Report From Counsel

Insights and Developments in the Law **Spring 2004**

Buy-Sell Agreements for Small Businesses

The transfer of ownership interests in a small business should take into account all of the considerations that make each business, and especially a family-owned business, unique. The vehicle for accomplishing the transfer is usually called a buy-sell agreement. Its name barely begins to describe the buy-sell agreement's various purposes. With professional advice, the agreement can be tailored to meet the objectives of each small business, whether the business is in the form of a close corporation, partnership, limited liability company, or some other structure.

A buy-sell agreement may serve as an orderly method for maintaining control over the company despite a change in the composition of its owners.

By creating a market for the ownership interest of a shareholder who has retired, become disabled, or died, a buy-sell agreement insures that such an interest can be converted into cash when cash is more important than having shares in the company. Since small businesses often pay out most or all of their profits in salaries, an equity interest in the business would be much less valuable if its owner was not assured of being able to sell that interest back to the business or to other shareholders.

Valuation of the Business

When a triggering event in a buy-sell agreement causes the interest of one owner of a business to be purchased by other owners, or by the business as an entity, a critical issue is placing a dollar value on that interest. It is difficult to set a market value for shares in closely held corporations, whose stock by its nature has little or no liquidity. An agreement can set the price for shares according to a predetermined formula, value as shown on the company's books, an appraisal by a third party, or some other method. In any event, it is important that the provisions on the valuation and purchase price of shares in the company be kept current.

Continued on page four.

Review Your Credit Report

When the time comes for an important transaction for an individual, such as buying insurance, taking out a mortgage, or applying for a job, having good credit can be critical. Second only to having good credit is being able to prove it in writing, in a consumer report compiled by one of the credit reporting agencies (CRAs) that have credit information on millions of Americans. If you have ever applied for a credit card, insurance, or a personal loan, one or more of the three major CRAs has a file on you.

By law a consumer has the right to request a copy of a report from a CRA, and that right should be exercised annually to check on the accuracy of the report's contents. Such oversight has added significance if a major purchase is being considered. Rectifying any errors ahead of time, which itself can be time-consuming, can shorten the waiting period for loan approval.

A CRA must divulge everything that is in a consumer report including, in most instances, the source of the information. The consumer also has the right to know who has requested the report during the preceding year, or two years if the request is related to employment. Aside from reports prompted only by the consumer's initiative, a report can be requested when a consumer is notified that a company has turned down the

Continued on page four.

When Noncompetition Agreements Cross State Lines

It is a common practice for an employer to require an employee to sign an agreement preventing the employee from competing with the employer for a certain period of time and in a designated geographic area. For many years, interpretation and enforcement of these noncompetition agreements or covenants not to compete, as they sometimes are called, have led to lawsuits. When an ex-employer attempts to enforce an agreement in another state, which happens more often in today's economy, special issues arise because of the variations in how receptive or hostile the different states are to the anticompetitive effects of these agreements.

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Dueling Lawsuits

When Mark was hired in Minnesota to work for a manufacturer of medical devices, he signed an agreement not to compete with the employer, for two years after leaving, and in any area where the employer marketed its products. In a typical "choice-of-law" clause, the agreement also said that it was governed by the laws of the state where the employee last worked for the employer.

After five years, Mark resigned and moved to California to take a job with a company that was competing head-to-head with his ex-employer. Correctly anticipating a fight, and wanting to reach the courthouse first, Mark and his new employer sued his former employer in a California court on the same day he started his new job. Except in limited circumstances, California law prohibits anticompetition agreements, so Mark asked for a declaration that the agreement he had signed was void and unenforceable against him in California. More than that, he also asked the court to prohibit the ex-employer from taking any action outside of the California court to enforce the agreement. At about the same time, the former employer did, in fact, sue in a Minnesota court, which issued a preliminary order to enforce the terms of the agreement.

A stalemate ensued, with each side having obtained a ruling in its favor, and purporting to prevent pursuit of the litigation in the other state. When the California case was appealed to that state's highest court, it ruled against any interference with the pending litigation in Minnesota. At the same time,

Continued on page three.

