



Valuation Issues Under a Buy-Sell Agreement

By Richard J. Contant

The valuation of an owner's equity (e.g., stock) in a closely-held business pursuant to a buy-sell agreement is a concept often inadequately analyzed and most often inadequately covered in such an agreement. As noted in a prior article in this series, a buy-sell agreement can be a standalone agreement or it can be incorporated into a stockholders' agreement, LLC operating agreement or partnership agreement. This article will review the basic issues that should be considered when thinking about a buy-sell agreement.

The primary question: Why do you want to put a value on the equity? Under a buy-sell agreement, an owner's equity is going to be transferred from the owner to another owner or to the business entity upon the occurrence of an event such as death, permanent disability or termination of employment. In such an event, you want a mechanism in place to establish the value of the equity when the "triggering event" occurs. This valuation is limited to the specific triggering events; it does not apply if the entire business is sold to a third person.

The second question is: How do you establish a "base value" for the equity? The initial process does *not* attempt to determine the "Fair Market Value" of the equity (*i.e.*, what the equity being transferred would bring when offered for sale by a ready, willing and able seller to a ready, willing and able buyer, neither being obligated to buy or sell). The process *does* involve determining what the parties to the transaction believe is "fair" for their business and their circumstances,

if either one was to be the seller and the other the buyer (or, in some cases, the business entity was to be the buyer).

Many times, the base value is the "adjusted book value" of the business. The valuation starts with the value of the assets and liabilities shown in the books of the business after depreciation and other general ledger adjustments is increased to reflect the current or fair market value of certain tangible assets (e.g., inventory) and goodwill.

Often, the parties will want the value of the equity determined by a

third party, such as a business appraiser or the business's accountant. The options are numerous. For example, using an average of two valuations, having two appraisers pick a third appraiser, and then either taking an average of all three appraisals, taking an average of the two closest, or having the third appraiser's valuation be definitive.

An increasingly popular method is for the owners themselves to agree on

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Legislative Update: S2485/A3738 May Exempt Certain Commercial Developers from Paying Non-Residential Development Fees

Commercial developers are advised to keep abreast of legislative developments that, if enacted, may exempt certain commercial developers from paying non-residential development fees. At the time of the writing of this update, companion bills in the Senate and Assembly, S2485 and A3738 (the "Proposed Moratorium"), were under serious consideration with the expectation that some form of moratorium legislation would be enacted by the end of the 2008-2009 New Jersey legislative session. The latest version of S2485/A3738, which was considered by the Assembly Budget Committee on June 15, 2009 and moved out of

Committee, provided for a temporary exemption from the 2.5% fee imposed by A-500 (enacted July 17, 2008) for non-residential development projects that received preliminary or final site plan approval prior to July 1, 2010, and which obtained building permits prior to July 1, 2011. The Proposed Moratorium also provides, under certain circumstances, that the municipality will be relieved of its COAH growth share obligation for such projects where the non-residential fee is not collected and/or returned.

For additional information on COAH fees, contact Nilufer Descherer, 201-342-6000, ext. 223.

Buying or Selling a Business: Non-Disclosure Agreements

By Gianfranco A. Pietrafesa

Editor's Note: This is the first in a series of articles on buying or selling a business.

Buying or selling a business is often a significant event, financially and otherwise, for both buyer and seller. Therefore, a buyer needs information about a seller's business to evaluate and decide whether to buy the business. However, a seller wants to protect its business and is often reluctant to disclose confidential information, especially to a business competitor.

This reluctance is understandable when one considers that the deal, for one reason or another, may fall through and a buyer will have possession of and may use the seller's confidential information to its advantage and the disadvantage of the seller. However, in order for a deal to happen, a buyer will need to review financial, customer and technical information about the seller's business.

A non-disclosure agreement (also known as a confidentiality agreement) provides a mechanism for a seller to release its confidential information to a buyer while minimizing the risk that the buyer will misuse the information or hire away a seller's key employees. It is usually the first document signed by the parties when buying or selling a business.

A non-disclosure agreement will begin with the buyer acknowledging that the information being provided to it by the seller is confidential and that the buyer will maintain the confidentiality of the information in accordance with the agreement. Next, the agreement will define the confidential information. Typically, the definition is broad enough to include all information that the seller discloses to the buyer.

The agreement will identify who has access to the confidential information and how the information can be used by the buyer. For example, the buyer may disclose the information only to those employees and representatives who actually need the infor-

mation to evaluate the business, and the information may be disclosed only after the buyer advises them that the information is confidential and subject to the non-disclosure agreement. Finally, the buyer should agree that it will not use the information for any purpose other than its evaluation of the business.

The seller may fear that its business may be harmed if its competitors, suppliers, employees and customers know that the company is for sale. If so, the non-disclosure agreement should include a provision prohibiting the buyer from disclosing the fact that it is interested in buying the business.

