CARR McCLELLAN
INGERSOLL THOMPSON & HORN

PERSPECTIVES ON LAW

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GOODBYES AND HELLOES

His family, many friends and our firm said goodbye to **Frank Ingersoll** this past July. One of our founding partners, Frank passed away on July 26, 2003 at the age of 91. Although retired since 1980, Frank was a frequent visitor to our offices. In the years following his retirement Frank continued to utilize his considerable knowledge and skills as a mediator, arbitrator and conservator. Our law firm owes much to Frank. He set the example for all of us with his community involvement, client service and excellence in business lawyering. Frank was at the forefront of many of the Peninsula's major civic and charitable organizations. He helped establish the Peninsula Hospital District and was its first legal counsel. Frank served as the first Town Counsel of the Town of Hillsborough and was the Better Business Bureau's incorporating attorney and its legal counsel for over two decades. Frank's leadership skills exhibited themselves not only in his legal work with clients and community organizations, but in his stewarding our firm to its leadership position in the Peninsula's business community. Frank's affable character, his words of encouragement and personal charisma will be missed. His legacy of excellence and service with endure through our firm.

As we say goodbye to Frank we say hello to **Charlotte Ito**. Charlotte joins our Estate Planning, Trusts and Wealth Transfer Group as a director after having served as lead partner of the estate planning group in the San Francisco law firm of Howard, Rice, Nemerovski, Canady, Falk & Rabkin. Charlotte is a 1983 Hastings graduate, holds an MBA in Finance and International Business from Berkeley's Haas School of Business and an LLM in tax from Golden Gate. She is an inactive CPA. Charlotte was employed as a tax manager at Arthur Andersen before starting her own firm of Ito & Johnson in 1992. She is fluent in Japanese. Charlotte's considerable talents will augment the breadth and depth of our Estate Planning, Trusts & Wealth Transfer Group. We are extremely pleased to have a person of Charlotte's character, knowledge, skills and experience, personality, and energy (she's a distance runner) join the firm.

As always, we hope you find the articles in this issue of *Perspectives* informative and interesting. We look forward to being of service to you, our clients and friends.

Mark Cassanego, President of Carr McClellan.

LIMITED LIABILITY COMPANIES – PROTECTING THE VEIL

By Michael Telleen, Esq.

Like a corporation, a limited liability company generally shields its owners from personal liability for the acts of the company. However, under California law members of a limited liability company will have personal liability for the acts of the limited liability company to the same extent that shareholders of a corporation might have personal liability for the acts of the corporation.

To protect the limited liability of shareholders of a California corporation, the corporation should be properly organized, adequately capitalized, and completely separate as a legal entity. Corporate formalities should be followed and records maintained. If a court finds that the corporate privilege has been abused, the corporate entity may be disregarded for the purpose of remedying the specific abuse and the corporate shareholders may be liable for the corporation's acts relating to that abuse.

An individual attacking the corporate status to achieve shareholder liability will try to "pierce the corporate veil," to prove that the corporation is merely an agent of the individuals behind it. An individual trying to pierce the corporate veil must generally prove two things: first, that there is a unity of interest and ownership between the corporation and the shareholders, such that the corporation and the shareholders are no longer separate; and second, that an injustice or fraud will occur if the corporation's actions are treated solely as the acts of the corporation.

A limited liability company can reduce the possibility that the individual members will be subject to liability for the limited liability company's actions by following the guidelines listed below:

• The limited liability company should be adequately capitalized to enable it to carry on its business.

• The limited liability company should obtain adequate insurance to meet its insurance needs. We suggest that the limited liability company consider coverage including liability insurance appropriate for its business, fire and casualty insurance, business interruption insurance, and workers' compensation insurance.

• The limited liability company should observe formalities, including but not limited to, holding member or manager meetings (if such meetings are required by the Operating Agreement), keeping minutes of any such meetings, keeping records of

(continued on page 8)

CHARITABLE ORGANIZATIONS

RULES REGARDING ASSET MANAGEMENT AND FINANCIAL RELATIONSHIPS – PART I

By Penelope Greenberg, Esq.