New Identity Theft Disclosure Law

California recently entered new territory in legislative responses to the growing problem of identity theft. A new law requires a business to notify any California resident whose personal information may have been compromised by a breach of its computer security. The legislature was acting, at least in part, in response to an incident in which hackers got the personal information of over a quarter of a million state employees in an attack on a government database. A company that violates the notification requirements is subject to a suit for damages and civil penalties.

The measure's impact would be significant even if it were confined to California, but the law likely will have much more far-reaching effects. It applies to any company that conducts business in California. It may take court decisions to sort out what constitutes doing business in California, but any business having contacts with California customers should be aware of this law. Moreover, although the law only speaks to the interests of California residents, a case can be made for notifying any customers affected by a breach. Otherwise, customers in other states who are the victims of identity theft might argue that a company was negligent in not extending them the same treatment as Californians.

The disclosure requirements apply only to unauthorized access to a person's name, plus either their Social Security number, driver's license number, or information from a financial account. Encrypted personal information or information in public records is outside of the law, but it is up to the business to determine what personal information in its possession is subject to the law and whether such information has been acquired by an unauthorized person. This places a premium on having adequate security systems and procedures in place to detect an intrusion and respond to it.

Businesses with customers in California are well advised to put into place incident response policies and procedures even before experiencing any breach of a security system. Not only will this allow the kind of prompt response required by the law, but another provision states that following such a policy for notifying affected persons will be treated as compliance with the law's notification requirements. If a business does not already have its own notification procedures in an information security policy, it must give the notice by methods set forth in the law.

Commercial Landlord Must Mitigate Damages

A state supreme court has ruled that a commercial landlord has a duty to mitigate damages when a tenant breaks the lease by leaving the property. A bookstore agreed to a ten-year lease in a shopping center. Citing lost profits due to competition from a new bookstore in the same mall, the tenant abandoned its store space with only six months left on the lease. For the rest of the lease term, the tenant paid no rent and the landlord did not rent the space to anyone else. When the landlord sued for the rent due under the lease, the tenant argued that the landlord should have reduced its damages by leasing the space to a new tenant.

A lease is a hybrid under the law, having aspects of property law and contract law. As originally conceived, leases were viewed primarily as transfers of an interest in property. If the tenant abandoned the property, he was seen as simply having given up that interest. The landlord could stand by and do nothing but demand the rent, which was due as a fixed obligation.

On the other hand, when seen mainly as a contract to convey an interest in property, a lease, like any other contract, carries with it the duty to mitigate damages. The injured party is expected to make efforts to avoid the consequences of the breach by the other party. The landlord need not accept just any new tenant, however, and only reasonable efforts are required. In the context of a shopping center, it may well be reasonable for the landlord to hold out for a tenant that will restore the overall balance of stores that existed before one tenant abandoned the premises.

The goal is to put the injured party in as good a position had the contract not been breached, at the least cost to the defaulting party. Some courts also have reasoned that requiring the landlord to mitigate damages encourages the productive use of land and decreases the likelihood of physical damage to the property.

Retail Space For Rent

In deciding that the shopping center landlord had been under an obligation to mitigate damages by attempting to re-rent the store space, the court was joining a modern trend that treats leases more as contracts for the use of property than transfers of property. The court also declined to make an exception for commercial leases. It is true that a commercial landlord has a special interest in maintaining the right mix of tenants in a shopping center. That interest is protected, however, not by relieving the landlord of the duty to mitigate damages, but by allowing the landlord to recover not just lost rent, but such other financial losses as may have been caused by the breach of the lease.

Noncompetition

Continued from page two.

the court recognized California's aversion to noncompetition agreements and allowed Mark's California case to proceed unless and until any Minnesota judgment became binding on the parties. In short, the race to a favorable judgment continued.

Georgia on His Mind

In another similar case, James signed a noncompetition agreement with a company in Ohio that gave computer support services to providers of wireless communications. Later, he left and relocated to Georgia, which does not prohibit noncompetition clauses outright but does subject them to close scrutiny. The agreement had provided that Ohio law was controlling.