The agreement will include certain limited exceptions to a buyer's obligation to maintain the confidentiality of the information. For example, the buyer will no longer be required to maintain the confidentiality of the information if it becomes publicly available through no fault of the buyer. The agreement will also address the buyer's return or destruction of the confidential information if it doesn't purchase the business.

Sometimes, a buyer's evaluation of a seller's confidential information alone may not provide it with enough

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News from Herten Burstein

Herten Burstein has been recently retained to defend the interests of several clients in connection with a number of complex commercial litigation matters.

- We have been retained by **Schering-Plough Corporation, Organon USA, Inc., Organon Pharmaceuticals USA, Inc., LLC, and Organon International, Inc.** to defend the interests of those companies in connection with the mass tort products liability cases that have been brought against the companies in connection with NuvaRing®, a prescription birth control product. In March 2009, the New Jersey Supreme Court designated all pending NuvaRing® cases, and all NuvaRing® cases that may be filed in the future as a mass tort and assigned them for centralized management in Bergen County before Judge Jonathan Harris. There are currently 77 cases in the NuvaRing® mass tort inventory.

- This is the latest of our firm's mass tort products liability cases. We recently represented **Wyeth** in connection with approximately 6,000 mass tort products liability cases relating to

the diet drug combination Phen-Fen, which were also centralized in Bergen County. The firm also represents Wyeth on other separate matters while continuing its defense of Wyeth in connection with an appeal that was filed in relation to one of the Phen-Fen actions tried in Bergen County last year. Our firm, along with the national law firm of Arnold & Porter, was trial counsel for Wyeth in the action.

- The firm was retained by **Fuddruckers, Inc.** to defend it against a class action lawsuit relating to Fuddruckers' gift cards and involving claims under New Jersey's Consumer Fraud Act, Gift Card statute, and Truth-in-Consumer Contract, Warranty and Notice Act. After aggressive motion practice by our team, the matter was quickly resolved in a manner most favorable to our client.

Thomas Herten, Thomas McGuire and LisaAnne Biccocchi, who are experienced in complex commercial and products liability litigation and are on the firm's Wyeth defense team, will

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be spearheading the NuvaRing® and Fuddruckers defense teams.

The firm recently scored a big victory by securing summary judgment on all claims in a products liability case brought against our client, **Mobile Drilling Company, Inc.** that was handled primarily by **LisaAnne Bicocchi**. The plaintiff alleged design defect and failure to warn claims against our client, which was the manufacturer of the geotechnical drill rig at issue. We were successful in persuading the court to grant summary judgment to Mobile on the grounds that the plaintiff failed to prove that the drill rig was defective in design or that the company failed to properly label and equip the drill rig with adequate warnings and to provide proper cautions upon its delivery. In addition, we successfully obtained an order of the court striking the plaintiff's expert report and precluding him from offering expert opinions regarding the drill rig on the grounds that his opinions were without foundation and not based on reliable scientific principles.

Litigation member **Jason Shafron**, as lead trial counsel, prevailed on all claims, and defeated all counterclaims, in a Superior Court jury trial on behalf of **Daibes Oil**, a major East Coast petroleum distributor.

Herten Burstein has been playing a role in the pioneering lawsuit before the California Supreme Court against the tobacco industry, which was the precursor to the settlements with the various attorneys general across the country. Litigation member **Terry Paul Bottinelli** was selected to be on the trial team in a California class action that calls to task the tobacco companies for false and deceptive advertising over the years, which has been referred to as "a major class action lawsuit against the tobacco industry."

The California Supreme Court reversed a lower court's ruling, reinstated consumers' right to sue for false advertising and ruled that smokers could hold the industry accountable for deceptive advertising. Brought on behalf of every Californian who saw the ads and purchased cigarettes from 1993 to 2001, the suit could expose the industry to billions of dollars in disgorgement of unlawful profits.

Litigation member **Daniel Gielchinsky** obtained a favorable result for a firm client after three days of hearings before the New York office of the American Arbitration Association. The matter involved claims and counterclaims between a construction manager and a general contractor stemming from the construction services rendered by the parties at a national bank branch located in Brooklyn.

Business lawyer and member of the firm **Gianfranco Pietrafesa** made a presentation with Robert Zak, a Hackensack CPA, to the Hudson-Bergen Inn of Transactional Counsel on valuation methods for determining the pur-

chase price under buy-sell agreements. He also wrote a paper on the topic as well as a second paper on events triggering buy-sell obligations, both of which are available on the firm's website. Franco also wrote an article on a federal court's diversity jurisdiction over limited liability companies, a topic of interest to business litigators, which was published in the *New Jersey Law Journal* and which is also available on the firm's website. In April, he was the moderator of the annual Business Law Symposium, which is sponsored by the Business Law Section of the New Jersey State Bar Association and the New Jersey Institute of Continuing Legal Education. Franco was also elected a trustee of the Hudson-Bergen Inn of Transactional Counsel and created the organization's website (www.HudsonBergenInn.com). He was also re-elected as a director and the secretary of the Business Law Section of the New Jersey State Bar Association.