ORGANIZATIONAL STRUCTURE AND TAX EXEMPT STATUS

Most charitable organizations in California are organized as California nonprofit public benefit corporations and are tax exempt under Section 501(c)(3) of the federal Internal Revenue Code and under the corresponding California provision. The organization is subject to both state and federal requirements regarding the management of the organization's assets and the nature of financial relationships between the organization and its board members and others.

Section 501(c)(3) organizations are either private foundations (which are privately funded, usually by one family or company) or public charities (which generally have broad based public funding). This distinction is important because it affects which rules apply to an organization's investments and financial relationships. A 501(c)(3) organization is a private foundation unless the organization qualifies as one of the four kinds of public charities, as follows:

IRC 509(a)(1)/IRC 170(b)(1)(A)(i) – (vi) [Traditional public charities].

- Church or convention/association of churches.
- Educational organization with regular faculty and curriculum and student body.
- Hospital or medical research organization.
- Holding company for property of state college or university.
- Federal, state, or local government.
- Corporation, trust, or community chest, fund, or foundation normally receiving a substantial part of its support from government or general public.

IRC 509(a)(2) [For example, museums and theaters with substantial admission income].

An organization normally receiving more than 1/3 of its support from gifts, grants, contributions, membership fees, and gross receipts from charitable activities (admissions, sale of merchandise, performance of services, etc.) and no more than 1/3 of its support from gross investment income and unrelated business income (net of unrelated business income tax).

IRC 509(a)(3) [Functionally somewhere between a private foundation and a donor advised fund held by a public charity].

"Program-related investments are often risky because of the nature of charitable endeavor itself, for example, helping people with few resources or prospects."

A "supporting" organization, which provides financial support to and/or supplements the charitable work of another publicly supported charity (or certain Section 501(c)(4), (5), or (6) organizations). Supporting organizations have a formal relationship with the supported charity and are sometimes created by donors who want to have a separate charitable entity over which they can exercise some control but who do not want a private foundation with its additional legal restrictions.

IRC 509(a)(4) [Rarely used].

An organization organized and operated for testing for public safety.

INVESTMENT RULES AND STANDARDS UNDER CALIFORNIA LAW

Whether the charitable organization is a private foundation or a public charity, Corporations Code Sections 5240 and 5231 and Probate Code Sections 18506 and 18504 provide the basic rules and standards under California law for managing the assets of a California nonprofit public benefit corporation.

Section 5240 investment standards – The investment rules of Corporations Code Section 5240 apply to all assets held by the corporation for investment except for those assets directly related to the corporation's public or charitable programs. The reason for this exception is obvious: program-related investments are often risky because of the nature of charitable endeavor itself, for example, helping people with few resources or prospects. To hold such investments to a prudent investor standard could prevent the corporation from implementing the very programs that it was designed to provide. However, for non-program related investments, Section 5240(b) sets forth the following investment criteria:

"…in investing, reinvesting, purchasing, acquiring, exchanging, selling and managing the corporation's investments, the board shall do the following:

(1) Avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital.

(2) Comply with additional standards, if any, imposed by the articles, bylaws or express terms of an instrument or agreement pursuant to which the assets were contributed to the corporation."

Section 5240(c) provides, however, that if the assets were contributed pursuant to an agreement or other instrument directing or authorizing how the assets are to be invested, compliance with those terms will not constitute violation of the above-described investment standard. Likewise, the investment standard is not violated if the board has followed the good faith performance standard for directors set forth in Corporations Code Section 5231(explained below).

Section 5240(d) specifies that the board may delegate its investment powers as provided in Corporations Code Section 5210, which authorizes the board to "delegate the management of

the activities of the corporation to any person or persons, management company, or committee however composed, provided that the activities and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board." Paragraph (d) also notes that in carrying out their investment duties, directors are subject to the provisions of Corporations Code Section 5231.

Section 5231 good faith performance standards – Corporations Code Section 5231(a) provides that a director shall perform his or her duties "in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."

