

When a target company has one owner, has been an S corporation since inception, and is being entirely sold in an all cash deal, the 338 Election can work well. However, deals today are complicated because there may be multiple shareholders that may have residences in different states, the company may have started as a C corporation before it became an S corporation, the buyer may require a 20 percent or larger rollover by the existing owners, the buyer may defer a portion of the payment through an escrow hold back, an installment note or an earn-out agreement, or the buyer may simply question the validity of the S corporation status of the target.

Many buyers and sellers can bridge their differences by introducing limited liability companies (“LLCs”) into the transaction. This can be done in many ways. For example, we recently worked with a private business, structured as an S corporation, where the buyer was going to purchase only 80 percent of the company and wanted the seller to retain one of the two divisions of the business. We restructured the target company so that the shareholders ended up owning an S corporation that owned an LLC, which held the division that the buyer was interested in acquiring and retained the other division. The buyer paid cash to the S corporation, in exchange for 80 percent of the LLC units.

The result was that the buyer automatically obtained a stepped-up basis in the assets, and the S corporation was able to invest in the deal using pre-tax dollars and was able to retain the division the buyer did not want without triggering a taxable event. This structure also permitted the business to continue to operate in a flow-through structure. In contrast, if the buyer had forced the seller to distribute the unwanted assets, it would have been a taxable event. Additionally, if the buyer had purchased 80 percent of the stock and made a 338 Election, it would trigger 100 percent of the gain and force the seller to invest using after-tax dollars.

By using LLCs, buyers and sellers often obtain more favorable tax results than in transactions with a 338 Election.

Andy A. Torosyan

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New California Paid Sick Leave Law is Nothing to Sneeze At
by Koray J. Bulut, Greenberg Traurig Shareholder, Labor & Employment

Starting July 1, 2015, virtually all employers in California will be required to provide three days of paid sick leave each year under a new law signed by Gov. Jerry Brown last week. A.B. 1522, the “Healthy Workplaces, Healthy Families Act of 2014,” will affect small and large employers alike, with only unionized workers, home health care providers and airline flight crews exempted from the mandate. It is anticipated that 6.5 million workers in the state, or 40 percent of California’s workforce, previously without paid sick time, will benefit from the new law.

Under A.B. 1522, all employees, full and part time, will earn paid sick leave at a rate of one hour for every 30 hours worked and can begin using the accrued time after 90 days of employment. Employers are permitted to cap accrual of paid sick leave at six days and limit the employee’s use of paid sick days to three days per year, with the remaining time carrying over from year to year. However, employers are not required to pay out accrued sick time at termination. A small nuance that should not be overlooked is that the law applies to out-of-state employees that are not required to pay out accrued sick time at termination. A small nuance that should not be overlooked is that the law applies to out-of-state employees that work in California 30 or more days within a calendar year. For example, an out-of-state employee who travels to the home office of his or her California employer one week every month will be covered by A.B. 1522.

Employees may use the paid sick time for their own health condition, caring for a family member, or if they are a victim of domestic violence. Existing law already requires employers that provide paid sick time to allow employees to use half of their yearly allotment for “kin care” (care of their sick child, parent, spouse or registered domestic partner). Under A.B. 1522, the definition of family member is expanded to include grandparents, grandchildren and siblings. Employers should revise sick time policies to reflect these broad rights of use.

In addition to accounting for and providing the accrued leave, employers are required to display posters telling employees of their right to paid sick days and informing them that retaliation for requesting or using paid sick days is illegal.

Although many California employers already provide at least three days of paid sick time, A.B. 1522 will impose additional administrative burdens on those employers, including:

- The employee’s sick leave balance must now be included on itemized wage statements, or in another writing, on each pay day.
- Accrued sick leave must carry over into the new year, subject to the cap of six days. Employers are permitted to avoid the administrative burdens of tracking accrual and carry over if three or more days of paid sick time are granted at the start of the year.
- Records documenting the hours worked, and paid sick days accrued and used by an employee, must be retained for three years. Employees will have the right to inspect these records.
- Former employees that are re-hired within one year are entitled to have previously accrued and unused paid sick days be reinstated.

The passage of the law makes California the second state in the nation, after Connecticut, to subject employers to paid sick leave mandates. However, Connecticut’s law, which took effect in 2012, applies only to larger employers with 50 or more workers and covers only “service workers.”

The new California requirement follows the lead set by San Francisco when, in 2006, it became the first locality in the nation to require employers to provide paid sick leave for all employees working within the county. Other cities, including New York City, the District of Columbia, Seattle, Portland, San Diego and five cities in New Jersey have followed suit. Legislation has been introduced and groups are campaigning for laws to make paid sick leave mandatory in at least 20 other states.

Koray J. Bulut
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M&A Secrets Revealed?  
Protecting a seller’s attorney communications

by James J. Scheinkman, Partner, and Katherine Annuschat, Associate, Snell & Wilmer

The attorney-client privilege is a bedrock principle of American jurisprudence whose purpose is to encourage clients to freely seek the aid of counsel with the confidence that the client’s secrets and confidences will in fact remain secret and confidential. Without the protection of the attorney-client privilege, individuals and companies may be less likely to have the candid attorney discussions necessary to understand and comply with the law while achieving their business objectives.

This is especially true in the case of owners seeking to sell their companies. The sale of an owner’s business is frequently the most important, complex, and stressful transaction the owner will ever face and involves the need to understand and seek guidance from counsel on a multitude of topics. These include disclosure and other seller obligations, deal terms and legal structures, potential liabilities, risk analysis and other issues. An owner will want to be able to share, without reservation, information and concerns with trusted counsel, free of the anxiety that confidential communications will be acquired and used by the buyer.

