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present

# PREPARING YOUR BUSINESS FOR SALE: ISSUES IN MERGERS AND ACQUISITIONS

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WEDNESDAY, JUNE 21, 2006  
THE RITZ-CARLTON PHILADELPHIA  
BROAD & CHESTNUT STREETS  
PHILADELPHIA, PA

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PREPARING YOUR BUSINESS FOR SALE SEMINAR

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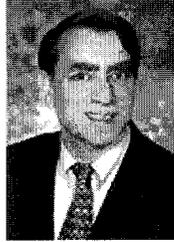
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# SPEAKER PROFILES

These materials are intended to generally educate the participants on current legal issues. They are not intended to provide legal advice. Accordingly, these materials should not be relied upon without seeking specific legal advice on matters discussed herein.

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## Richard J. Busis

Member  
Chair, Securities Law Department  
Philadelphia Office  
(215) 665-2756  
rbusis@cozen.com

### AREAS OF EXPERIENCE

- Securities Offerings and Regulation
- Mergers & Acquisitions

### EDUCATION

- J.D. Harvard Law School, *cum laude*, 1984
- M.A. University of Pennsylvania, 1980
- B.A. University of Pennsylvania, *summa cum laude*, 1975

### MEMBERSHIPS

- President, Temple Beth Hillel-Beth El
- Vice Chairman of the Board, Beck Institute for Cognitive Therapy and Research

Richard J. Busis is Chair of the Securities Law Department and a Member of the Firm. Mr. Busis counsels a diverse group of public and private companies, ranging from start-up companies seeking venture capital to Nasdaq and NYSE-listed companies, in a wide variety of corporate and securities transactions. His practice has a particular emphasis on securities offerings and mergers and acquisitions. In his securities practice, Mr. Busis represents not only companies seeking to raise capital, but also underwriters, placement agents and venture funds.

Mr. Busis also devotes a significant portion of his practice to representing high-tech, internet and other emerging growth companies in venture and other capital raising transactions, joint ventures and strategic alliances, as well as licensing and technology development arrangements. He has a particular expertise in investments involving Israeli Companies.

Mr. Busis is a member of the Greater Philadelphia Venture Group. He is also President of Temple Beth Hillel-Beth El and the Vice Chairman of the Board of the Beck Institute for Cognitive Therapy and Research.

Mr. Busis received his B.A. from the University of Pennsylvania, *summa cum laude*, in 1975, his M.A. in Ancient Near Eastern History from the University of Pennsylvania in 1980, and his law degree from the Harvard Law School, *cum laude*, in 1984. He was an editor of the *Harvard Law Review* and is a member of Phi Beta Kappa.



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## Dennis L. Cohen

Member  
Chair, Tax Department  
Chair, Tax Litigation Department  
Philadelphia Office  
(215) 665-4154  
dcohen@cozen.com

### AREAS OF EXPERIENCE

- Structuring of mergers, acquisitions, dispositions, financings and exchanges of businesses and real estate
- IRS disputes
- Employee Benefits
- Corporate Transactions

### EDUCATION

- J.D., University of Pennsylvania Law School, 1972
- B.A., University of Pennsylvania, 1969

### BAR ADMISSIONS

- Pennsylvania

### COURT ADMISSIONS

- U.S. District Court: Eastern District of Pennsylvania
- U.S. Tax Court

### MEMBERSHIPS

- American Bar Association: Tax Section
- Pennsylvania Bar Association: Tax Section
- Philadelphia Bar Association: Council, Tax Section

Dennis L. Cohen, Chair of the Tax Department and Tax Litigation Department, has an extensive tax law background which runs the full range of federal, state and local income tax matters, with particular emphasis on the tax-wise structuring of commercial transactions, planning to minimize the tax burdens of businesses and individuals, and handling tax controversies with the Internal Revenue Service and other taxing authorities.

Dennis has a great depth of experience in such diverse but important areas as real estate acquisition, development, ownership and disposition, including tax-free, like-kind exchanges; employee benefits matters, including the negotiation and preparation of employment and severance agreements, qualified retirement plans, and equity-based incentive arrangements such as stock option, restricted stock and stock appreciation rights plans; corporate transactions such as mergers, acquisitions and liquidations; planning for start-up, small and medium-sized businesses; tax issues facing public charities and other tax-exempt organizations, and municipal finance matters. He is a member of the tax sections of the American and Pennsylvania bar associations. In 2003, Dennis was elected to the council of the Philadelphia Bar Association's Tax Section for a two-year term.

In addition to the foregoing, Dennis frequently lectures and writes on various topics of federal income tax law and developments, has authored articles and has been quoted in numerous publications, including the *Financial Times*, *Wall Street Journal*, *SBN Magazine*, *Entrepreneur Magazine*, *thestreet.com*, *Mpower Magazine* and *The Legal Intelligencer*, and has appeared as a commentator regarding tax issues on local television and radio news shows, including National Public Radio and Comcast Newsmakers. During 2003 and 2005, Dennis was the course planner and a speaker at the PBI Seminar "Tax Consequences in Divorce: Avoiding the Pitfalls." He served as an adjunct professor of taxation in the Graduate School of Philadelphia University from 1993-2000. In 2004 and 2005, Dennis was selected by *Law & Politics* and *Philadelphia Magazine* as a Pennsylvania Super Lawyer.



## Jay A. Dorsch

Member  
Chair, Employee Benefits and Executive Compensation Department  
Philadelphia Office  
(215) 665-4685  
jdorsch@cozen.com

### AREAS OF EXPERIENCE

- Qualified and Non-Qualified Employee Benefits Plans
- Plan Assets Fiduciary Issues
- Welfare Benefits Programs
- Retiree Medical Benefits Issues
- Executive Compensation Arrangements

### EDUCATION

- LL.M., New York University School of Law, 1984
- J.D., Rutgers School of Law - Newark, 1980
- B.S., University of Pennsylvania, *cum laude*, 1977

### MEMBERSHIPS

- The Practicing Law Institute, Employee Benefits Law Advisory Committee

Jay Dorsch is a Member of the firm and Chair of the Employee Benefits and Executive Compensation Department. Jay regularly represents Fortune 500 clients and tax-exempt entities in all aspects of employee benefits and executive compensation matters, and related fiduciary and tax concerns. He has extensive experience with qualified and non-qualified employee benefit plans. Jay regularly represents clients before the IRS, the Department of Labor and the Pension Benefit Guaranty Corporation. He has extensive experience handling the employee benefits aspects of mergers and acquisitions, the fiduciary issues pertaining to plan assets, and other commercial transactions. In addition, Jay has designed, drafted and implemented all types of executive compensation arrangements, including deferred compensation plans, top hat plans, SERPS and equity based compensation plans, such as stock option plans, and restructured stock plans. Jay advises clients on a regular basis regarding welfare benefit programs, including retiree medical benefits, self-insured programs, and cafeteria plans, to comply with the changing law in this area, and to protect the client from unwanted claims and expenses. He also counsels in connection with retiree medical benefits issues and the resolution of disputed claims for welfare and retirement plan benefits.

Jay has lectured on employee plans for The Practicing Law Institute, and is a member of its Employee Benefits Law Advisory Committee. He was selected a 2004 and 2005 "Pennsylvania Super Lawyer" by his peers, appearing in *Philadelphia Magazine* and *Pennsylvania Super Lawyers*. The American College of Employee Benefits Counsel recently named Jay a 2005 Fellow, one of only 20 employee benefits attorneys selected throughout the country.

Jay earned his undergraduate degree from The Wharton School at the University of Pennsylvania (B.S. economics, *cum laude*, 1977), his law degree from Rutgers School of Law Newark (J.D., 1980) and his master of laws from New York University Law School (LL.M. taxation, 1984). Jay is admitted to practice in New Jersey, New York and Pennsylvania.



**Steve N. Economou, Managing Director**

Steve has over 20 years of diverse corporate finance experience including mergers and acquisitions, private equity, management buyouts, and financial opinions including fairness and valuation opinions. He has completed hundreds of transactions and advisory assignments. Steve has also advised numerous public companies and portfolio companies of private equity firms. He focuses on providing financial advisory services to technology oriented; mid and small cap public; and mid-market private companies.

Prior to joining Curtis Financial, Steve was a Managing Director in the mergers and acquisitions group of Fleet Boston Financial. He was also a Managing Director and Principal at Howard, Lawson & Co., a regional investment banking boutique specializing in corporate finance advisory services and valuations for middle market companies. Steve began his career in the venture capital group of Howard, Lawson & Co. where he led direct investments in emerging growth technology companies and management buyouts. He was also a Principal in the merchant banking affiliate of Howard, Lawson & Co.

Steve earned an MBA degree with a concentration in Finance from the University of Cincinnati and a BA degree in Economics from the University of Pittsburgh. He holds NASD Licenses Series 7 and 63. Steve maintains professional affiliations with the Greater Philadelphia Venture Group, Association for Corporate Growth, and the Investment Committee of Ben Franklin Technology Partners of Southeastern Pennsylvania.



## Sarah A. Kelly

Member  
Philadelphia Office  
(215) 665-5536  
skelly@cozen.com

### AREAS OF EXPERIENCE

- Labor & Employment

### EDUCATION

- J.D. University of Pennsylvania Law School, 1985
- M.S. University of Pennsylvania, 1979
- B.A. Tufts University, 1977

### MEMBERSHIPS

- American Bar Association, Equal Employment Opportunity Law Committee
- Philadelphia Bar Association

### PUBLICATIONS

- Cozen and O'Connor Attorneys Address Employment Law Issues
- Cozen and O'Connor Labor Attorney Urges Employers to Take a Proactive Approach

Sarah A. Kelly concentrates her practice in employment law and employment discrimination law and related litigation, sexual harassment law, and in counseling employers on issues in labor and employment law. She has 19 years of experience, both at leading law firms and as in-house counsel for two major financial services corporations.

As a member of the Labor and Employment Law Practice Group at Cozen O'Connor, Sarah provides practical expertise in managing and litigating the full range of employment law issues, from individual cases to class-action suits. She also enjoys an enviable track record in investigating and litigating sexual harassment cases.

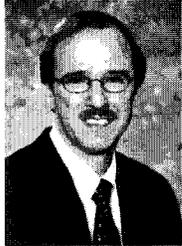
Sarah is a 1985 graduate of the University of Pennsylvania Law School, with a B.A. from Tufts University. Her law firm experience includes over eight years at Morgan Lewis & Bockius, as well as three years at Blank, Rome, Comisky & McCauley, both in Philadelphia. In addition, she was the first employment law counsel for CoreStates Financial Corp., and also served as Senior Employment Counsel for PNC Bank Corp.

Her client-side experience has given her a unique perspective on how to forge workable solutions to real-world problems, enabling clients to avoid litigation or, when that is not possible, to best position themselves for success in the courts. She brings valuable insights for counseling employers on issues in major downsizings, the Americans with Disabilities Act guidelines and the Family and Medical Leave Act.

Sarah is admitted to practice in Pennsylvania and New Jersey. She is a member of the American and Philadelphia Bar Associations, and for the former participates in its Equal Employment Opportunity Law Committee. She is a frequent lecturer at the annual PBI Employment Law Institute and often speaks to client groups on how to address discrimination and harassment issues in the everyday workplace. She also serves as a member of the Board of Directors of St. Agnes Medical Center. She was selected a 2005 "Pennsylvania Super Lawyer" by her peers, appearing in *Philadelphia Magazine* and *Pennsylvania Super Lawyers*.

### PBI Employment Law Institute Presentations:

- ♦ 2004 - Sarbanes - Oxley Whistleblower Claims
- ♦ 2003 - Use of Experts in Sexual Harassment Litigation
- ♦ 2002 - Practical Approach to Layoffs and Reductions in Force
- ♦ 2001 - Reasonable Accommodation and Disability - Related Inquiries under the



## Larry P. Laubach

Member  
Chair, Corporate Law Practice Group  
Philadelphia Office  
(215) 665- 4666  
llaubach@cozen.com

### AREAS OF EXPERIENCE

- Corporate Law
- Corporate Planning
- E-Commerce and Internet Business Law
- Emerging Business & Venture Capital
- International Corporate Law
- Mergers and Acquisitions
- Securities Offerings and Regulations

### EDUCATION

- J.D., University of Pennsylvania, magna cum laude, 1980
- B.A., Franklin & Marshall College, magna cum laude, 1977

### MEMBERSHIPS

- Pennsylvania Bar Association
- American Bar Association

Larry P. Laubach, a Member of the Firm and Chair of the Corporate Law Practice Group, joined the Philadelphia office in March 2002, having previously practiced with Schnader Harrison Segal & Lewis LLP for 22 years. He focuses his practice on corporate and business transactions involving publicly and privately held corporations, including mergers and acquisitions, venture capital financing, technology licensing, public and private sales of equity and debt securities, and compliance with federal and state securities laws. He also advises a wide range of clients on general corporate, business and contractual matters.

### Larry's recent experience includes:

- Representation of a pre-clinical drug testing company in its sale to a public company for \$65 million in cash and stock.
- Representation of a diversified company in its redemption of the stock of certain of its shareholders for \$118 million.
- Representation of a consumer products company in its sale of a product line for \$10 million.
- Representation of a borrower in its \$50 million loan from a consortium of banks.
- Representation of a borrower in its \$20 million loan from a bank.
- Representation of a strategic investor in numerous venture investments of between \$5 million and \$15 million in various companies.
- Representation of an insurance company in its private placement of \$35 million of preferred stock.
- Representation of institutional investors in the purchase of \$65 million of preferred stock of an insurance company.
- Representation of an institutional investor in the purchase of \$25 million of convertible notes and preferred stock of a real estate company.



- Representation of a medical device company in the sale of all of its stock to a diversified company for \$50 million.
- Representation of a distributor in the purchase for \$15 million of the assets of another distributor in a private foreclosure sale under Section 9-504 of the Uniform Commercial Code.
- Representation of a public company in the telecommunications business in its acquisition of a telecommunications manufacturing company for \$35 million.
- Representation of a public company in the equipment manufacturing business in its sale for \$12 million to a German company.
- Representation of an insurance company in its acquisition by a public company for \$140 million.