Section 5231(b) notes that "a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by (1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented; (2) Counsel, independent accountants or others persons as to matters which the director believes to be within such person's professional or expert competence; or (3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefore is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted." [Underlining added.]

"...Blind reliance is not sufficient. The director must believe that the third parties are reliable and competent..."

Note that blind reliance is not sufficient. The director must believe that the third parties are reliable and competent as to the matters involved.

Section 5231(c) provides that so long as there has been no self-dealing* by the director, compliance with the above good faith performance standards means that the director "shall have no liability based upon any alleged failure to discharge the person's obligations as a director, including…any actions or omissions which exceed or defeat a public or charitable purpose to which a corporation, or assets held by it, are dedicated."

*(Self-dealing, as described in Corporations Code Section 5233, means a transaction between the corporation and the director in which the director has a material financial interest and which has not met the required safeguards and standards. There are also separate self-dealing rules applicable to private foundations set out in Section 4941 of the Internal Revenue Code.)

Uniform Management of Institutional Funds Act ("Act") (Probate Code Sections 18500 - 18509) – Corporations Code Section 5240(e) explains that the Uniform Management of Institution Funds Act in the Probate Code is applicable according to the terms of the Act, although the Act does not alter the duties and liabilities of directors under Section 5240. In other words, compliance with both the Act and Section 5240 are required. The language of the Probate Code, while more specific than the Corporations Code provisions, includes the same concepts of prudence and attention to the big picture over the long haul.

Probate Code Section 18506 recites the standard of care under the Act as follows:

"(a) When investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing property, appropriating appreciation, and delegating investment management for the benefit of an institution [including a charitable corporation], the members of the governing board shall act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the institution. In the course of administering the fund pursuant to this standard, individual investments shall be considered as part of an overall investment strategy.

(b) In exercising judgment under this section, the members of the governing board shall consider the long- and short-term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, general economic conditions, the appropriateness of a reasonable proportion of higher risk investment with respect to institutional funds as a whole, income, growth, and long-term net appreciation, as well as the probable safety funds.

Section 18504 describes the governing board's investment authority as follows:

"In addition to an investment otherwise authorized by law or by the applicable gift instrument, the governing board, subject to any specific limitations set forth in the applicable gift instrument, may do any or all of the following:

(a) Invest and reinvest an institutional fund in any real or personal property deemed advisable by the governing board, whether or not it [the property] produces a current return, including mortgages, deeds of trust, stocks, bonds, debentures, and other securities of profit or nonprofit corporations, shares in or obligations of associations or partnerships, and obligations of any government or subdivision or instrumentality thereof.

(b) Retain property contributed by a donor to an institutional fund for as long as the governing board deems advisable.

(c) Include all or any part of an institutional fund in any pooled or common fund maintained by the institution.

(d) Invest all or any part of an institutional fund in any other pooled or common fund available for investment, including shares or interests in regulated investment companies, mutual funds, common trust funds, investment partnerships, real estate investment trusts, or similar organizations in which funds are commingled and investment determinations are made by persons other than the governing board."

Like the Corporations Code, the Act, in Section 18505, allows the board to delegate investment

management (unless contrary to the applicable gift instrument or laws applicable to governmental institutions or funds).

SPECIAL INVESTMENT RULES FOR PRIVATE FOUNDATIONS

Excess Business Holdings – As a general rule under Internal Revenue Code ("IRC") Section 4943, a private foundation may not own more than 20% of any one business enterprise, whatever form the enterprise takes. This limit is designed to avoid unfair competition by exempt organizations and the possible shift in the foundation's focus from charitable works to managing business investments. (Consistent with that rationale, the 20% limitation does not apply to functionally related businesses, such as a business that is substantially related to the exercise or performance of the foundation's charitable purpose. It also does not apply to a program-related investment or a business whose gross income is 95% or more from passive sources, e.g., dividends, interest, royalties, certain rentals, etc.)