Like Mark in the California case, James went to work for a competitor in his new state and sued there to invalidate the covenant not to compete. Unlike the California case, however, there were no dueling lawsuits in different states because James had misrepresented to his first employer that he was leaving to become a stockbroker.

James's lawsuit in Georgia to rid himself of the agreement was partially successful. The agreement was too broad and restrictive to pass muster under Georgia law, so it could not be enforced there, even though the agreement itself referred to Ohio law. James was relieved of the agreement, but only while working in Georgia, because, as the court put it, "the public policy of Georgia is not that way everywhere."

Buy-Sell Agreements

Continued from page one.

Orderly Transition of Ownership

A buy-sell agreement also may serve as an orderly method for maintaining control over the company despite a change in the composition of its owners. In a family-owned business, this may mean a clause in the agreement effectively keeping the business in the family by allowing remaining family members to buy the interest of a departing owner. For children who decide not to carry on in the business, cash, perhaps generated by life insurance on a senior owner, might be an alternative to inheriting part of the business.

A typical buy-sell agreement for a family business provides that, on the death or departure of one shareholder, the remaining shareholders have the right to purchase his or her shares. Those participating in the buyout usually acquire those shares in an amount commensurate with their holdings. An alternative could give the corporation itself the right to purchase the shares. However, this option may bring into play laws for the protection of creditors that limit the power of corporations to purchase their own shares. A hybrid approach sometimes used in buy-sell agreements allows the business to buy its own shares, only to the extent permitted by relevant statutes, but the remaining shareholders could then purchase any shares not acquired by the corporation.

Avoid Conflicting Terms

Since one of the triggers for application of a buy-sell agreement is a shareholder's death, shareholders should avoid conflicts between the terms of the agreement and their estate plans. When the terms of an agreement and a will cannot easily be reconciled, the odds increase for litigation, rather than the smooth transition for which the agreement was designed. If a will predates the agreement, it may be necessary to draft a new will that is consistent with the agreement. A less-complicated approach is to amend the will with a codicil providing that business interests are to be disposed of according to the buy-sell agreement.

Consistency between an estate plan and a buy-sell agreement is important not only as to disposition of shares, but also as to voting or management rights in the company. A shareholder should determine whether his estate or heirs should have such rights, and then be sure that the documents accurately reflect the shareholder's wishes. Similarly, a shareholder should consider whether limits on his executor's voting rights are desirable, so as to avoid the possibility that the executor will act to frustrate the shareholder's intent.

One purpose of any contract is to avoid future disputes between the parties by establishing rights and duties for future contingencies. Aside from dealing with the substantive issues raised by transferred ownership, a buy-sell agreement also can head off conflict, or at least help solve it, by providing for a form of alternative dispute resolution or mediation.

Credit Report

Continued from page one.

consumer's application for credit. That notice, including the CRA's name, address, and phone number, is required by law.

If you detect errors in your report, the process of setting the record straight involves contacting both the CRA and the provider of the information in dispute. A consumer's rights concerning errors in a consumer report are as follows:

- If disputed information cannot be verified, the CRA must delete it;

- If there is inaccurate information, the CRA must correct it;

- If there is incomplete information, such as a record that shows that a consumer made late payments but does not show that the consumer is current, the CRA must complete it;

- The CRA, having changed or removed information after a reinvestigation, may not put it back in the file unless the information provider verifies the information and the CRA gives advance notice to the consumer;

- The CRA must delete any account not belonging to the consumer;

- If requested by the consumer, the CRA must send notices of a corrected report to anyone who received it in the preceding six months, or two years if received for employment purposes.

If the credit story told by a consumer report is sad but true, the best ally for a consumer who has changed his ways is the passage of time. As a general rule, accurate negative information in a report can stay there for only seven years. There are some exceptions, for which the "shelf life" of negative information is extended. For example, bankruptcy information may be reported for ten years, and there is no time limit for information on criminal convictions. Similarly, there is no time limit for credit information stemming from an application for a job paying more than $75,000, or an application for more than $150,000 worth of credit or life insurance.