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Non-Disclosure

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information to make a decision whether to buy the business. In such situations, a buyer may want to speak to the seller's key employees and even its major suppliers and customers. The seller, however, may not want anyone to know about a possible sale of the business. A non-disclosure agreement will address how a buyer can speak with a seller's employees, customers and suppliers. In the event that the deal falls through, the agreement will also include provisions prohibiting the buyer from hiring the seller's employees for a period of time, and prohibit-

ing the buyer from soliciting the seller's customers or disrupting the seller's relationships with its suppliers.

In order to make a deal happen, a buyer and a seller must ask their attorneys to prepare and negotiate a non-disclosure agreement to address these important issues.

For more information on non-disclosure agreements, or on buying or selling a business, please contact Gianfranco A. Pietrafesa at gpietrafesa@hertenburstein.com, another member of the firm's Business Law Group or the attorney with whom you normally consult at the firm.

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

E-Mails Can Modify Contracts

Our clients send e-mails so casually and with such informality, even in the business environment, that it is easy to forget that they may carry significant legal consequences. It is wise to bear in mind that even e-mails written in the most conversational style may create legal obligations no less binding than a more conventional written agreement.

If a business wants to entirely avoid the possibility of having e-mails treated as binding amendments to existing contracts, the best approach is to be as clear and direct as possible on the subject by including language in contracts to the effect that e-mails do not count as signed writings for purposes of any contract amendments.

Cautionary Case

A 2008 New York case on point involved an individual who sold his public relations firm to a global communications company. The deal included an employment contract under which the seller was to continue as chairman and CEO of the new company for three years. Soon, the new company was losing money and the seller was presented with the option of either leaving or taking on new responsibilities.

E-mail then entered the picture when an employee of the communications company sent yet another option to the seller in an e-mail that spelled out how the seller would allocate his time. The seller replied by e-mail that he enthusiastically accepted that proposal. For his part, the representative of the communications company replied by e-mail that he was thrilled with the seller's decision to accept the new offer. In both e-mails, the sender had typed his name after the message.

The seller later had a change of heart and sued to enforce the terms of the original employment agreement. An appellate court ruled against him on the ground that the exchange of e-mails on the new employment proposal constituted a binding amendment to the employment agreement.

This was so even though the original agreement required that any changes had to be in the form of signed writings.

The court reasoned that the e-mails effectively were signed writings because the parties' names appeared at the end of the e-mails, signifying an intent to authenticate the preceding contents of the messages. Likewise, the e-mails also were signed writings for purposes of the Statute of Frauds, which requires certain contracts to be in writing in order to be enforceable. In short, when the seller and his e-mail correspondent clicked "send" and "reply," they were sealing a new deal that the seller could not avoid, even though it was in an electronic form.

For more information on e-mail communication, please contact Jason Shafron at jshafron@hertenburstein.com.

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Member **Nilufer DeScherer** was a presenter at the annual Use Symposium and Basic Course in Land Use Law and Planning Training Program, sponsored by the Bergen County Bar Association and Bergen County Bar Foundation. Nilufer, who was the Section Chairperson for the Municipal Master Plan Session, presented on topics including redevelopment, transit villages, transfer of development rights and the state's smart growth initiatives. More than 100 members of Bergen County land use boards and governing bodies attended the event.

Litigation member **Daniel Gielchinsky** has completed his first annual term as a barrister with the Bankruptcy Inns of Court. Dan continues to serve as a barrister for the Morris Pashman Inns of Court during its 2008-2010 session.

Buy-Sell Agreement

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the value of the equity, and memorializing that agreement in a certificate of agreed value that remains "good" or "binding" for a period of time, such as one year or eighteen months after its execution. Good practice would have the certificate value updated once a year. If the triggering event occurs after that period and the parties to the transaction cannot agree on the value, the certificate value is adjusted by an agreed methodology, such as the increase or decrease in the net worth of the business from the date of the most recent certificate to the date of the triggering event.

The third question is: What adjustments, if any, to that value do you make with respect to each of the triggering events? In most cases, the value upon death is the highest value, 100% of the value determined by the valuation method specified in the buy-sell agreement. Often, a buyout upon the death of an owner is funded by insurance, and the value is the greater of the life insurance proceeds payable on the death of the deceased owner, or the value determined by the buy-sell agreement. This is also the case if there is a disability insurance policy funding the purchase upon an owner's permanent disability.

On the contrary, when an owner voluntarily gives up his position in the business (such as when he terminates his employment), the value is discounted (for example, by 25% of the value). When an owner involuntarily gives up his equity (such as when his equity is levied upon by a creditor), the value can be discounted further (for example, anywhere from 75% to 90% of the value).

There are many issues that business owners must carefully consider when selecting the method to value their equity in their business in a buy-sell agreement. They should do so in consultation with their accountant and attorney.

For more information on buy-sell agreements, please contact Richard J. Contant at rcontant@hertenburstein.com, a member of the firm's Business Law Group or the attorney with whom you normally consult at the firm.