The 20% is calculated by adding up the foundation's holdings plus those of its disqualified persons (substantial contributors, foundation managers [officers, directors, or trustees], family members of those, and certain corporations and businesses in which such people have certain holdings). However, if the foundation owns no more than 2% of the voting stock and not more than 2% of the value of all outstanding shares of all classes of stock, then the foundation will not be treated as having excess business holdings in the corporation. (This 2% rule has some qualifications that make it a little more complicated than this in reality.)

In some cases, the 20% limit is increased to 35% if the foundation can show that effective control of the business enterprise rests with some third party and not with the foundation. In some circumstances, corporate holdings that do not include the power to vote or otherwise exercise control over the enterprise do not count as part of the 20%.

If a foundation finds itself with excess business holdings, it must dispose of the excess within the applicable time limits or be liable for a 5% excise tax on the value of the excess holdings. That tax is followed by a 200% tax if the excess holdings are not divested by the end of the taxable year. If the excess business holdings resulted from a gift or from a disposition by will, trust, or intestacy, the foundation generally has five years to bring its holdings down to the applicable limit. If the excess holding limit is exceeded because of a purchase by a disqualified person, the foundation has 90 days to get back below its limit, counting from when the foundation knew or should have known of the purchase. If the foundation itself is the purchaser, it must dispose of the excess holding immediately and pay the 5% excise tax unless the foundation did not know and had no reason to know that its purchase put it above the limit, in which case the deadline is 90 days.

Obviously, the safest strategy is for the foundation to stay well away from the 20% limit and for those involved to stay aware of their investment holdings and those of the foundation.

"Prudence, aided by advice from qualified advisors and guided by a clear vision of the charitable mission of the organization, should keep the organization's investment policies on the right track."

Jeopardizing Investments – Under IRC Section 4944, a private foundation may not invest "any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes." Violation of this rule results in a 5% excise tax on the foundation and a 5% tax on any foundation manager (maximum $5,000) who knew the investment violated the rule unless his or her participation was not willful and was due to reasonable cause. Additional taxes follow on both (maximum $10,000 on the manager) if the situation is not corrected within the applicable time limit.

Basically, this rule requires that the prudent person rule be followed as to the foundation's investments. If the foundation is meeting the investment criteria applicable under California law, Section 4944 will almost certainly be satisfied as well. The determination whether a particular investment jeopardizes the carrying out of the foundation's exempt purposes is made on an investment by investment basis, taking into account the portfolio as a whole. No category of investments is a per se violation of Section 4944 but the following will be "closely scrutinized" say the IRS regulations: trading in securities on the margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of "puts" and "calls" and "straddles" and warrants and selling short.

As with the rule against excess business holdings, program-related investments are acceptable in any event. "Investments, the primary purpose of which is to accomplish one or more of the [charitable] purposes and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes." (IRC Section 4944(c)) For example, a charitable organization could have a loan program for charitable projects that are technically poor credit risks but if such assistance is part of the mission of the organization, there is no problem.

It is also possible to be too cautious in investments and to hold assets in such low yielding, super safe investments that growth in the value of the assets or their earnings is unduly limited. The minimum annual payout requirement for private foundations is 5% of the fair market value of its investment assets, basically. An investment policy that over the long term produces less than the required payout may not qualify as prudent.

For private foundations and public charities alike, the basic rule is one of common sense. Prudence, aided by advice from qualified advisors and guided by a clear vision of the charitable mission of the organization, should keep the organization's investment policies on the right track.

Part II will appear in the next issue of Perspectives and will cover Compensation, Self-Dealing, Enforcement and Practicalities.

Penelope Greenberg is a member of the Exempt Organizations Group.

WAIVER BY MINORITY SHAREHOLDER MAY NOT PROTECT MAJORITY SHAREHOLDER FROM BREACH OF FIDUCIARY DUTY ACTION BASED ON FRAUD

By Lori Lutzker, Esq.

For those of you thinking about buying or selling a company, think about the recent case of Neubauer v. Goldfarb decided by the Second Appellate District Court on April 23, 2003.