Larry is active in bar associations. He is a member of the Council of the Business Law Section of the Pennsylvania Bar Association and the Title 15 Taskforce of the Business Law Section of the Pennsylvania Bar Association, which recommends changes to the corporation, partnership and related laws of Pennsylvania. He also served as a member of the LLC Taskforce of the Business Law Section of the Pennsylvania Bar Association, which created standard forms for Pennsylvania limited liability companies. Larry has also recently lectured at several Pennsylvania Bar Institute programs involving mergers and acquisitions.

Larry earned his Bachelor of Arts degree in accounting from Franklin & Marshall College, *magna cum laude*, in 1977, where he was a member of Phi Beta Kappa. He earned his law degree from the University of Pennsylvania, *magna cum laude*, in 1980, where he was an editor of the *Penn Law Review* and a member of the Order of the Coif.



**Howard M. Snyder, Vice President**

Howard has over 18 years of investment banking and financial services industry experience serving middle market, large corporations and private equity firms both domestically and internationally. Howard focuses on providing transaction related advisory and corporate finance services to growth and mature middle market companies. He has completed merger and acquisition, target search and capital raise assignments for private and public clients in a wide range of manufacturing, distribution and service industries totaling over \$1.2 billion in transaction value.

Prior to joining Curtis Financial, Howard was a Vice President with Matrix Capital Markets Group, a regional investment banking firm, where opened the firm's Philadelphia office and established their Plastics and Packaging Industry Group. Previously, Howard worked with Shattuck Hammond Partners, LLC, a New York City boutique investment bank, and an original member of PricewaterhouseCoopers Securities, LLC, the investment banking subsidiary of PricewaterhouseCoopers LLP.

Howard earned an MBA from Drexel University where he specialized in Finance and a BBA from Emory University where he majored in General Business. He holds NASD Licenses Series 7 and 63. Howard resides in Bala Cynwyd, PA with his wife and three children.



## Harmon S. Spolan

Member  
Chair, Financial Services Department  
Co-Marketing Partner  
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hspolan@cozen.com

### AREAS OF EXPERIENCE

- Financial Services
- Marketing

### EDUCATION

- LL.B. Temple University  
School of Law, 1959
- A.B. Temple University, 1957

### MEMBERSHIPS

- Board Member, YMHA
- Board Member, Jewish Federation of Philadelphia
- Chancellor's Cabinet, Jewish Theological Seminary of America
- Board Member, Friends of Rittenhouse Square
- Board Member, TRM
- Investment Committee, Economic Conversion Fund, Philadelphia Naval Base, 1996-2001 (Mayoral appointment)
- Regional Selection Panel, President's Commission on White House Fellows, 1990-1993
- Philadelphia Bar Association
- American Bar Association
- The Oxford Society
- The Union League of Philadelphia

Harmon S. Spolan is a Member of the firm who served as president of Jefferson Bank for 22 years, until April 1999, when he joined Cozen O'Connor as Chair of the Financial Services Department and co-marketing partner. He provides leadership for the firm's financial service attorneys and spearheads marketing efforts for the Business Law Group.

Under his leadership, Jefferson Bank became the largest financial institution based in Philadelphia. Mr. Spolan previously served as president of the State National Bank of Maryland, as a member of the Wharton School Faculty, Department of Legal Studies, of the University of Pennsylvania, and as an attorney in private practice.

By appointment of the mayor of the city of Philadelphia, Mr. Spolan was a member of the Investment Committee of the Economic Conversion Fund for the Philadelphia Naval Base. He serves as a member of the Board for YMHA, Jewish Federation of Philadelphia, Jewish Theological Seminary of America, Friends of Rittenhouse Square, and TRM. In 2003, he was appointed to the Board of Directors for Carelift International, an international medical relief agency. Additionally, Mr. Spolan is also a member of the Philadelphia and American Bar Associations.

Mr. Spolan is AV rated in Martindale Hubbell. He has received a number of honors, including the Brandeis Award, Zionist Organization of America (1991); the Torch of Liberty Award, Anti-Defamation League (1994); the Outstanding Service Award, South Street Headhouse District (1998); and the Community Leader Award, Abrams Hebrew Academy Annual Dinner (1999). He has authored numerous articles on finance, as well as "Banker's Handbook of Federal Aids to Financing," published by Warren, Gorham and Lamont, Inc.

Mr. Spolan earned his Bachelor of Arts Degree at Temple University in 1957 and his law degree at the Temple University School of Law in 1959. He also pursued graduate studies at The Wharton School of the University of Pennsylvania and at Brasenose College, Oxford University, England.



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# Preparing Your Business for Sale

## Seminar Outline

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## PREPARING YOUR BUSINESS FOR SALE

June 21, 2006

### SEMINAR OUTLINE

#### I. Preparing Your Business for Sale: 8:30 to 9:20 a.m.

*Moderator: Richard Busis*

*Panel: Dennis Cohen; Jay Dorsch; Sarah Kelly; Howard Snyder*

- (a) Why sell?
  - (i) Estate/succession planning
  - (ii) Timing of business cycle
  - (iii) Competition
  - (iv) Access to capital; business opportunities
  - (v) Reactive – potential buyer contacts the business
- (b) M&A environment today
- (c) Valuation – understand what your business is worth
  - (i) Minimum value for seller, without regard to intrinsic value of business
  - (ii) How buyer will value the business
    - (A) Strategic vs. financial buyer
    - (B) Financial metrics
    - (C) Non-financial items
      - (1) Market size
      - (2) Competition
      - (3) Complementary product or geography for strategic buyer
- (d) Get your house in order
  - (i) Condition and appearance of facilities
  - (ii) Management team
    - (A) Strengths and weaknesses
    - (B) Dependence on owner
  - (iii) Accounting issues

- (A) Audited statements; deviations from GAAP
- (B) Be able to generate type of data a buyer will want
  - (1) Profitability by product line/customer
- (C) Internal controls for Sarbanes-Oxley
- (iv) Business Plan
  - (A) Budget
  - (B) Projections
  - (C) Understand valuation drivers from buyer's perspective
- (v) Corporate records
  - (A) Corporation in good standing
  - (B) Minute books
  - (C) Board of Directors functioning
    - (1) Independent directors – if minority shareholders
- (vi) Contracts
- (vii) Related party transactions – know arm's length terms
- (e) Make sure ownership is as desired
  - (i) Estate planning issues
    - (A) Transfer in advance to get long-term capital gain
  - (ii) Employee participation
    - (A) Compensation issues
- (f) Selecting advisors/role of advisors
  - (i) Investment banker
  - (ii) Attorney
  - (iii) Accountant
- (g) Know parameters of ability to negotiate – control of minority investors
  - (i) Build consensus with other owners
  - (ii) Shareholder agreement – drag-along
  - (iii) Blocking ability of minority shareholders
- (h) Tax issues

- (i) Labor issues
  - (i) Securing assets of business through confidentiality and non-competition agreements
  - (ii) Planning for multi-employer pension plan withdrawal liability
- (j) Employee benefits issues
  - (i) Compliance
    - (A) Plan documents
    - (B) Government filings
    - (C) Nondiscrimination testing
  - (ii) Deferred compensation agreements
  - (iii) 401(k) Plan issues
  - (iv) Defined benefit plan issues
  - (v) Multiemployer plan issues
  - (vi) Employee Stock Ownership Plans (ESOPs)
  - (vii) Executive compensation issues

II. Due Diligence: 9:20 to 9:30 a.m.

*Moderator: Larry Laubach*

*Panel: Dennis Cohen; Jay Dorsch; Sarah Kelly; Howard Snyder*

- (a) Confidentiality issues
- (b) Providing information
  - (i) Responding to buyer's checklist
  - (ii) Data room
  - (iii) Virtual data room
- (c) How to protect confidential client information
  - (i) Customer lists
  - (ii) When to let buyer meet with key management, customers, suppliers
- (d) Accounting issues – audited financial statements
- (e) Tax issues

- (f) Labor issues
  - (i) Union issues
- (g) Employee benefits issues

III. Break: 9:30 to 9:45 a.m.

IV. Structuring and Negotiating the Deal 9:45 to 10:35 a.m.

*Moderator: Larry Laubach*

*Panel: Dennis Cohen; Jay Dorsch; Steve Economou; Sarah Kelly*

- (a) Transaction alternatives
  - (i) Private company sale
  - (ii) Divestitures
  - (iii) Management buyouts
  - (iv) Leveraged buyouts
  - (v) Recapitalization
  - (vi) Growth equity investments
- (b) Sale process approaches
  - (i) Unsolicited offer
  - (ii) Negotiated approach
  - (iii) Auction: full vs. limited
  - (iv) Bifurcated process
  - (v) Staple-on financing
- (c) Confidentiality agreements; no-shop agreement
- (d) Letter of intent vs. straight to agreement
- (e) Form of transaction
  - (i) Stock purchase
    - (A) Section 338(h)(10) election
  - (ii) Asset purchase
  - (iii) Merger

- (f) Tax issues
- (g) Form of consideration
  - (i) Purchase price
    - (A) Stock, cash, note from buyer
    - (B) Combination
    - (C) Installment sale
    - (D) Retention of an interest by seller
  - (ii) Earnout
  - (iii) Escrow
  - (iv) Employment and restrictive covenant agreements
    - (A) Consulting/employment post-sale
    - (B) Taking care of employees
  - (v) Continuing post-transaction benefits
- (h) Liability and indemnification issues
  - (i) Representation and warranty insurance
  - (ii) Baskets and caps
- (i) Corporate law considerations
  - (i) Assignment of contracts
  - (ii) Change of control provisions
- (j) Disclosure of negotiations
  - (A) Key employees
  - (B) Customers
  - (C) Lenders
  - (D) Minority shareholders
- (k) Labor issues
  - (i) Allocation of WARN Act and other responsibilities and liabilities
  - (ii) Dealing with multi-employer pension plan withdrawal liability
  - (iii) Finding hidden assets – unemployment compensation reserve accounts

- (iv) Allocation of vacation pay, sick leave and other employee benefits
- (v) Impact of labor law successorship on buyer
- (l) Employee benefits issues
  - (i) Plan terminations
  - (ii) Continuing employee compensation and benefits
  - (iii) Retirement plan asset transfers
  - (iv) Company stock in retirement plans
- (m) Hart-Scott-Rodino filings
- (n) Investment banking issues

V. Conclusion 10:35 to 10:50 a.m.

*Moderator: Richard Busis*

*Panel: Dennis Cohen; Jay Dorsch; Steve Economou; Sarah Kelly*

- (a) Maximizing value
- (b) Don't kill the deal

VI. Questions: 10:50 to 11:00 a.m.



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## CORPORATE LAW

A broad array of business enterprises seek advice and counsel from our attorneys regarding organizational, operational and transactional matters. Among the firm's clients are entrepreneurial start-up enterprises, partnerships, closely held companies and publicly owned companies ranging from local and regional businesses to large multinational conglomerates. These clients are engaged in the broadest range of businesses and include manufacturers, service companies, banks and financial institutions, health care organizations, investment banking firms, retailers, high-technology enterprises, nonprofit organizations, real estate developers, operators and brokerage firms, sports and entertainment companies and professional organizations.

### NO MATTER WHAT YOUR NEED, WE CAN HELP

Our corporate attorneys offer more than just technical legal expertise; they frequently become involved in many aspects of clients' businesses.

Our corporate attorneys regularly counsel clients on matters related to organization and structure, provide advice on matters arising in day-to-day operations, assist in negotiating and documenting financing and business expansion transactions and provide guidance in acquisitions, sales, mergers and divestitures. Specific legal services offered by our corporate attorneys include:

- Negotiating and preparing agreements for business combinations and divestitures, including asset and stock purchase and sales transactions, mergers, consolidations, reorganizations, liquidations, divisions and similar restructurings
- Representing issuers and underwriters in private placements and public offerings of equity and debt securities
- Negotiating, on behalf of lenders and borrowers, secured and unsecured bank and other institutional loan agreements, mortgages and similar financing instruments
- Structuring strategic alliances and cutting-edge joint ventures, establishing licensing and technology transfer arrangements, negotiating venture financing transactions and developing other creative financing techniques;



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- Assisting publicly held companies with federal securities law reporting and compliance obligations and practices
- Advising officers and directors on fiduciary responsibilities and obligations and corporate governance issues
- Establishing the initial organizational structure, including preparing shareholder, partnership, limited liability company and similar agreements defining the rights of the parties
- Developing and documenting executive compensation arrangements and employee benefit programs
- Preparing dealership, distributorship, licensing, technology transfer, franchise and similar agreements

*For further information, please contact:*

*Larry P. Laubach, Esquire*

*(215) 665-4666*

*(800) 523-2900, ext. 4666*

*llaubach@cozen.com*



## MERGERS AND ACQUISITIONS

Businesses develop either by expanding core operations or through mergers and acquisitions. For businesses that choose to pursue the latter strategy, advice from Cozen O'Connor's skilled and experienced Mergers and Acquisitions attorneys can be invaluable. From preparing the letter of intent, to negotiating the terms of the agreement, performing the due diligence, and closing the transaction, our attorneys have the experience to guide clients, from small entrepreneurial enterprises to large multinational corporations, through complex business transactions.

### THE MATTERS WE HANDLE

Our skilled attorneys have extensive experience in representing and advising purchasers, target companies and financial advisors in a wide variety of transactions, including:

- asset sales and purchases
- stock sales and purchases
- cross-border transactions
- mergers and consolidations
- spin-offs and roll-ups
- auction transactions
- joint ventures
- recapitalizations

Because Cozen O'Connor is a full service firm, our Mergers and Acquisitions attorneys can call on attorneys from our tax, ERISA, real estate, labor and intellectual property groups to address the many legal issues that arise in complex business transactions. Our Bankruptcy, Insolvency and Restructuring attorneys provide invaluable assistance in the acquisition of financially troubled enterprises. With an international office in London, our attorneys are also skilled in cross border transactions.