Transfer of the Privilege to the Buyer

Nevertheless, the M&A process often results in the disclosure of communications the owner thought were confidential to the buyer who succeeds to the assets and rights of the acquired business, including its books and records. As a result, the buyer can use such confidential information to its advantage in litigation against the owner in numerous ways, including accessing the information to develop case strategy, submitting the communications into evidence and disqualifying the counsel who previously represented the acquired business from representing the owner. This reality was exemplified last year by the decision of the Delaware Chancery Court in Great Hill Equity Partners IV, L.P. v. Alfi Growth Equity Fund I, L.L.P.

In Great Hill, then Chancellor Strine, a leading jurist who has since been appointed Chief Justice of the Delaware Supreme Court, held that, in a merger transaction, the attorney-client privilege of the acquired company regarding negotiations over the merger passed to the acquiring corporation. The selling shareholders in Great Hill tried to argue, based in part on an earlier decision by the New York Court of Appeals in Tekni-Plex, Inc. v. Meyner and Landis, that pre-merger attorney-client communications regarding the merger negotiations did not pass to the surviving corporation on account of the importance of promoting the policies underlying the privilege, including encouraging full and frank communication between attorneys and their clients. The Court in Great Hill disagreed, in part on the basis of the express language of the Delaware merger statute, which provides that “all property, rights, privileges, powers and franchises” shall become the property of the surviving corporation. The Court further emphasized that the seller could have negotiated in the merger agreement the retention of the privilege and had not taken any action for an entire year after closing to ensure the privilege remained in the selling shareholders’ possession.

In California, the privilege can also easily pass to a buyer. This is particularly the case when the transaction is structured as a merger or stock sale. Under California Evidence Code Section 953, a successor to a merged corporation becomes the holder of the attorney-client privilege. Moreover, California Courts have long recognized that following a change in ownership of a company, the new ownership is free to use and waive the privilege of the acquired company. In at least one recent case (Favila v. Katten Muchin Rosenman LLP), however, the Court held that a sale of substantially all of the assets of a company did not result in the transfer of the attorney-client privilege.

Inapplicability or Waiver of the Privilege

Independent of the issue of whether the privilege passes to the buyer are the questions of whether the privilege applied in the first place, or, if it did apply, was it waived in the process. Just because a company hires an attorney as part of its deal team, this does not make all the communications with the attorney privileged. California Evidence Code Section 952 defines confidential information between a client and lawyer as:

“information transmitted between a client and his or her lawyer in the course of that relationship and in confidence by a means which, so far as the client is aware, discloses the information to no third persons other than those who are present to further the interest of the client in the consultation or those to whom disclosure is reasonably necessary for the transmission of the information or the accomplishment of the purpose for which the lawyer is consulted…”

In this context, consultation between a client and a lawyer over a lawyer’s bargaining points on business terms with the other side, business-related documents that are shared with the lawyer, and drafts of contracts shared with third parties may be privileged. The privilege may be waived if disclosures are provided broadly among members of the seller’s deal team, which may include investment bankers, valuation experts, accountants, family members or others whose involvement may be determined after the fact to not be necessary. Disclosure in a negotiation session to the other side of legal analysis for a particular position may also result in waiver of the privilege. There are also exceptions to the privilege in cases of a joint representation of the selling company and its owners if there is a post-closing dispute between the selling company under new ownership and the former owners. Moreover, if a written document contains both privileged and non-privileged information, the owner may only be able to redact the portion which is privileged and may be required to disclose the rest.

Apart from the legal challenges of establishing, maintaining and not waiving the privilege, there is the practical consideration that, almost always following a sale, the buyer will have physical possession of the selling company’s books and records including emails and electronic data. This is particularly important both as to what information a buyer may glean and also the Great Hill court’s admonishment as to the effect of an owner’s failure to take reasonable steps to ensure the buyer did not have access to the privileged communications.

Takeaway Points

There are a number of takeaways sellers and their counsel should consider during the M&A process. These include:

Initiating discussions at the beginning of the transaction process among the attorney, the client and other deal team members as to the limitations of the attorney-client privilege.

Understanding how information is to be communicated between attorney and client, and issues involving the buyer’s access post-closing to the selling company’s email and electronic filing and retrieval systems.

Educating the team on the need to avoid inadvertent and unnecessary copying or forwarding of emails and other documents to team members.

Operating under a working assumption that all written communications could either not be subject to the privilege or may wind up in the hands of an adverse buyer.

Segregating legal communications from business or non-legal communications.

Being cognizant of issues arising from joint representation of the selling company and the owners, prior representation of the selling company on matters other than the business sale, or the structure of the transaction.

Being careful of disclosure during negotiation sessions to the buyer of legal analysis or internal communications among the sell team.

Particularly in the context of a stock sale or a merger, insisting on provisions in the definitive documents that vest the privilege as to sale negotiations in the selling owners post-closing, providing for the ability post-closing to access and retain in the owners’ exclusive possession privileged documents, and addressing related issues, such as a conflict waiver by the target company in the event of a post-closing dispute.

Taking actions post-closing to possess and control privileged documents.

Conclusion

To be sure, the treatment of attorney-client communications is but one of many items that sellers and their counsel will need to address as part of the sales process. Frequently, practical requirements in proceeding expeditiously to complete the transaction may impact the ability to adopt optimal procedures to protect and maintain the privilege. Just the same, it is important that clients and their attorneys discuss the issues surrounding the attorney-client privilege early on so that the client not discover for the first time in a post-closing dispute that the confidence the client thought to be secret are not so secret.

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