Neubauer owned forty percent of the shares of HCC Industries, Inc. ("HCC") worth approximately $1 million. The remaining sixty percent of the corporation was owned by Goldfarb, the president and chief executive officer, his brother and the chief financial officer (collectively the "Goldfarbs"). In order to facilitate the negotiation and closing of a sale, Neubauer agreed to sell his shares to HCC for $70 per share. Less than 90 days later, the Goldfarbs sold their shares for $347 per share. Believing that the Goldfarbs had intentionally misled him as to the value of his shares, Neubauer brought an action against the Goldfarbs for breach of fiduciary duty and related torts.

The agreement between Neubauer and HCC provided: "Seller acknowledges that neither HCC nor its officers, directors or controlling shareholders have any fiduciary duty to seller or HCC in connection with the execution of this agreement or a sale including, but not limited to, the fairness of the overall consideration or the allocation thereof." The agreement further stated that "seller . . . has requested and received such information in connection with the execution of this agreement as he believes to be necessary in order to make an informed decision to enter into this agreement and to bind himself as set forth herein" and "the provisions hereof have been thoroughly reviewed by all parties and have been the subject of negotiations."

The Goldfarbs sought judgment in their favor on the ground that in the agreement Neubauer knowingly and intelligently waived any fiduciary duty the Goldfarbs owed to him. They also contended that all of his tort claims were barred because Neubauer released them from liability on any claim based on their subsequent sale of HCC, which resulted in their receiving a higher price for their shares than Neubauer received. The court rejected both these contentions and held that the purported waiver of the Goldfarbs' fiduciary duties was void as it was against public policy.

"In order to facilitate the negotiation and closing of a sale, Neubauer agreed to sell his shares to HCC for $70 per share. Less than 90 days later, the Goldfarbs sold their shares for $347 per share."

The court began by observing that: "The law has traditionally viewed with disfavor attempts to secure insulation from one's own negligence or willful misconduct." "Furthermore," the court noted, "it is the express statutory policy of this state that all contracts which have for their object, directly or indirectly, to exempt anyone from the responsibility for his own fraud or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law." The court found "this public policy applies with added force when the exculpatory provision purports to immunize persons charged with a fiduciary duty from the consequences of betraying their trusts." Moreover, "the California Supreme Court has evinced a clear policy of enforcing only those exculpatory provisions which do not affect the public interest."

The court concluded that a breach of fiduciary duty constitutes a "willful injury to the . . . property of another" and, therefore, cannot be contractually excused. Furthermore, the court observed that the buying and selling of corporate stock are transactions, which affect a public interest. As additional evidence that the waiver of a director's fiduciary duty is against public policy, the court noted that in Corporations Code § 204(a)(10) provides that articles of incorporation "may not eliminate or limit the liability of directors [to the corporation] for acts or omissions that involve intentional misconduct . . . or that involve the absence of good faith on the part of the director . . . ."

The court held that the waiver of corporate directors' and majority shareholders' fiduciary duties to minority shareholders in private close corporations is against public policy and a contract provision in a buy-sell agreement purporting to effect such a waiver is void.

The court went on to note that even if the Goldfarbs' fiduciary duty validly could be waived, a waiver requires the knowing and intelligent relinquishment of a right. If it turned out the Goldfarbs withheld material information, a trier of fact could find that Neubauer's purported waiver was not fully informed.

Under this case, it is highly unlikely that a waiver and release by a minority shareholder would ever be enforceable in an action against majority shareholders for breach of fiduciary duty based on fraud.

Lori Lutzker is a member of the Corporate & Business Group.

A PRIMER ON THE SALE OF A PRIVATELY HELD BUSINESS – PART II

By Mark Cassanego, Esq.

In the first part of this article, we reviewed how to prepare a business for sale, considered factors relevant to the proper timing to sell a business, and reviewed the processes involved in valuing a business, conducting due diligence and identifying potential buyers. In this issue we will complete our "Primer" by reviewing deal structure and documentation.