Our attorneys are also able to navigate clients through the domestic and foreign regulatory hurdles that often arise in mergers and acquisitions transactions. From matters before the Federal Trade Commission, the Securities Exchange Commission, and similar regulators in foreign jurisdictions, our attorneys have the experience and relationships necessary to successfully guide clients through these processes.

## REPRESENTATIVE TRANSACTIONS

Over the past three years, attorneys in our Mergers and Acquisitions Department have handled hundreds of transactions ranging in size from under \$1,000,000 to more than \$1,000,000,000. These deals have involved transactions in the chemical, health care, telecommunications, automotive, information technology, records management, banking, entertainment and manufacturing industries. Our clients have included financial intermediaries, strategic acquirers and sellers, industry consolidators, and management of family run businesses.

Specific examples of the types of matters we handle include the following:

- Act as U.S. acquisition counsel for a London based market research company that is listed on the London Stock Exchange in a series of acquisitions valued in excess of \$100 million.
- Represent a network integration, consulting, maintenance and support company in its acquisitions, which to date total more than \$100 million.
- Represented a pharmacy benefit management company listed on the New York Stock Exchange in a \$500 million merger with another New York Stock Exchange company.
- Represented leading document storage company in \$750 million in equity, debt and bank financings and in 40 acquisitions worth more than \$200 million. Later represented the same client in a \$110 million initial public offering and in a \$2 billion merger.
- Represented a NYSE company in a merger valued at \$2,000,000,000.

*For further information, please contact:*

*Edward Baxter, Esq.*

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## SECURITIES OFFERINGS AND REGULATION

In today's increasingly global economy, having access to adequate capital is vital. Cozen O'Connor's securities attorneys are experienced in leading our clients through the labyrinth of federal and state securities law issues in an efficient and cost-effective manner. As an entrepreneurial firm, our attorneys understand the mindset and needs of our predominantly entrepreneurial client base. We recognize the speed with which our clients need to act and have the expertise to negotiate both with other parties as well as regulators to accomplish those goals.

With the escalating volatility of the securities markets, market timing becomes critical as companies need to take advantage of increasingly short windows of opportunity. Our experienced, service oriented attorneys do what it takes to meet our clients' needs.

We are involved in all types of public and private equity and debt offerings. Our attorneys also help our public company clients with the full range of securities compliance issues, from periodic filings and proxy statements to Rule 144 and Section 16 issues.

### PUBLIC EQUITY OFFERINGS

We represent primarily issuers and regional underwriters in initial public offerings as well as secondary offerings. Our clients run the spectrum from high-tech and Internet related companies to more traditional "old economy" companies.

Because our experienced attorneys understand the issues that the SEC focuses on, we are able to help our clients plan for these issues even before the IPO process begins.

### PUBLIC DEBT OFFERINGS

We represent our clients in underwritten high-yield debt offerings as well as rated securities. Over the past few years, our clients have raised in excess of \$500 million in public debt financing. To many entrepreneurial clients, high-yield public debt is an attractive, nondilutive way to raise growth capital.



## PRIVATE OFFERINGS

Related to our emerging business and venture capital practice, we are actively involved in representing players in all aspects of private offerings. We advise our clients about the various structures for private offerings and help choose the method that will minimize both the time and cost of complying with the federal and multiple state regulatory schemes.

We represent companies, venture capitalists and placement agents in debt, convertible debt and equity private placements. Because we represent investors as well as issuers, we understand the needs of both parties. This not only helps us to be more effective negotiators, but also enables us to facilitate bringing a transaction to closing.

## MERGERS AND ACQUISITIONS

Merger and acquisition transactions frequently involve the issuance of securities. We assist our clients in structuring M&A transactions to optimize benefits, while keeping in mind the securities and other legal implications of the various possible structures.

For example, when we negotiated a merger agreement between the two largest companies involved in the records management business, we also registered over \$1 billion of stock that was issued in the merger.

## ONGOING COMPLIANCE MATTERS

In addition to assisting our clients in public and private offerings, we are also experienced in helping our public clients comply with their ongoing securities law obligations. As state and federal regulators attempt to revise the regulatory framework to take into account the new ways, such as the Internet, that companies and investors communicate with each other, the regulatory framework is rapidly changing. We advise our clients on the following types of matters:

- Regulation FD
- the revised tender offer rules
- employee benefit plan securities issues
- Section 16
- Rule 144

As technology changes the way the securities markets operate, the SEC and other regulators are struggling to keep the legal framework in step with reality. We keep our clients abreast of emerging regulatory issues.



## BROKER-DEALERS AND INVESTMENT ADVISORS

With our main Philadelphia office located in the same building as the Philadelphia Stock Exchange, we have broad experience in representing broker-dealers in the full range of their regulatory issues. These include:

- registration as broker-dealer
- NASD compliance issues
- arbitrations

In addition, we have developed a practice of assisting clients in creating hedge funds and in becoming registered investment advisors.

## OUR ATTORNEYS

Our securities attorneys are experienced in multiple aspects of the securities practice and come from a variety of backgrounds. The chairman of our Securities Department was recently a panelist on an ABA seminar on Regulation FD for more than 1,500 practitioners from around the country. In addition, several of the attorneys in our Washington, D.C. office held significant positions at the Securities and Exchange Commission and continue to maintain frequent contact with the SEC.

*For further information, please contact:*

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*or*

*Ralph V. De Martino, Esq.*

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*(800) 540-1355*

*rdemartino@cozen.com*



## LABOR AND EMPLOYMENT

Cozen O'Connor's Labor and Employment Law Department consists of a dedicated team of attorneys who take a comprehensive view of workplace problems while drawing on the firm's deep litigation talent. The result is a unique ability to provide sound, practical advice supported by the litigation resources necessary to solve complex and time-sensitive workplace problems.

### ADDRESSING WORKPLACE PROBLEMS

Attorneys in the department have broad-based experience in the resolution of workplace problems, acting as advisors to in-house corporate counsel, human resources professionals and business executives in developing sound and effective policies. They help clients structure their personnel policies and business transactions to enhance productivity, comply with legal requirements and avoid litigation. Cozen O'Connor's workplace audit offers clients an opportunity to receive experienced and practical guidance on a wide range of employment issues.

### WHEN TROUBLE ARISES, WE CAN HELP

Although preventive measures and planning can be extremely useful in eliminating liability or reducing exposure, even the best workplace policies cannot eliminate administrative investigations and claims. Our Labor and Employment attorneys have decades of experience in representing employers before federal agencies such as the EEOC, NLRB, OSHA, Department of Labor and various state antidiscrimination agencies.

Our attorneys are routinely called upon to serve as trial and appellate specialists in all types of claims, such as:

- age, race, religion, national origin, gender, sexual harassment and disability discrimination
- defamation
- invasion of privacy



- noncompetition agreements
- duty-of-loyalty claims
- equal-pay disputes
- employment benefits disputes
- pension and benefit plan fiduciary liability
- wage-and-hour, whistle-blower and wrongful-discharge claims

## LABOR MATTERS

Our Labor and Employment attorneys bring considerable experience in dealing with the NLRB and guiding a company's election campaign. They also are experienced in helping employers evaluate and implement alternative labor-management relationships. And they are adept at negotiating collective bargaining agreements, defending agreement terms in arbitration proceedings, responding to unfair labor practice charges, dealing with work stoppages and mass picketing. In addition, they are experienced at helping clients promote their business interests while still maintaining a working relationship with their workforce, unionized or not.

*For further information, please contact:*

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*jpasek@cozen.com*

## EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

The attorneys in Cozen O'Connor's Employee Benefits and Executive Compensation Department are experienced in all issues relating to employee benefit plans and executive compensation, including:

- qualified and nonqualified plans
- retirement plans
- executive compensation programs
- health and welfare benefits
- ERISA fiduciary responsibility issues
- the legal aspects of benefit plan investments
- the benefit issues relating to mergers, acquisitions and divestitures
- equity based incentive compensation
- the use of plans in acquisitions and family planning
- plan terminations
- the benefit issues that are unique to tax exempt entities
- funding and underfunding of benefit plans
- multiemployer pension plans
- ERISA litigation

### EXECUTIVE COMPENSATION

Executive compensation arrangements can be tailored to accomplish the unique objectives of both the plan sponsor and the executive. With our knowledge of the legal and regulatory framework, we can design an executive compensation program that is customized to meet your specific goals. Our attorneys assist clients in the design and drafting of all forms of executive compensation arrangements, including:

- stock option plans
- restricted stock plans
- stock purchase plans
- stock appreciation rights
- phantom stock
- other innovative stock-based compensation programs, including plans for internet companies



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ATTORNEYS

We also have extensive experience in drafting a variety of employment contracts, retention agreements and change in control agreements. We counsel clients on the enforceability of restrictive covenants and confidentiality provisions. Our attorneys also assist clients with tax and securities law issues relating to these plans, programs and agreements, including governmental filings and shareholder disclosures.

### QUALIFIED PLANS

Our attorneys design and implement qualified retirement plans for companies of virtually every size. In addition to traditional defined benefit pension plans and defined contribution plans, we design and implement 401(k) plans, cash balance plans, age - and service - weighted defined contribution plans, target benefit plans, and ESOPs.

We also counsel clients in critical plan qualification issues, for example non-discrimination testing, that can emerge in the administration of their plans and assist clients in self audits of their plans to ensure legal compliance. Our attorneys advise clients on the securities law implications of investing plan assets in employer stock.

### NONQUALIFIED RETIREMENT PLANS

Nonqualified plans (sometimes referred to as SERPS) have become an important aspect of executive compensation. We design many types of these arrangements - from the simple to the complex. We also advise clients on different options available for funding these arrangements including rabbi, springing and secular trusts, and insurance related products, taking into account the tax goals of both the employer and employee.

### HEALTH AND WELFARE BENEFITS

Health and welfare benefits have become valued core offerings in today's workplace. The complexity and cost of these benefits present challenges to all plan sponsors. Our attorneys design and draft health and welfare plan documents that satisfy the statutory requirements of ERISA, the ADA, the FMLA, HIPAA and other federal laws, while protecting clients from unwanted liabilities. Our experience in ERISA litigation and employment law enhances our ability to identify and address potential issues in plan



design and administration before problems or liabilities exist. We also provide advice on ways to provide cost effective health coverage and welfare benefits as well as on the creation of self-funded plans and managed care programs. Our attorneys design and implement cafeteria plans, flexible spending programs, employee assistance programs, transportation and tuition assistance plans and similar benefit programs.

### ERISA FIDUCIARY RESPONSIBILITY

We counsel clients in discharging their fiduciary duties under ERISA. We assist in establishing committees, procedures, and agreements that protect the employees, officers and directors who administer and act as fiduciaries with respect to clients' retirement plans. Our ERISA attorneys have considerable experience in designing transactions to accommodate the special needs of tax exempt investors. They advise clients extensively in all aspects of plan investment including:

- the fiduciary standards imposed by ERISA
- the unrelated business tax aspects of the investment
- whether the investment is a prohibited transaction
- whether the investment creates a "plan asset" issue under ERISA

### MERGERS AND ACQUISITIONS

We advise clients on the intricate employee benefits issues related to mergers and acquisitions. Our attorneys are skilled in analyzing defined benefit pension plans and other benefit programs and executive compensation arrangements, including severance plans, unfunded top-hat and supplemental arrangements, and retiree health benefits, as to potential liabilities.

### TERMINATIONS, FUNDING AND UNDERFUNDING

Our attorneys assist many companies in the recovery of excess assets in their pension funds and the replacement of the terminated benefit programs with new, more modern retirement programs. We counsel many clients, both in and out of bankruptcy, on the legal and financial ramifications of pension underfundings and negotiate with various governmental agencies on behalf of clients and creditors' committees regarding these issues.



## MULTIEMPLOYER PENSION PLANS

Many of our clients contribute to union-sponsored multiemployer pension plans which have special rules and potential liabilities. We represent corporate clients contributing to these funds as well as certain funds themselves.

## ERISA LITIGATION

In the last few years, litigation in the benefits area has increased dramatically. We represent clients in all aspects of ERISA litigation including, fiduciary liability, retiree medical benefits, severance matters and retirement and welfare benefit claims.

## ARTICLES, SEMINARS AND NEWSLETTERS

Our attorneys present client seminars in the areas of employee benefits and relations, and executive compensation. We present programs to clients' in-house human resources and management sectors on a variety of contemporary employee benefits topics. In addition, we provide client advisories on important changes and developments in the law relating to employer benefits and compensation.

Our attorneys also teach courses on qualified and nonqualified plan design, and other employee benefits topics. We are committed to staying ahead of developments in the Employee Benefits and the Executive Compensation area.

*For further information, please contact:*

*Jay A. Dorsch, Esq.*

*(215) 665-4685*

*(800) 523-2900 ext. 4685*

*jdorsch@cozen.com*



## REPRESENTATIVE TRANSACTIONS

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Represented Vermont Pure Holdings Ltd., a publicly traded bottler and distributor of natural spring water, in the sale of its retail bottling assets and business to MicroPack Corporation for approximately \$10.5 million.

Represented eight venture funds in the sale of American WholeHealth, Inc., a portfolio company, for approximately \$40 million.

Represented client New Spring Ventures, a prominent local venture fund, in connection with New Spring's acquisition of a controlling interest in Network Communications Technologies, Inc., a North Carolina based IT services firm, and the related \$5.0 Million financing.

Represented a New York Stock Exchange company in a \$1.2 billion merger with another New York Stock Exchange company.

Represented Morphotek, Inc., a fast growing biotech company located in Malvern, Pa., in the successful closing of a \$26 million venture financing from a group of very prominent venture funds, including SR One Ltd, Forward Ventures, China Development Industrial Bank, Rock Maple Ventures, Burrill & Co., CB Health Ventures and Flagship Ventures.

Represented controlling shareholders of Lehigh Press, Inc., a textbook cover manufacturer, in a stock purchase agreement in which national printing company, Von Hoffman Corporation will purchase all of the stock of Lehigh.

Successfully represented South Jersey Gas Company in connection with the registration with the SEC, negotiation and sale of \$85.5 million of South Jersey Gas Company bonds.

Achieved the closing of the first synthetic fixed rate bond issue for the Bethlehem Area School District, the first such deal for a Pennsylvania School District.