LETTERS OF INTENT

The conclusion of the first phase of a successful business sale negotiation process usually results in a letter of intent that sets forth the principal terms of the proposed deal. The letter delineates the structure, price and terms of the transaction; generally describes the scope of representations and warranties and conditions to closing; and sets forth any special arrangements, including the scope of indemnification to be provided by the seller and/or its shareholders. The letter of intent may also outline post-closing employment commitments made by the buyer to some or all of seller's employees. Especially helpful when the transaction is complex, a letter of intent can be either binding or non-binding. However, whether binding or non-binding, the letter often is considered to create an "ethical" obligation to "stick to" the principal terms of the transaction set forth in the letter of intent, and some courts have held that even non-binding letters of intent create legal obligations to negotiate in good faith.

"...Whether binding or non-binding, the letter [of intent] often is considered to create an 'ethical' obligation to 'stick to' the principal terms of the transaction..."

If the parties have not already entered into a non-disclosure agreement, the letter of intent typically includes a legally binding confidentiality provision. Potential buyers will generally insist on a "lock-up" or "no-shop" provision, which legally binds the seller to negotiate exclusively with the buyer for a set period of time during which due diligence is conducted and the definitive agreement is drafted and negotiated.

STRUCTURE OF THE DEAL

A sale of a business is generally structured in one of three ways: asset purchase, stock purchase or merger. While dependant on a variety of factors, the choice of which structure is best for you will be based largely on the resulting tax consequences described below.

Asset Purchase

In an asset purchase, all or substantially all of the assets of the business are purchased from the owner. This type of transaction is often structured at the insistence of the buyer to avoid assumption of any unknown or contingent liabilities of the seller's business. In general, federal and state income taxes on the seller's gain are based on the difference between the purchase price for assets and the tax basis of those assets. If proceeds of the sale are distributed to shareholders, and if the seller is a "C" corporation, an additional tax may be imposed on the shareholder, thereby imposing a "double tax." Different tax results apply to "S" corporations, limited liability companies and partnerships, which generally allow for the avoiding of a "double tax."

The buyer and seller must report to the IRS the allocation of the purchase price among the assets purchased using what is referred to as the residual method. The purchase price is first allocated to cash, marketable securities, inventory, equipment, etc. according to their fair market values. The amount of the purchase price that exceeds the aggregate fair market value of specific assets is allocated to goodwill as the residual. The buyer generally will acquire a new tax basis in the assets purchased equal to the purchase price.

Generally, sales tax will be assessed on the value of the tangible personal property being transferred, excluding inventory or other property held for resale.

California real property sold in the transaction is generally reassessed to its current fair market value and a city and county real property documentary transfer tax will be charged.

The mechanics of an asset sale require the specific transfer of all assets and rights being sold or assigned, including leases, licenses, vehicles, real property, contracts, etc. Separate documents of transfer, such as deeds, bills of sale, and assignments may be required to effectively transfer the assets or rights being acquired to avoid a claim that the leases have been breached. Most often leases require tenants to obtain the consent of landlords to any assignments or subleases. Accordingly, landlord consents may need to be obtained prior to the effective date of a transaction.

Stock Purchase

In a stock purchase, all of the capital stock of the corporation, representing the ownership of the corporation rather than the corporation's assets, is purchased. Under this type of transfer, all liabilities of the acquired corporation, whether known, unknown or contingent, stay with it by operation of law. Tax ramifications for these transactions include:

- Owners of stock will have a gain or loss based on the difference between the purchase price for the stock and their cost basis in the stock.
- The buyer acquires a new tax basis in the stock equal to the purchase price. (The buyer can elect to treat the purchase of the stock like the pur-chase of assets for tax purposes, however, the "cost" of such an election is the recognition of any gain.)
- Section 382 of the Internal Revenue Code limits the utilization of any net operating loss carryforward, which an acquired corporation

may have if 50 percent or more of a corporation's stock transfers during a three-year period.

Merger

A merger is a combination of two entities accomplished under state law by filing a merger document with the Secretary of State of the state of organization of the surviving entity. A cash-out merger, in which the acquired corporation's stock is converted into the right to receive the cash purchase price, is treated for most purposes as a sale of stock. This structure provides mechanical advantages when the business has a large number of shareholders, since the separate individual agreement of each shareholder is not required. Rather, a buyer can obtain 100 percent of the corporation's stock through a majority vote of shareholders. Shareholders who vote against the merger are limited to exercising their appraisal rights as their only remedy.

Nontaxable Merger or Reorganization

Corporate parties to a merger have available a structure that allows the seller and its shareholders to defer recognition of gain which might otherwise be recognized as a result of the transaction. To take advantage of this structure, the general rule is that sellers must not have "cashed-out." Nontaxable mergers or acquisitions take various forms, including statutory mergers, exchange reorganizations and stock-for-assets transactions.

Statutory Merger – To qualify for tax deferral treatment, at least 50 percent of the purchase price must be paid in stock of the buyer. Any part of the purchase price paid in cash will be taxed, often at the ordinary rates, to the extent of the corporation's earnings and profits. Because assets and liabilities transfer automatically in a statutory merger, there is less paperwork than in an asset purchase or a stock purchase. Any assets unwanted by the buyer can be disposed of prior to the merger without affecting the tax-free nature of the deal.

Forward and reverse triangular mergers are variations of the statutory merger structures and are often used to insulate assets and liabilities in a subsidiary of the buyer. In a forward triangular merger, the seller merges into a new subsidy of the buyer and the seller's shareholders receive stock of the buyer. In a reverse triangular merger, a subsidiary of the buyer merges into the seller and the seller's shareholders receive stock of the buyer. To utilize a reverse triangular merger, 80 percent of the purchase price must be paid in stock of the acquiring corporation. This type of merger is advantageous when it is important for the acquired company to survive the merger when the seller holds transferable licenses, leases, etc.

"B" Reorganization – A "B" reorganization, named after Internal Revenue Code Section 368(a)(1)(B), is a stock-for-stock swap in which the buyer exchanges its stock for the stock of the seller through an agreement with the seller's shareholders. In one sense this form may be considered the simplest of the nontaxable mergers but it is also the most restrictive. In order to achieve a tax deferral, 80 percent of the selling company's total voting shares and 80 percent of the voting shares of each class must agree to the deal. If any medium of exchange is used other than stock, it may jeopardize the tax-free nature of the transaction. For instance, all or a portion of a selling shareholder's compensation under a new employment contract may be treated as cash received in the acquisition. Similar results can be achieved through a reverse triangular merger.

"Shareholders who vote against the merger are limited to exercising their appraisal rights as their only remedy."

Stock-for-Assets – In this transaction, the buyer exchanges its stock for substantially all of the assets (90 percent of the net assets and 70 percent of the gross assets is required) of the seller. The stock of the buyer is distributed to shareholders of the seller in complete liquidation. Up to 20 percent of the purchase price can be received in cash or by assumption of liabilities without disqualifying the transaction as non-taxable.

Other Structural Components of Acquisitions – Regardless of the type of merger or acquisition structure chosen, it will often include additional contract terms that define the relationship selling shareholders or the selling entities' employees will have with the new or acquiring entity. These might include covenants not to compete, consulting agreements or new employment contracts. The terms of the transaction will also need to address the transfer and allocation of the purchase price among intangible assets such as goodwill, going concern value, customer-based intangibles, licenses or rights granted by governments, patents, copyrights, formulas, know-how, franchises, trade names and covenants not to compete.

DEFINITIVE AGREEMENTS

After completing all the preparatory work leading up to a sale, identifying a buyer, determining the transaction structure, obtaining any necessary preliminary approvals and completing negotiations, the next step is to set out the specific terms of the final agreement. Building on the letter of intent, the definitive agreement will legally bind any necessary parties to complete the deal, including shareholders that may be asked to make representations and warranties and provide indemnification, in addition to those provided by the company. The agreement will include the details of the financial terms, such as amounts of cash to be transferred, debt incurred, hold-back escrows and contingent payments. It is in the definitive agreement that the owner must make the representations and warranties that serve as a disclosure device and the basis upon which indemnification may later be sought. These representations will reflect the work that was done during the due diligence stage and covers many matters central to assuring the buyer that it will be purchasing the business in the condition represented and that no circumstances exist that affect value. The litany of representations and warranties most often include corporate matters, status of contracts, condition of assets, confirmation of title, financial statements, taxes, hazardous material disclosures and absence of litigation.