Represented a New York Stock Exchange company in a \$500 million merger with another New York Stock Exchange company.

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Principal Office: 1900 Market Street, Philadelphia, PA 19103 • (215) 665-2000 • (215) 665-2013 (Fax) • [www.cozen.com](http://www.cozen.com)

500 +Attorneys: Atlanta • Charlotte • Cherry Hill • Chicago • Dallas • Denver • Houston  
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Newark • Philadelphia • San Diego • San Francisco • Santa Fe • Seattle • Toronto  
Trenton • Washington, DC • West Conshohocken • Wilmington



## REPRESENTATIVE TRANSACTIONS

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Served as bond counsel in a \$2.4B bond deal which financed the consolidation of highway authorities in New Jersey, and won accolades as *The Bond Buyer's* "Deal of the Year."

Represented Taylor Nelson Sofres, plc, a London stock exchange company in the \$435 million acquisition of NFO WorldGroup, Inc.

Closed the first part of a complicated financing transaction that spanned 10 months relating to the purchase of a Hotel and Casino in Central City, Colorado.

Completed Centocor, Inc.'s acquisition of the Commonwealth Corporate Center in Horsham, Pennsylvania from Advanta Corp. The purchase price was \$31.5 million and involved vigorous negotiations. The office park is situated on four contiguous properties comprising more than 80 acres. Centocor, Inc. is a subsidiary of Johnson & Johnson.

Representation of a number of borrowers in a \$60 million loan facility consisting of a revolving loan and multiple term loans.

Obtained a land development approval in Lower Gwynedd Township for Johnson & Johnson subsidiary Ortho-McNeil. The approval is for a fourteen building, seven phase project that will begin next year and end in 2011, adding approximately 800,000 square feet of office, manufacturing and warehouse space and approximately 1,200 employees. Johnson & Johnson refers to this type of facility as a "Site of Excellence", intended to attract the brightest scientists for its research development projects, as well as those of its subsidiaries.

Assisted GCA Services Group, a newly formed facilities management company, to secure debt financing and obtain \$90 million of equity funding.

Represented TherImmune Research Corporation, a preclinical contract research organization, in its acquisition by Gene Logic Inc., a publicly traded genomics company, for \$52 million.

Represented Newtek Business Services, Inc. in acquisition of Commercial Capital Corp., one of 14 nationwide, non-bank SBA licensees, including recapitalization, renegotiation of Deutsche Bank \$100 MM credit line and strategic joint investment by Credit Suisse First Boston affiliate.

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## REPRESENTATIVE TRANSACTIONS

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Represented Newtek Business Services and SBA lending subsidiary, Newtek Small Business Finance, in negotiation of exclusive or non-exclusive business services provider agreements to be marketed to customers or members of Merrill Lynch, National Credit Union Association, Column Financial, Cendant Corporation, Veterans' Corporation of America and others.

Represented an entity formed by a client in a \$125 million equity financing transaction to purchase the preferred and common limited partnership interests of Stokes Land Group, LLP.

Represented IndustryBrains, Inc. in its merger with publicly held Marchex, Inc. for approximately \$31 million.

Represented Blue Cross of Northeastern Pennsylvania in a \$30 million sale of interests in its operating subsidiaries to Highmark.

Represented the shareholders of an environmental equipment rental company in a \$40 million sale to a private equity fund.

Represented the minority shareholders of Kremer Laser Eye Centers in the sale of their interests to a public company, and their simultaneous purchase of interests in the successor company.

Represented Expense Watch, Inc. in a \$7 million equity investment from a venture capital fund.

Represented Talisman Companies in a \$68 million combination first mortgage and mezzanine debt financing to acquire and redevelop a regional mall in Minneapolis, MN.

Represented Chester Valley Bancorp in its merger with Willow Grove Bancorp closing in August 2005. Chester Valley Bancorp got cash and stock having a total value of \$130 million.

Represented Pine Environmental Services, Inc. in the sale of substantially all of its assets to a wholly owned subsidiary of RAF Industries, Inc. for a purchase price of approximately \$34.5 million, subject to increase for earnout payment. The transaction closed on June 7, 2005.

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Newark • Philadelphia • San Diego • San Francisco • Santa Fe • Seattle • Toronto  
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## REPRESENTATIVE TRANSACTIONS

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Represented John Maneely Co., a specialty steel manufacturer, in its acquisition by Carlyle Group, a private equity fund, for \$510 million. Transaction was noted in the *Wall Street Journal*, *Philadelphia Inquirer*, and *The Daily Deal*.

Represented Flagship Credit Corp., a sub-prime finance company, in an \$81 million equity investment by Equifin, a private equity fund.

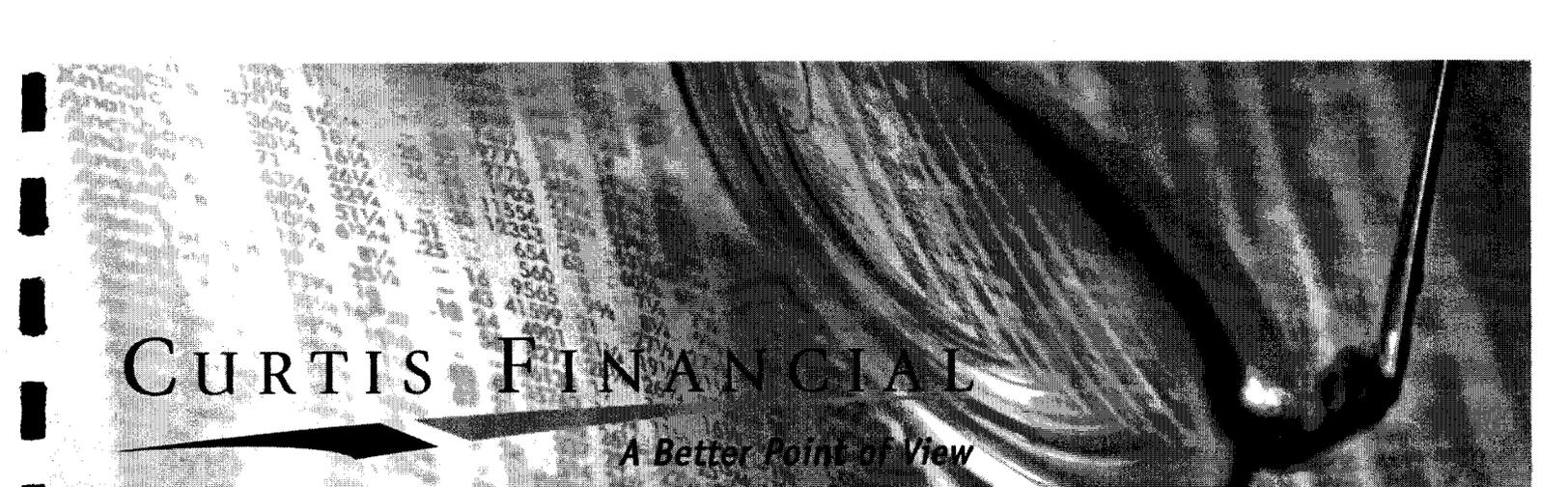
Represented LLR, a private equity fund, in its acquisition of Reading Body Works, for \$80 million.

Represented Medical Broadcasting Co., in its sale to Digitas for \$35 million.

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# CURTIS FINANCIAL

*A Better Point of View*

**CURTIS FINANCIAL** is a leading middle market investment banking and corporate finance advisory firm.

Founded in 1994, Curtis Financial professionals have consistently achieved successful results for our clients including:

- Over 200 merger and acquisition transactions completed
- Over 100 financings closed
- Over 70 Fairness Opinions
- Over 1,000 Valuations

Curtis Financial's extensive experience and rigorous analysis attain results that consistently exceed our clients' expectations.

- Experienced and Professional Advice
- Reputation for Quality Work
- Industry Sector Expertise
- Extensive Industry and Private Equity Relationships
- Senior Banker Attention
- Superior Results

## **Our Focus**

We deliver quality investment banking and corporate finance services to small to medium sized businesses with revenues ranging from \$5 million to \$150 million.

## **Our Clients**

Our clients include high growth companies and established businesses. We serve entrepreneurs, family owned businesses, corporations, management teams and private equity funds.

## **Our Experience**

Our senior professionals each have over 15 years of investment banking and corporate finance advisory experience with national and regional investment banking and consulting firms. We have experience in a wide variety of industries with special focus and experience in the following sectors:

- Business Services
- Consumer Products and Food
- Engineering and Construction
- Financial Services and Insurance
- Healthcare and Life Sciences
- Industrial
- IT/Outsourcing/Software
- Plastics and Packaging
- Technology
- Telecommunications

## **Our Services**

### **Mergers & Acquisitions**

We advise on all types of sale transactions, including: (i) merger and acquisition of private family-owned and closely held public companies; (ii) divestitures of portfolio companies by private equity groups; (iii) divestitures of subsidiaries and operating divisions by larger companies; (iv) sales of small-cap publicly-traded companies; and (v) management buyouts.

### **Fairness Opinions & Valuations**

Our analyses are prepared to meet the full range of client and fiduciary needs, including: mergers and acquisitions, stock options, shareholder disputes, gifting, tax planning, private financings, insider transactions, employee stock option plans and GAAP accounting.

### **Financings & Private Placements**

We serve both growth companies and established businesses in raising private senior debt, mezzanine debt and equity capital to support growth, acquisitions, recapitalizations and shareholder liquidity events and restructurings.

### **Corporate Finance Services**

We provide a wide range of customized analytical services including Shareholder Alternatives Assessments, Strategic Liquidity Reviews, Joint Venture Analysis, and Board Advisory projects.

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# CURTIS FINANCIAL

*A Better Point of View*

Two Penn Center Plaza, Suite 1520, Philadelphia, PA 19102  
[www.curtisfinancial.com](http://www.curtisfinancial.com)

Securities offered through Curtis Securities, LLC, a registered Broker Dealer, member NASD, SIPC

# Our Senior Professionals

**Kevin J. Rudd**  
President

CPA/ABV, CFA



Kevin founded Curtis Financial in 1994 and has more than 19 years of experience providing strategic financial consulting services to hundreds of transaction-oriented middle market and emerging growth companies. Kevin's primary focus is providing financial based analyses and advisory services as they relate to selling and buying businesses, joint ventures, business valuations and raising private capital.

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**Steve N. Economou**  
Managing Director



Steve has nearly 20 years of diverse corporate finance experience including mergers and acquisitions, private equity, management buyouts, and fairness and valuation opinions. Steve has completed hundreds of valuations, fairness opinions and advised on over 100 transactions. Steve's primary focus is on technology and growth companies, public companies and consumer products.

215.557.2219  
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**Anthony J. Latini, Jr.**  
Managing Director

CFA



Tony has provided corporate finance and investment banking services to middle market and large corporate clients for the past 14 years during which he has completed \$1.5 billion in M&A transaction value and raised in excess of \$500 million in debt and junior capital. In addition to a variety of industry experience, Tony specializes in the financial services industry.

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**Eric Meltzer**  
Managing Director



Eric has over 15 years of investment banking experience on Wall Street and in the investment banking group of a major money center bank. During his career, Eric has raised more than \$500 million through senior and subordinated debt, as well as through venture capital and initial public offerings. Eric has extensive experience in the telecommunications industry.

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**Jason M. Cunningham**  
Vice President

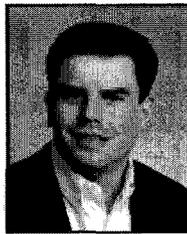


Jason has over seven years of investment banking experience providing a wide range of transaction and valuation advisory services. Jason has advised middle market clients in various industries on public and private company mergers and acquisitions, spin-offs, private placements, strategic alternatives reviews, and business valuation issues.

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**Michael Demers**  
Vice President

CFA



Mike has over five years of experience in connection with mergers and acquisitions, shareholder buyouts and valuation services including shareholder disputes, litigation support and estate tax planning. Mike specializes in the financial services and healthcare industries.

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**Howard M. Snyder**  
Vice President



Howard has 14 years of investment banking experience serving middle market, large corporations and private equity firms both domestically and internationally. Howard has completed transactions totaling over \$1.2 billion in transaction value. Howard's primary focus is the plastics, packaging and specialty chemicals industries.

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# the Curtis Alert

## Philadelphia and the State of Private Equity

Valuation multiples are at their highest levels in a decade. Financing is widely available and leverage multiples are at cyclical highs. We talked with three of the region's leading private equity professions to discuss:

- \* Have valuation multiples peaked?
- \* What investments are they making now as compared to five years ago?
- \* Why do deals fall apart?
- \* Does Philly get respect?

Here's who we spoke with:

### Steven Graham, Senior Managing Principal, Graham Partners

Graham Partners manages over \$850 million in equity in three funds with a principal focus of acquiring domestic manufacturing companies that possess innovative technology capable of transforming their industry. Acquisitions generally have revenues between \$20 million and \$350 million.

### David Proctor, Senior Vice President, Wind River Holdings, L.P.

Wind River Holdings seeks to acquire companies that have strong opportunities for growth, a high-caliber management team, a leading and recognized brand in its respective market and annual sales of up to \$100 million. Wind River seeks to hold its investments between 10 and 20 years.

### Howard Ross, Principal, LLR Equity Partners, L.P.

LLR Partners has more than \$600 million under management. LLR typically invests between \$10 million to \$40 million in buyout, recapitalization and growth equity transactions. In addition to outright acquisitions, LLR makes minority investments and does not seek to acquire operational control of a company.