Although the definitive agreement generally binds the parties to consummate the transaction,
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Limited Liability Companies

(continued from page 1)

all company activities; maintaining separateness and arm's length dealings between the company and the members; and obtaining member approval of the company's transactions where required by the Operating Agreement. Note that if the Operating Agreement does not require the holding of meetings of members or managers, the California limited liability company act provides that the failure to hold meetings or observe formalities relating to the calling or conduct of meetings shall not be considered a factor establishing that a member should be subject to personal liability for the limited liability company's actions.

- All agreements or other documents, signed on behalf of the limited liability company, should be signed in the company's name. A signature block should give the name of the company and then the authorized person's signature, name and title.
- Company funds should not be commingled with the funds of the members or any other entity. Furthermore, the company should maintain separate operations and records from those of other entities and its members.
- All withholding tax payments should be made.

Michael Telleen is a member of the Corporate & Business Group.

Selling A Business – Part II

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it often does so only subject to the satisfaction of certain pre-closing conditions. Principal among typical conditions are buyer's obtaining of satisfactory financing, receipt of landlords' consents to lease assignments and completion of due diligence. Buyers negotiate for many and broad conditions while sellers prefer to limit them to a few.

The definitive agreement also spells out the potential obligations of the seller and its principal shareholders to indemnify the buyer from any damages suffered in the event that any of the representations or warranties turn out to be inaccurate. Indemnity provisions often include "baskets" and "caps" which protect seller from deminimus claims and from catastrophic claims. The procedures that the buyer and seller must follow in dealing with indemnity claims are also set forth in the definitive agreement. Most often the parties agree to some form of arbitration to resolve any indemnity disputes.

Finally, pay close attention to any boilerplate language included in the agreement. These sections are important but often overlooked. Provisions such as choice of law, venue for litigation or arbitration, and attorneys' fees clauses can have a real impact on results if ever called into play.

GOLDEN PARCHUTE PAYMENTS

A golden parachute payment is compensation paid to a company executive that is contingent on a change in ownership. To be considered a golden parachute payment the present value of the compensation must be greater than three times the average annual compensation to that executive for the past five years. As part of preparing a business for sale, the owner needs to evaluate any existing parachute payment agreements and their post sale tax consequences. Parachute payments are not deductible and are subject to a 20 percent excise tax. Exceptions are available for certain small business corporations, or if the payment is approved by a 75 percent shareholders vote.

FAIRNESS OPINIONS

California corporate law requires fairness opinions to be delivered to shareholders in transactions where an "interested party" is, or is part of, the buying group. Interested parties could be persons in control of the seller, or persons controlled by an officer or director of the seller. These opinions must be given by an unaffiliated party who is engaged in the business of advising others regarding the value of businesses or securities. Typically fairness opinions are given by investment banking firms or financial advisory firms.

CONCLUSION

There is a tremendous range of complexity involved in the sale of a business. Small businesses with few assets may present extremely complex legal, personal or negotiating issues, while large businesses may involve relatively straight forward challenges. However, regardless of the size of the company, the fundamental steps that should be taken to achieve the desired objectives of the owner are very similar. Clarify the goals to be achieved in selling the business, determine the best time to sell the business, get your house in order by conducting a thorough due diligence review of the business and taking steps to maximize its value, select a potential buyer or buyers, decide which transaction structure is best for your situation and distill the terms of the sale into a detailed letter of intent and comprehensive agreement.

Mark Cassanego is a member of the Corporate & Business Group.

CARR McCLELLAN
INGERSOLL THOMPSON & HORN
PROFESSIONAL CORPORATION

CARR McCLELLAN
216 PARK ROAD
BURLINGAME
CALIFORNIA 94010

P 650.342.9600
F 650.342.7685

WWW.CARR-MCCLELLAN.COM

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