### Sale Multiples – Are We at the Top of the Cycle?

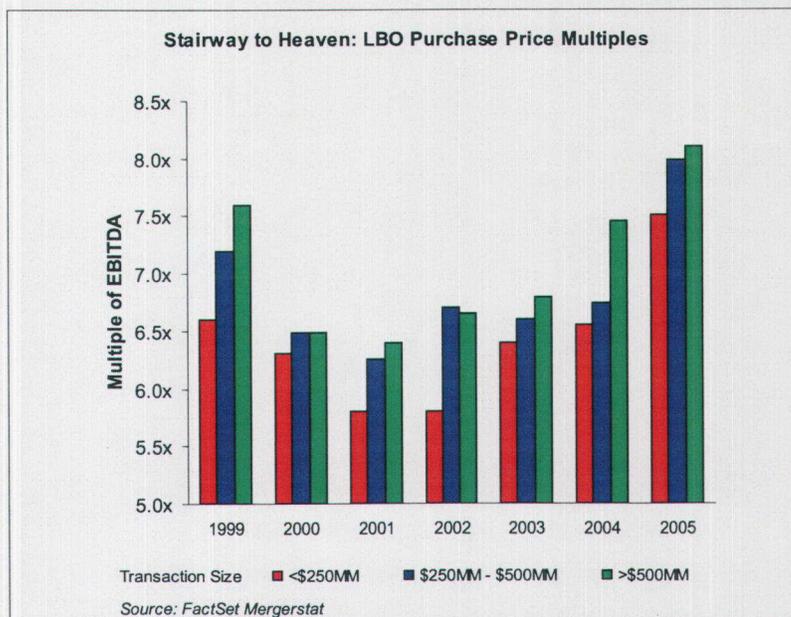
**Graham:** LBO valuations are closely tied to the credit environment and the overall liquidity in the credit markets. At this juncture, LBO lenders in the middle market are allowing transactions to be leveraged at 5.0 to 6.5 times the trailing twelve month EBITDA, a level that's 1.5 to 2.0 times EBITDA more than was the case three to five years ago. Debt has a pre-tax cost of between 5% and 15% (for senior through mezzanine) which is cheaper than private equity which has an implied pre-tax cost of 25% or more. This greater availability of lower cost capital means LBO funds can pay somewhat higher multiples and still generate the same returns on their equity.

Still, while acquisition multiples are very high, they are not as high as in late 1997 or early 1998, (prior to the August 1998 collapse of Long Term Capital Management). The yield curve is fairly flat today and the cost of long-term capital is thus

pretty attractive relative to historical norms, so I'm not sure whether acquisition multiples have yet peaked. In general, acquisition prices are going to ebb and flow in direct proportion with the credit environment.

**Proctor:** Part of what is pushing up prices for companies is the greater supply of money chasing a somewhat limited number of deals. There is a staggering number of middle market companies owned by people between the ages of 50 and 60. That supply of additional acquisition opportunities on the horizon may push prices down as they come on the market. Of course, it may be that additional private capital will continue to hold up the prices that are paid for middle market companies. It is unclear which way this supply-demand dynamic is going to play out.

**Ross:** For a family owned company, there couldn't be a better time than the present to sell. Multiples are at a cyclical high and we are late in the cycle. The cycle is being



driven by a good economy, lots of equity capital and cheap debt. Good times don't last forever and lenders are starting to tighten up. This cycle has had a good five-year run. It's been a phenomenal run from 2002 through 2006. We're seeing some pretty robust multiples and I'm not sure they will be there two years from now. There might be a year or 18 months left but valuations aren't going up from here.

### Has the Market for Mid-size Private Companies Changed in the Last Five Years?

**Proctor:** The LBO (leveraged buyout) marketplace has evolved. In the early days, back in the 1980s, investors bought divisions of larger corporations that could operate more nimbly outside of the bureaucracy of the large parent corporation. Over time, financing became more sophisticated and much of the upside of these deals has been competed away.

In the last five years there has been a real flourishing of the private equity markets. Much of this has been due to a tremendous shift in the micro cap market (companies with market capitalization of less than \$400 million) from public to private. Many companies that formerly would have been public are taking private equity rather than face the new risks of being public, such as Sarbanes-Oxley. There really isn't a public

market exit available to smaller companies any more unless they have exceptional growth.

Also, investors have realized that public micro cap stocks are essentially no more liquid than similar private equity financed companies. There is so much trading of private companies going on that liquidity in the private market has improved significantly. We also now have a track record of private equity groups and we can look and see which ones are reliable buyers and which are not. Part of the current high sales multiples may be the result of this new "private market" liquidity – the big increase in transaction volume has permanently reduced the illiquidity risk of private equity; it's not just a matter of a cyclical phenomenon.

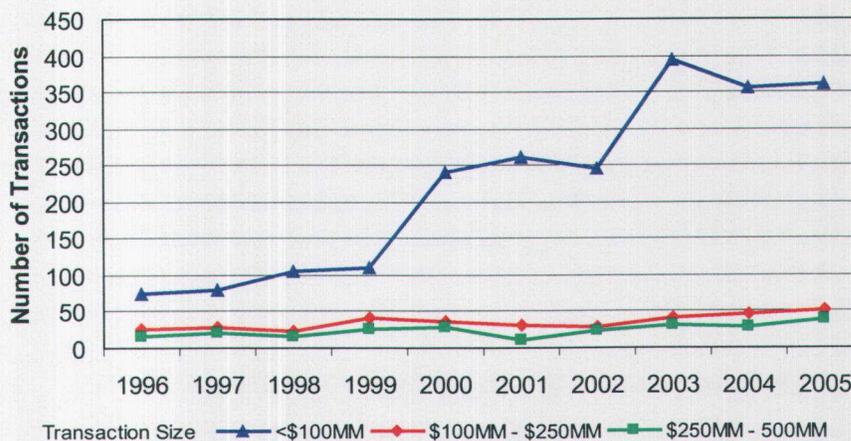
**Ross:** One of the major differences over the last several years as compared to the prior 30 years is the emergence in a big way of private equity as being a viable option for an exit for a middle market company. We've also never had so many tiers of funds. Funds like ours may acquire a platform company of a moderate size, make some add-on acquisitions, and later trade the company up to a larger national fund. That's new. That whole hierarchy wasn't around five years ago. Back then the only buyers of the companies we buy were strategic buyers. Private equity is much more of a viable exit for

middle market private companies than it used to be.

**Graham:** While the universe of buyout groups has grown significantly since the late 1990s, there is far more specialization among these firms today. Therefore, the numbers of truly interested buyers for a particular firm might not be as numerous as one might initially think. We find that in most of the competitive sales processes that we are involved in there frequently are only one or two highly interested buyers when you get to the finish line.

The other major trend is far greater involvement by private equity investors in the operational elements of their companies. This increased involvement is often handled day-to-day by what we call an "Operating Partner" who is an industry executive with significant big-company senior management experience. Our Operating Partners typically sit on the boards of our portfolio companies and act as player-coaches, working very closely with the senior management teams of the portfolio companies on matters of strategy, succession planning, customer issues, manufacturing issues, etc. In short, the private equity business isn't just about managing money; it's about actively managing/overseeing the operating company as well.

Small is Beautiful: Number of Transactions by Size



Source: FactSet Mergerstat

## What Does a Seller Need to Know?

**Ross:** As a general matter, we find that sellers today are far more sophisticated than they were in the past. Business owners just seem to be more informed about private equity than was formerly the case. In addition, there are more brokers, such as Curtis Financial, that are active in representing sellers. That helps to ensure a successful transaction.

**Proctor:** Sellers need to do two things. They need to set goals regarding what they are trying to accomplish financially. They need to ask themselves why they are selling and how much they expect to take off the table – and whether or not that's realistic. Second, and something we almost never see, a seller should ask how the private equity investor intends to make money off of the seller's company. This may not be so important to the seller if the company is sold outright for cash but if the seller wants to retain a stub or the consideration is not all cash, it can be very important.

**Graham:** At Graham Partners, we are a classic cash take-out, control LBO buyer, not a growth equity investor. Those who sell to us are typically paid out at closing, though they may roll-over some equity and own a minority position going forward.

## Are You Buying Different Kinds of Companies as Compared to Five Years Ago?

**Graham:** No. The key to our investment strategy is that we are looking for companies that benefit from a fundamental shift in the business, say, the shift from a natural material to a synthetic material. For example, we have a company that makes wine corks from synthetic material. We're looking for healthy, fast-growing companies that are benefiting from this kind of conversion. If anything is different in our business model today it is the intensity with which we and our Operating Partners become involved with our companies. We do much more in that regard and we do it much more quickly than five years ago.

**Ross:** No. We look for strong companies that have a unique business model, that are

growing and have competent management. These companies command higher multiples.

**Proctor:** No. We look for strong management teams in industries with fragmented customer bases and supplier characteristics. We are looking to grow a company over a period of 10 to 20 years. Typically, we are looking for branded services or products, consumer or industrial. If anything has changed over the last five years, it would be our increased focus on the brand. We look to enhance the value of the brand within the industry. Size of the company relative to the market is irrelevant but the company needs to have \$5 million in EBITDA; there needs to be some "clay" to work with.

## Why Do Deals Fail?

**Ross:** In a sale, the problem is typically a matter of valuation and the form of consideration – how much is cash at close, etc. In a recapitalization, problems tend to arise over matters of corporate governance. Good advisors can help prepare business owners as to what are the standard terms and conditions. More middle market companies are hiring such advisors these days – that's healthy – it makes these kinds of failures less frequent.

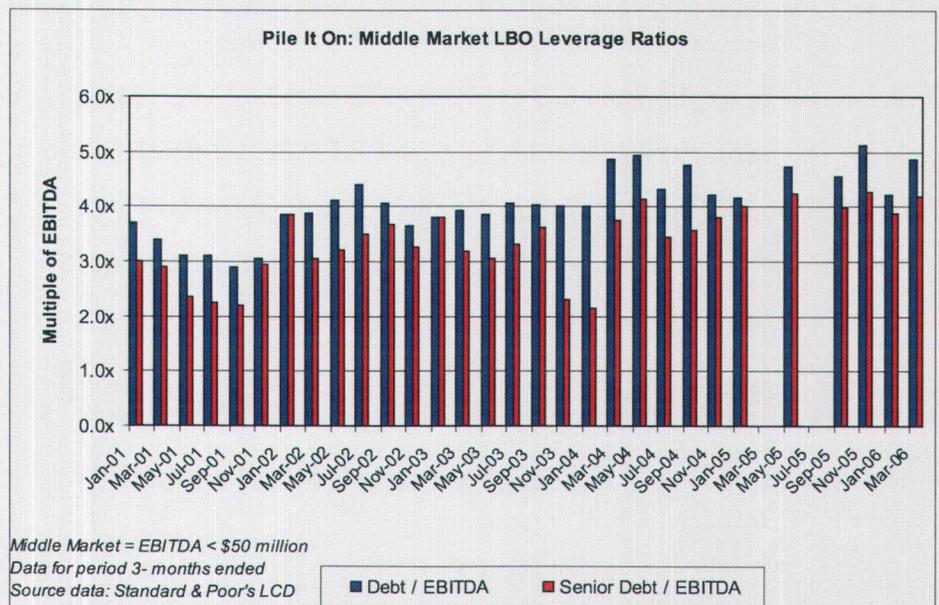
**Graham:** When deals blow up during due diligence it is typically because the actual

performance of the business, upon close examination, turns out to be less than what was advertised. Because we examine potential investments in close detail, managements typically can't answer our questions – we're asking about matters they may have never considered. You always have to be willing to walk away from a deal if the due diligence reveals fundamental weaknesses that were not disclosed during preliminary presentation by management.

**Proctor:** Deals fall apart due to breakdowns in communication. And there is a ton of ego. When egos take over, you can get irrational action – on everybody's side. That hasn't changed – it probably never will.

## Yo — What about Philly?

**Ross:** The investment opportunities in the Philadelphia region are excellent. There are a lot of middle market companies in the region that are not mined by outsider investment groups. A lot of Philadelphia businessmen like the idea of being funded locally. But Philadelphia clearly lags as a home of private equity funds. LLR is just eight years old – we have \$620 million under management – and we are among the biggest private equity groups in the region. There are no larger nationally known funds here like TA Associates, Summit or Golder Thoma. I think many of the bigger national funds think they can cover the Philadel-



phia market with offices in Washington, DC or New York.

**Proctor:** There are a lot of boutique investment banks in Philadelphia and each seems to prosper by having a specific focus or certain relationships. On the private equity front, there are not a lot of buyout shops as compared to, say, Chicago, Boston or even Cleveland. Philadelphia is relatively stronger on the venture capital side, particularly in Bio and Pharma – early stage investments as compared to later stage private equity.

**Graham:** Of the estimated \$1.5 trillion of private equity commitments raised since the early 1980s, easily \$1.2 trillion has been committed to the LBO sector, not venture capital. Venture capital is a comparatively small sector in part because of the much smaller size of the companies involved in these transactions. In terms of the private equity profile, Philadelphia-based firms have raised less than 1% of the private equity capital raised historically, which is a disproportionately small amount for the fifth largest city in the U.S.

On the LBO side, the private equity business evolved out of the large investment banks, which have a presence in New York, Los Angeles, Chicago, San Francisco and Boston. So, Philadelphia wasn't really on

the map. On the venture side, the major firms grew up in Silicon Valley and outside of Boston, again leaving Philadelphia somewhat out of the mainstream.

For Graham Partners, we see relatively limited deal flow from Pennsylvania, Delaware and New Jersey. We see many incredibly well managed companies in these regions. But our focus is closely connected to product innovation and for some reason the companies that are developing new products in the manufacturing sector tend to be located in geographic regions with rapid population growth, such as the West Coast and the Southeast.

Philadelphia area companies in pharma and pharma-related products and services are experiencing some growth, and that is where we have seen innovation and more corporate activity locally. If you want to focus on buying a growth-oriented business in this region, that would be a sector to consider.

*Curtis Financial Group, LLC thanks each of the participants for their comments at this interesting point in the financial and corporate transaction markets. We hope these comments are useful to business owners and their advisors in the Philadelphia region.*

**Transaction Services**

- Sales, Divestitures and Mergers
- Acquisitions and Management Led Buyouts
- Raising Capital

**Corporate Finance Advisory Services**

- Fairness Opinions
- Strategic Alternatives Analysis
- Business Valuations
- Intangible Asset Valuations

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**CommunityBanks**

Community Banks Insurance Services, LLC  
NASDAQ: CMTY

has acquired



**Wiley Insurance Agency, Inc.**

*The undersigned served as financial advisor to Community Banks, Inc. in connection with this transaction*

CURTIS SECURITIES

A Better Point of View



*Two River Community Bank and The Town Bank have been acquired by a newly formed holding company in an all-stock transaction.*

*The undersigned served as exclusive financial advisor to Two River Community Bank and issued a fairness opinion in connection with this transaction.*

CURTIS SECURITIES

A Better Point of View

**AOC Acquisition Corp.**

*has acquired the musical instruments and electronic assemblies assets of*



*The undersigned provided a fairness opinion to the Board of Directors of Allen Organ Company in connection with this transaction*

CURTIS FINANCIAL

A Better Point of View

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# CURTIS FINANCIAL

A Better Point of View

## 2006 Closed and Announced Transactions<sup>1</sup>

**April 2006**

**AOC Acquisition Corp.**  
has announced its intention to acquire the musical instruments and electronic assemblies assets of

**Allen ORGAN COMPANY**

The undersigned provided a fairness opinion to the Board of Directors of Allen Organ Company in connection with this transaction

**CURTIS FINANCIAL**  
A Better Point of View

**Oneida**  
Communications Group  
has raised \$10,000,000 of Series A Preferred Equity from

**CATALYST**  
and  
**NORTHWOOD VENTURES**

The undersigned advised Oneida Communications Group in connection with this financing.

**CURTIS SECURITIES**  
A Better Point of View

**June 2006**

**ICM**  
INVENTORY CONTROLLED MERCHANDISING  
has been acquired by newly formed subsidiary of

**SANDUSCO, Inc.**

The undersigned served as exclusive financial advisor to ICM in connection with this transaction

**CURTIS SECURITIES**  
A Better Point of View

**Two River COMMUNITY BANK**  
**Town Bank**

Two River Community Bank and The Town Bank have been acquired by a newly formed holding company in an all-stock transaction.

The undersigned served as exclusive financial advisor to Two River Community Bank and issued a fairness opinion in connection with this transaction.

**CURTIS SECURITIES**  
A Better Point of View

**May 2006**

**CommunityBanks**  
Community Banks Insurance Services, LLC  
NASDAQ: CMTY  
has acquired

**Wiley Insurance Agency, Inc.**

The undersigned served as financial advisor to Community Banks, Inc. in connection with this transaction

**CURTIS SECURITIES**  
A Better Point of View

**June 2006**

**LUCID SECURITY**  
has been acquired by  
Liberty Acquisition Corp.  
A newly formed subsidiary of

**Ambiron TrustWave**

The undersigned provided a fairness opinion to the Board of Directors of Lucid Security in connection with this transaction

**CURTIS FINANCIAL**  
A Better Point of View

**Oneida**  
Communications Group  
has acquired the rights to the BRS and EBS licenses, representing 589,000 pops, of

**BROADCASTING ORION SYSTEMS**

The undersigned advised Oneida Communications Group in connection with this transaction.

**CURTIS SECURITIES**  
A Better Point of View

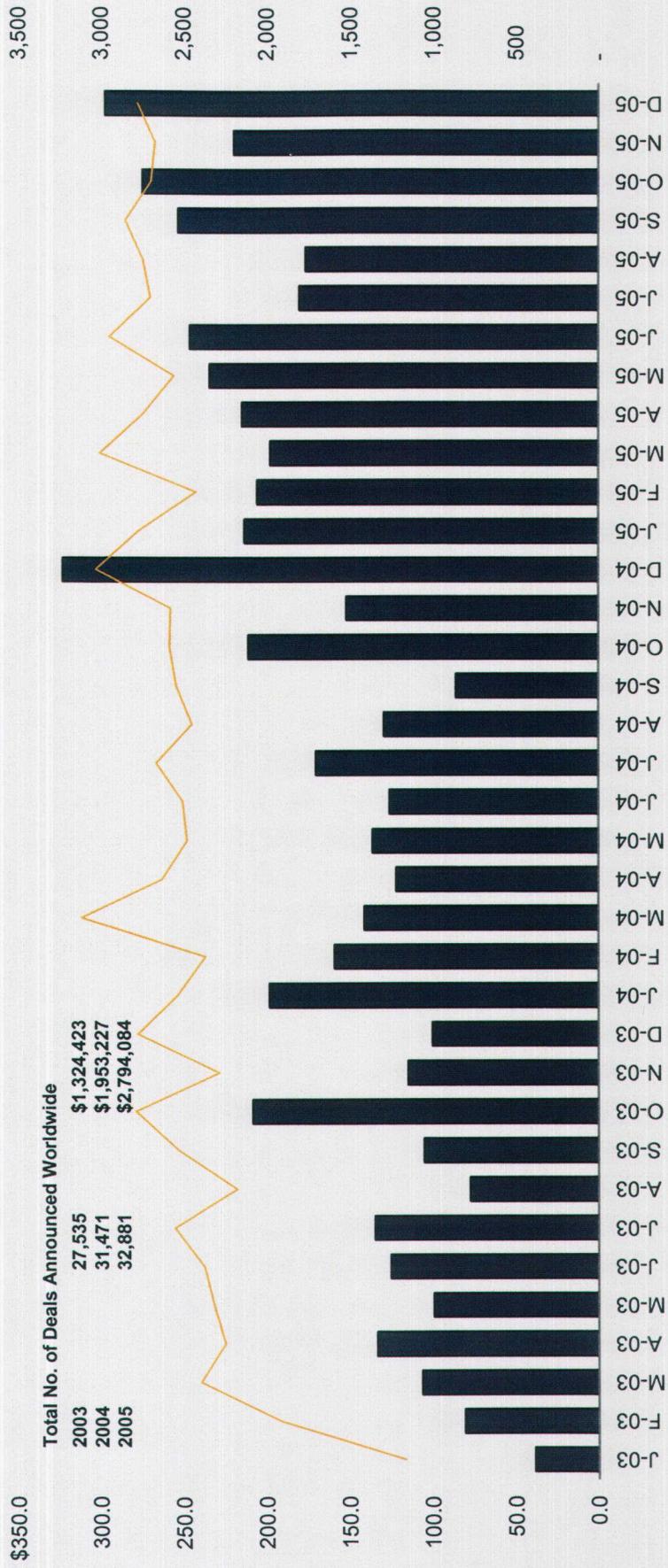
<sup>1</sup> As of June 21, 2006

**Recent Trends and Statistics in Mergers and  
Acquisitions**

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# M&A Global Volume

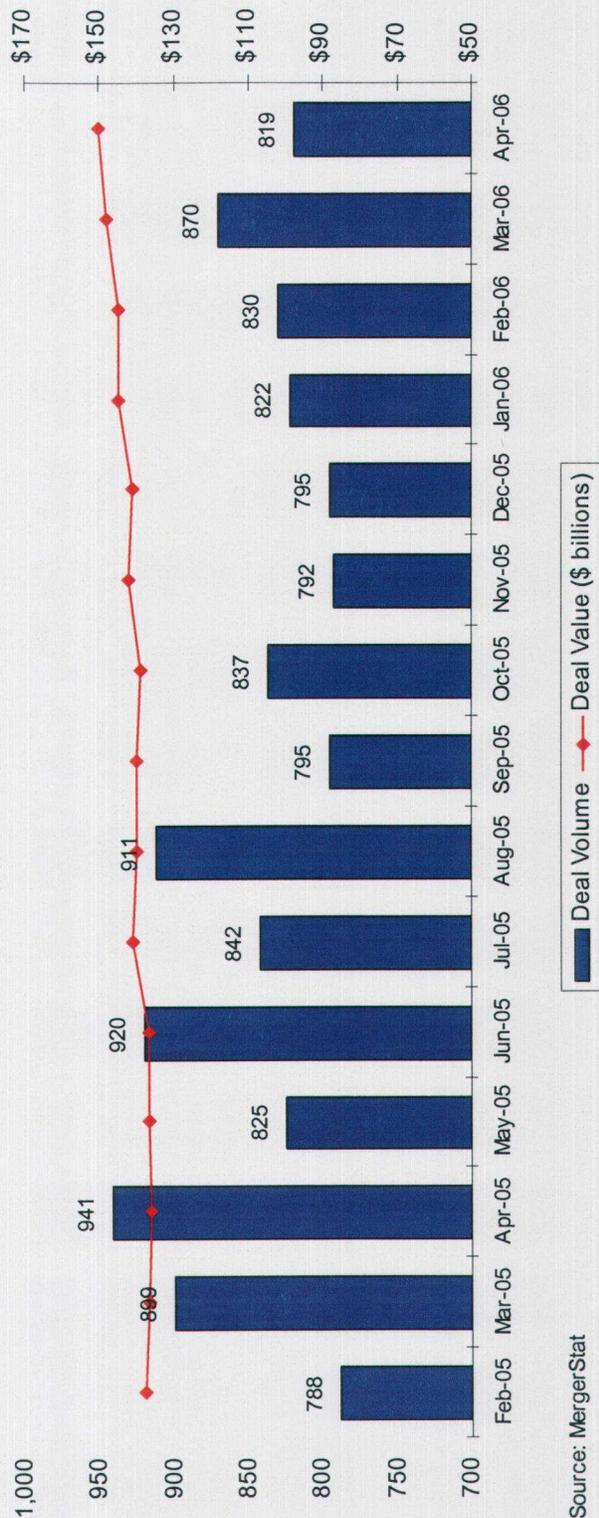
- M&A volume in 2005 was the highest year since 2000
  - \$2.9 trillion in announced global deal volume, up 38% from 2004 and almost \$1.14 trillion from US activity, up 28%
- Industry consolidation drove an across-the-board surge in activity, particularly in real estate, financial services, telecommunications and energy



## U.S. M&A Volume

- Merger and acquisition activity has continued at historically high levels through the first four months of 2006.

U.S. Mergers & Acquisitions Market



# U.S. M&A Volume

- Middle Market transactions continued to represent the largest single segment within the total number of deals when ranked by size

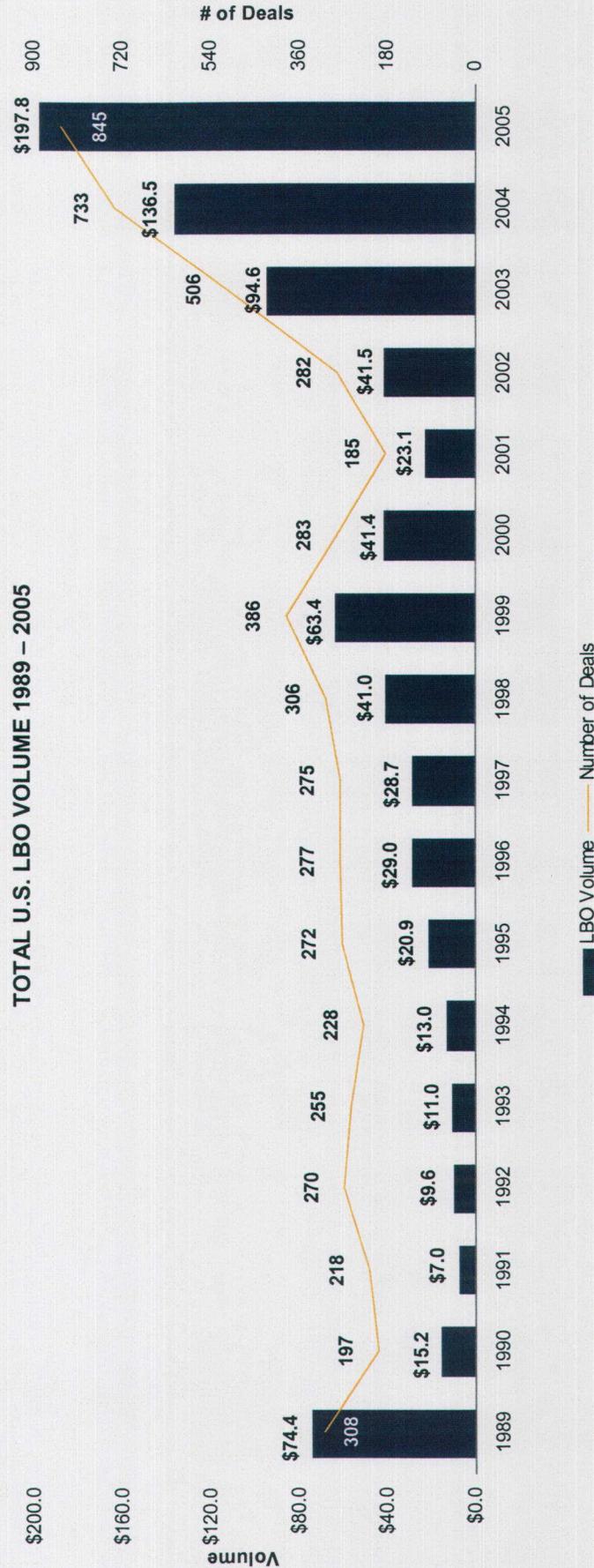
Deal Size	Number of Deals		
	12/31/2004	12/31/2005	4/30/2006
\$1 Billion +	135	171	178
\$500M to \$999.9M	121	152	171
\$250M to \$499.9M	211	233	268
<b>\$100M to \$249.9M</b>	<b>398</b>	<b>415</b>	<b>435</b>
<b>\$50M to \$99.9M</b>	<b>390</b>	<b>445</b>	<b>490</b>
<b>\$25M to \$49.9M</b>	<b>497</b>	<b>515</b>	<b>523</b>
\$10M to \$24.9M	594	672	690
Under \$10M	1,038	1,079	1,083
Undisclosed	6,755	6,687	6,824
<b>Total</b>	<b>10,139</b>	<b>10,369</b>	<b>10,662</b>

{ Middle Market } 37.7% of all disclosed transactions

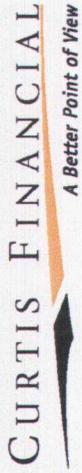
Deal Size	Aggregate Value (\$Bil)		
	12/31/2004	12/31/2005	4/30/2006
\$1 Billion +	468.2	695.5	680.4
\$500M to \$999.9M	82.8	106.4	121.6
\$250M to \$499.9M	72.7	81.5	93.4
<b>\$100M to \$249.9M</b>	<b>63.5</b>	<b>65.7</b>	<b>68.4</b>
<b>\$50M to \$99.9M</b>	<b>27.4</b>	<b>31.2</b>	<b>34.7</b>
<b>\$25M to \$49.9M</b>	<b>17.8</b>	<b>18.0</b>	<b>18.3</b>
\$10M to \$24.9M	9.6	10.9	11.3
Under \$10M	4.3	4.4	4.5
Undisclosed	-	-	-
<b>Total</b>	<b>\$746.3</b>	<b>\$1,013.8</b>	<b>\$1,032.6</b>

# M&A Leverage Buyout Volume

- In 2005, private equity deal flow far exceeded all previous years
- There were 845 completed leveraged buyouts worth a disclosed value of \$197.8 billion representing a 45% increase over 2004 disclosed deal values

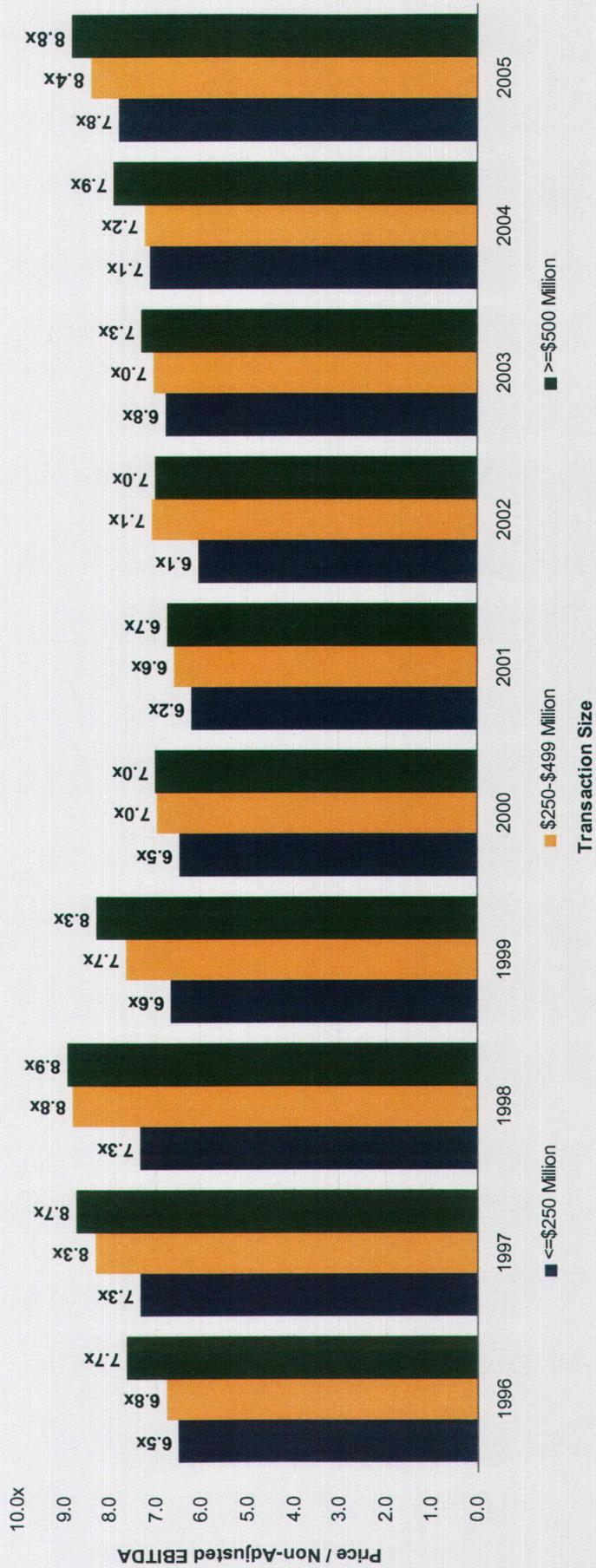


# M&A Purchase Price Multiples



- Purchase price multiples continued to rise from the lows in 2001, supported by a robust high yield market
- The demand for quality acquisition targets is driving the larger financial and strategic buyers solidly into the middle market creating competition with established middle market financial sponsors

DOMESTIC BUYOUT PURCHASE PRICE MULTIPLES BY TRANSACTION SIZE 1996 — 2005

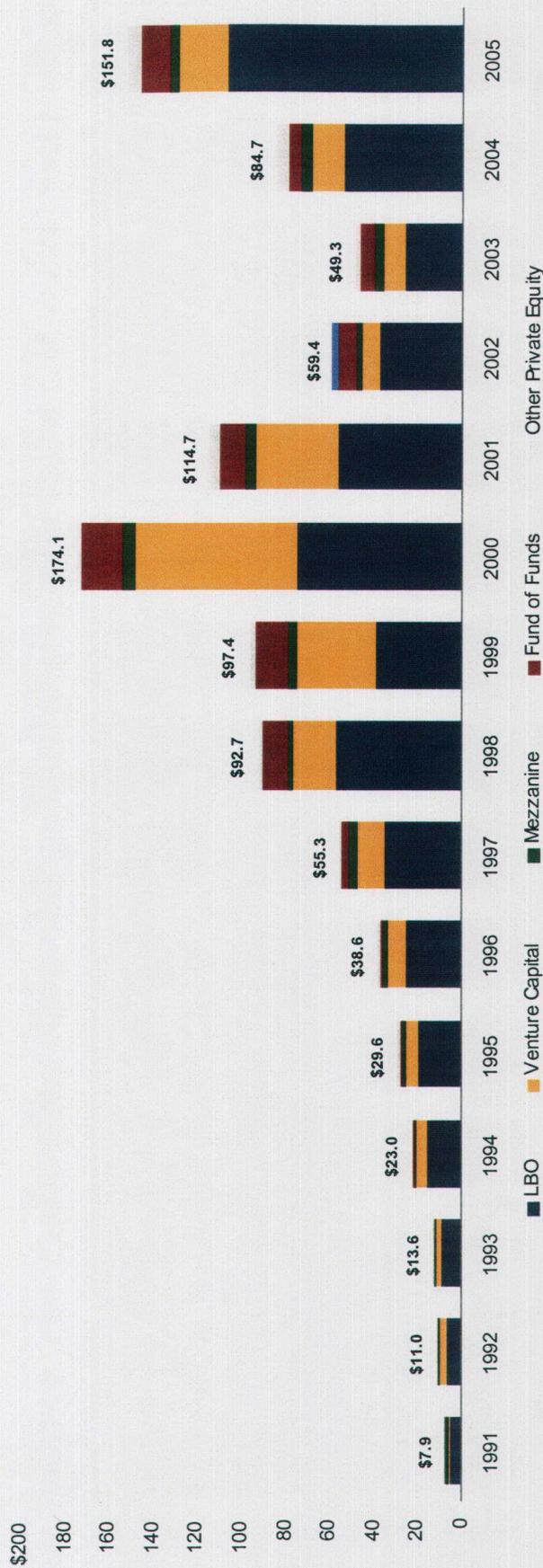


# Private Equity Fund Capital Overhang



- As a result of the robust fund-raising market, the dramatic increase in deal volume since 2001 and the number of new private equity funds being founded, many sponsors have raised or targeted new, larger funds.
- Financial Sponsors raised \$106.4 billion during 2005, over \$50 billion ahead of 2004 and well in excess of the previous record of \$78.4 billion set in 2000

ANNUAL COMMITMENT TO U.S. PRIVATE EQUITY FUNDS



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# Negotiated Sale or the Auction Process – Which is the Better Way to Sell a Business?

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JUNE 21, 2006

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## ALTERNATIVE SALE PROCESSES

Factors to Consider	Exclusive One-off Negotiation	Closed Negotiation	Targeted Solicitation	Controlled Sale	Controlled Auction	Public Auction	Broadcast Distribution
<i>Description</i>	Exclusive 1 on 1 negotiation between Seller and Buyer	Limited contacts, focus on initiating buyer and parties that have contacted the Seller in the past	High level approach to a selected group of pre-screened Buyers  Executive summary approach to "test" interest	Typical smaller middle market IB marketing process  Wide range of logical Buyers contacted based on probable interest and ability to close	Typical middle market IB marketing process  Wide range of logical Buyers contacted based on probable interest and ability to close	Company is being liquidated or  Board announces "seeking alternatives"	Internet postings,  Newsletter listings,  Blast emails  Business opportunities  Business brokers  Smaller companies  Local in nature
<i>Common Situations</i>	Seller receives "compelling bid" from "most logical" Buyer  Compelling mutual interest  Mutual trust	Seller receives an unsolicited approach from a large industry player or PEG	Seller or Advisor believes there is an opportunity to sell, but potential market is limited and/or Seller is opportunistic	Family business without succession  Seller reaches a "time to sell"	Seller reaches a "time to sell"  Corporate divestiture  PEG "harvesting"	363 Sale  Plant closing	
<i>Sale Approach</i>	Reactive and unstructured	Reactive and unstructured	Proactive and semi-structured	Proactive and semi-structured	Proactive and structured	Very structured	Very unstructured

## ALTERNATIVE SALE PROCESSES

Factors to Consider	Exclusive One-off Negotiation	Closed Negotiation	Targeted Solicitation	Controlled Sale	Controlled Auction	Public Auction	Broadcast Distribution
<i>Better for:</i>	True "trophy" company Small universe of motivated Buyers Companies with a proprietary advantage and real barriers to entry	Small universe of motivated Buyers Strategic and highly motivated PEG Buyers Pre-qualified Buyers	Limited universe of potential Buyers Smaller but profitable company Attractive to strategic Buyers	Smaller middle market companies Attractive to both financial and strategic Buyers	High quality; larger mid-market companies Companies with assets and earnings Hot companies in hot industries	Sellers that have no choice	Smaller regional companies that are attractive to local buyers and entrepreneurs
<i>Initial Level of Disclosure</i>	Initially controlled by Seller Speed of process may require more info. early	Measured and controlled by Target until reach LOI and full diligence Few recipients of confidential data	Limited until hypothesis is proven correct	Detailed OM delivered to pre-qualified and interested Buyers	Detailed OM delivered to pre-qualified and interested Buyers	Limit OM to whoever requests	Modest OMs, but widely distributed
<i>No. of Potential Buyers</i>	One	Less than ten	Less than ten	20 – 100	20 – 100	100+	Hundreds, potentially thousands
<i>Timing</i>	Unpredictable	6 months or less	9 months or less	9 months or less	9 months or less	9 months or less	12 months or more

## ALTERNATIVE SALE PROCESSES

Factors to Consider	Exclusive One-off Negotiation	Closed Negotiation	Targeted Solicitation	Controlled Sale	Controlled Auction	Public Auction	Broadcast Distribution
<b>Advantages to Seller</b>	Maintain confidentiality Not "shopped" Can trade terms vs. \$ Value Social vs. \$ Value	Speed Few recipients of confidential data Reduced business interruption	Test opportunity to sell efficiently Minimize potential waste of time	Perceived as committed Seller Stimulate sense of competition among Buyers Multiple interested buyers Fully-vetted and informed process	Perceived as committed Seller Stimulate sense of competition among Buyers Multiple interested buyers Fully-vetted and informed process	Closing will happen as quickly as possible	Reach large universe of Buyers
<b>Disadvantages to Seller</b>	Value left behind Market not-tested Potential waste of time Buyer simply seeking proprietary info. or deals	Full sphere of Buyers not reached Value left behind Distracted management	May not be considered a serious Seller Experienced Buyers can "string-along" until they are exclusive	Some Buyers unwilling to participate in bidding war Buyers moving at different pace Risk of "tire-kickers" Potentially extends process	Not all Buyers like structured process Perception of "shopping" High traffic	Tire kickers and low bidders Recovery from "busted" auction	Loss of confidentiality Tire-kickers and "opportunistic buyers" High traffic interfering with business

## ALTERNATIVE SALE PROCESSES

Factors to Consider	Exclusive One-off Negotiation	Closed Negotiation	Targeted Solicitation	Controlled Sale	Controlled Auction	Public Auction	Broadcast Distribution
<p><i>Financial Advisor Must:</i></p>	<p>Keep Buyer honest</p> <p>Understand market value of Seller to win other terms</p>	<p>Understand market value of Seller to win other terms</p> <p>Keep Buyers honest and bidding to get best deal</p>	<p>Maintain Buyer interest</p> <p>Keep Buyers honest and bidding to get best deal and structure</p>	<p>Maintain Buyer interest</p> <p>Qualify buyers</p>	<p>Qualify Buyers</p> <p>Keep progress moving as scheduled</p>	<p>Facilitator, little additional value added</p>	<p>Have wide distribution</p>



# LABOR & EMPLOYMENT OBSERVER

NEWS ON CONTEMPORARY ISSUES

**SPRING 2006**

IN THIS ISSUE

CHANGES ARE FINALLY COMING TO THE EEO-1 REPORT

EMPLOYEE LEAVES OF ABSENCE: OVERLAPPING AND CONFLICTING REQUIREMENTS

U. S. DEPARTMENT OF LABOR ISSUES USERRA FINAL REGULATIONS

NEW JERSEY'S IDENTITY THEFT PROTECTION ACT

TENTH CIRCUIT IMPOSES STRICT STANDARDS FOR THE OLDER WORKERS' BENEFIT PROTECTION ACT

EMPLOYEES NOW FREE TO BRING RETALIATORY HARASSMENT CLAIMS

LABOR & EMPLOYMENT ATTORNEYS "IN THE SPOTLIGHT"

## CHANGES ARE FINALLY COMING TO THE EEO-1 REPORT

### WHAT IS THE EEO-1 REPORT?

The Employer Information Report, also known as the EEO-1 Report, provides the federal government with workforce data, broken down by job category and then by race, ethnicity and gender within each job category. It is filed by an estimated 45,000 employers each year.

Two federal government agencies use the collected data: the Equal Employment Opportunity Commission (EEOC) and the Office of Federal Contract Compliance Programs (OFCCP). The EEOC uses the data to support civil rights enforcement and to analyze employment trends, such as female and minority representation in companies, industries and/or geographic areas. The OFCCP uses the data to determine which employer facilities to select for compliance evaluations.

### WHICH EMPLOYERS MUST FILE THE EEO-1 REPORT?

Generally private employers of 100 or more employees must file the EEO-1 Report each year, by September 30. In addition, federal government contractors and first-tier subcontractors with 50 or more employees that have a federal contract, subcontract or purchase order amounting to \$50,000 or more are required to file an EEO-1 Report. Finally, many financial institutions with 50 or more employees also are required to file this report.

### WHAT'S NEW?

The EEO-1 Report has remained virtually unchanged for the last 40 years. Now however, multiple changes are being made. They are:

- |                   |                 |
|-------------------|-----------------|
| PHILADELPHIA      | SAN DIEGO       |
| ATLANTA           | SAN FRANCISCO   |
| CHARLOTTE         | SANTA FE        |
| CHERRY HILL       | SEATTLE         |
| CHICAGO           | TORONTO         |
| DALLAS            | TRENTON         |
| DENVER            | WASHINGTON, DC  |
| HOUSTON           | W. CONSHOHOCKEN |
| LONDON            | WICHITA         |
| LOS ANGELES       | WILMINGTON      |
| NEW YORK DOWNTOWN |                 |
| NEW YORK MIDTOWN  |                 |
| NEWARK            |                 |

[www.cozen.com](http://www.cozen.com)

### Changes to ethnic and racial categories

- Adds a new category of “two or more races, not Hispanic or Latino”
- Divides the previous “Asian or Pacific Islander” category into two separate categories: “Asian, not Hispanic or Latino” and “Native Hawaiian or other Pacific Islander, not Hispanic or Latino”
- Renames “Hispanic” category to “Hispanic or Latino”
- Renames “Black” category to “Black or African American, not Hispanic or Latino”

Furthermore, employers now will be required to offer employees the opportunity to self-identify their ethnic and racial category and cannot rely on employment records or visual identification only. The rationale for this change, as set forth in the EEOC’s Final Notice of Submission of the new EEO-1 Report for the Office of Management and Budget review, is for the federal government to capture the increasing complexity of race in America.

### Changes to job categories

- Divides the previous “Officials and Managers” category into two new categories based upon the employee’s level of responsibility and influence within the organization, into “Executive/Senior

Level Officials and Managers” and “First/Mid-Level Officials and Managers”

- Moves the non-managerial business and financial occupations from the “Officials and Managers” category to the “Professionals” category

The new “Executive/Senior Level Officials and Managers” category is limited to employees who plan, direct and formulate policy, set strategy and provide overall direction for the organization and is meant to include those employees who are at the highest levels of organizations, such as CEOs, COOs, CFOs, CIOs and presidents or executive vice presidents of functional areas. The “First/Mid-Level Officials and Managers” category, on the other hand, applies to employees who direct and execute the organization’s day-to-day operations. It includes middle level managers and those who report to them.

### WHAT DO THE CHANGES MEAN FOR EMPLOYERS?

Employers will need to assess which jobs now belong in a different or new job category and resurvey their workforces to collect ethnic and racial information that comports with the new ethnic and racial categories.

### WHAT CAN EMPLOYERS DO TO PREPARE FOR THE NEW REPORTING FORMAT?

Employers will need to redesign their human resources systems to properly track and account for the new job and

To suggest topics or for questions, please contact Jeffrey I. Pasek, Esq., Chair of Cozen O'Connor's Labor & Employment Department. Jeff can be reached at 215-665-2072 or 800-523-2900 or at [jpasek@cozen.com](mailto:jpasek@cozen.com). To obtain additional copies, permission to reprint articles, or to change mailing information, please contact Lori Scheetz 800-523-2900 or at [lscheetz@cozen.com](mailto:lscheetz@cozen.com).

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ethnic and racial categories. Perhaps the most significant change for some employers, however, will be the method they employ to collect ethnic and racial data. Now employers will be required to offer employees the opportunity to self-identify their ethnic and racial category and cannot rely on employment records or visual observation unless the employee declines to make a self-identification. Accordingly, employers will need to create an appropriate form for this purpose.

#### WHEN WILL THE NEW EEO-1 REPORT TAKE EFFECT?

The new EEO-1 Report will be required for the first time in 2007 and must be filed by September 30, 2007. The current EEO-1 Report must be used for 2006 submissions.

#### WHERE CAN EMPLOYERS GET MORE INFORMATION ABOUT THE NEW EEO-1 REPORT?

The new EEO-1 Report format and the new Instruction Booklet (revised January 2006) may be found at <http://www.eeoc.gov/eeo1/index.html>.

*Please contact Debra S. Friedman, Esquire for further information and assistance at [dfriedman@cozen.com](mailto:dfriedman@cozen.com) or (215) 665-3719.*

#### EMPLOYEE LEAVES OF ABSENCE: OVERLAPPING AND CONFLICTING REQUIREMENTS

Your company may be liable for damages to an employee who requests a medical leave of absence even if you

comply fully with the federal Family and Medical Leave Act (FMLA). Your company also may be liable to an employee who requests a medical leave of absence even if you comply fully with the federal Americans with Disabilities Act (ADA). In other words, your company may be liable under one or more laws or regulations that govern an employee leave issue, even if you fully comply with another equally applicable law.

There are various federal, state and local laws that address employee leave situations. The two most significant sources, and in fact the two most confusing, are the FMLA and the ADA. The provisions of both of those statutes and the terms within the terms, have been the subject of numerous agency regulations and court decisions. However, it is important not only to understand the requirements and provisions of each statute separately; it is crucial that your company understands the interplay between these statutes, particularly when an employee's situation is potentially covered by both statutes.

While an analysis of each and every leave requirement is beyond the scope of the present discussion, this article summarizes the primary differences between the FMLA and the ADA.

#### EMPLOYERS COVERED AND EMPLOYEES PROTECTED

The FMLA is not an anti-discrimination statute per se. It identifies a specific amount of leave a covered employer must provide to an eligible employee under certain circumstances. In fact, if an employee and the circumstances are covered, the FMLA states that leave is the one

required accommodation. On the other hand, the ADA is a civil rights statute, prohibiting discrimination against covered individuals with a disability. Although the ADA contains certain general requirements involving disabled employees, it does not identify a specific amount of leave an employer must provide and does not even require that leave be provided in every situation.

The FMLA essentially covers employers who have 50 or more employees at a worksite for each working day during each of 20 or more workweeks in the current or preceding calendar year. Public agencies and public and private elementary and secondary schools are covered without regard to the number of employees. An employee is eligible for benefits under the FMLA if he or she has been employed for at least 12 months and for at least 1,250 hours during the prior 12-month period. While an employee must have worked for a total of 12 months, it is not necessary that those 12 months be consecutive. However, the 1,250 hours must have been worked in the preceding 12 months. Courts also have held that the 1,250-hour requirement must be computed from the date the leave commences (rather than when notice is given) and includes only hours that the employee actually worked.

The ADA essentially defines a covered employer as any "person" who has 15 or more employees for each working day in each of 20 or more calendar weeks in the current or preceding calendar year. An employee is protected under the Act if he or she is (1) a qualified individual; (2) with a covered disability; (3) and was excluded from a position or discriminated against because of that disability. The regulations governing the

ADA state that an individual is "qualified" if he or she can perform the essential functions of the employment position that the individual holds or desires with or without reasonable accommodation. Like the coverage provisions of the FMLA, these definitions contain separately defined "terms" that must be understood in order to properly determine whether and to what extent the statute is triggered. Unlike the FMLA, however, the ADA does not impose a minimum number of hours or months as a precondition to an employee obtaining the Act's benefits. Thus, for example, a "probationary" employee who has been with a company only a few weeks may still be entitled to leave and other benefits under the ADA, although the employee would not be entitled to FMLA benefits.

#### EMPLOYEE ENTITLEMENT TO A LEAVE OF ABSENCE

The FMLA provides four reasons an eligible employee may take FMLA leave: (1) because of the birth of the employee's child and to care for the child; (2) because of the placement of a child with the employee for adoption or foster care; (3) to care for the employee's spouse, child or parent if the spouse, child or parent has a "serious health condition" (in-laws are not included); or (4) because of a "serious health condition" that makes the employee unable to perform the functions of his or her position. The Act and the governing regulations impose strict employee notification and certification requirements, as well as requirements that an employer publish notices and designate leave as "FMLA leave" within certain time frames. If an eligible employee requests leave for one of the above four reasons, the employer must provide up to 12 weeks of unpaid leave during a 12-



month period. An employer certainly can adopt a policy entitling an employee to more generous leave, but a company's leave policy cannot diminish rights granted under the FMLA.

The ADA does not identify leave as the only option and does not state that leave can only be taken for certain reasons. Instead, as long as the employee has a covered disability, the ADA imposes a duty on the employee and employer to engage in an interactive process in order to determine what reasonable accommodation may be necessary and effective. According to the EEOC's regulations and guidance manuals, the first step in that process requires the employee to tell the company that he or she needs an adjustment or change at work for a reason related to a medical condition. The next step imposes a duty on the company to clarify, if necessary, and ultimately identify the appropriate reasonable accommodation. Unlike the FMLA, a leave of absence is only one possible accommodation. An employer is not required to grant a leave of absence in every case if there is another accommodation that is effective or if doing so would create an undue hardship for the employer. In addition, leave may be unpaid as long as the employer also provides unpaid leaves for non-disabled individuals.

Finally, unlike the FMLA, the ADA does not impose a maximum leave period when a leave of absence is given as an accommodation. Under the FMLA, an employee who is unable to return to work after 12 weeks is not entitled to job restoration. However, in some circumstances, an employer may be required under the ADA to extend a leave previously granted, or, in some circumstances, even grant an indefinite leave without an end

date for some reasonable amount of time, provided that the employee cooperates with the employer and continues to provide the employer with sufficient grounds that such leave is needed. Thus, "no fault" termination policies whereby an employee is terminated for a failure to return to work after a specifically prescribed period of time may run afoul of the ADA.

#### EMPLOYEE RIGHT TO REINSTATEMENT AFTER LEAVE

Under the FMLA, unless the employee is a "highly compensated employee" as that term is defined, an employee who returns from leave must either be restored to the position held when the leave commenced or to an equivalent position with equivalent employment benefits, pay and other terms and conditions. As a condition of job restoration after a leave is taken because of the employee's own "serious health condition," the employer may require a return-to-work certification from the employee's health care provider as long as that requirement is pursuant to a uniformly applied practice or policy regarding leaves generally.

The ADA, on the other hand, requires that an employee be restored to the same position he or she held before the leave commenced, unless the employer can prove that holding the position open would impose an undue hardship. The governing regulations and judicial decisions state that in the limited cases where undue hardship can be proven, the employer must at that point consider whether it has a vacant equivalent position and, if so, must reassign the employee to that equivalent position.

### CONTINUATION OF BENEFITS DURING THE LEAVE

The FMLA requires an employer to maintain coverage for an employee under any group health plan for the duration of the leave period at the level and under the conditions such coverage would have been provided if the employee had continued working continuously for the leave duration. In certain circumstances, an employer may recover its insurance premiums if the employee fails to return to work for reasons other than reasons beyond the employee's control. Under the ADA, an employer is not required to continue the employee's benefits unless the employer otherwise provides benefit continuation to non-disabled individuals under similar circumstances.

### CREATING ALTERNATE, LIGHT DUTY POSITIONS

As noted above, a leave of absence is the mandated accommodation under the FMLA. Therefore, an employer may not require that an employee accept an alternate or light duty position. An employer may, however, offer a light duty position to the employee, who may or may not accept that alternative. Under the ADA, while an employer is not required to create a new position, considering and ultimately placing an employee in a vacant, light duty position may be a required accommodation, when no other accommodation would permit the employee to remain in his or her current position.

### THE UNDUE HARDSHIP DEFENSE

An undue hardship defense is not available under the FMLA. However, under the ADA, an employer may not be required to accommodate an employee if doing so

would cause an undue hardship for the employer. Courts consider several factors to determine whether an undue hardship exists, including the nature and net cost of the accommodation required, the overall financial resources of the employer's facility and of the employer itself and the impact of the accommodation on the employer's operation. As a general matter, once an employee shows that an accommodation is reasonable in the sense that it will provide the desired effect, courts give an employer the opportunity to show that costs are excessive in relation either to the benefits of the requested accommodation or to the employer's financial health or survival.

In order to minimize potential liability, every employer should become familiar with the rights and obligations that presently exist in the various leave statutes and should keep abreast of all developments that may affect those rights and obligations.

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### U.S. DEPARTMENT OF LABOR ISSUES USERRA FINAL REGULATIONS

The U.S. Department of Labor recently issued final regulations interpreting USERRA, the Uniformed Services Employment and Re-employment Rights Act. The final regulations do not impose any new obligations on employers. However, they do clarify existing obligations pertaining to military leave.

During this time of increased military service by U.S. service members, employers are advised to review their military

leave and benefits policies and practices to ensure that they are in compliance with USERRA. Since the final regulations also finalize the USERRA notice posting requirement, employers must make sure that they have posted the proper USERRA notice. A copy of the USERRA poster may be obtained from the Department of Labor's website at <http://www.dol.gov/vets/programs/userra/poster.html>.

## **NEW JERSEY'S IDENTITY THEFT PROTECTION ACT**

On January 1, 2006, New Jersey's Identity Theft Protection Act became effective, creating additional safeguards for the use and disclosure of an individual's personal information. In sum, the Act: (1) requires local law enforcement to take reports of identity theft; (2) requires credit reporting agencies to place a freeze on accounts of identity theft victims; (3) requires businesses to notify individuals who have customer information stolen; and (4) prohibits businesses from printing Social Security numbers on mailed materials or from displaying those numbers in any manner.

What does this mean for New Jersey employers? The new law requires New Jersey employers to provide additional information when conducting background checks and to review their recordkeeping and personnel practices to ensure compliance with several new requirements.

First, for companies that obtain background checks pursuant to the Fair Credit Reporting Act and take adverse action based on that information, an additional consumer notice is required. New Jersey employers are

required to include a document entitled "New Jersey Consumers Have The Right to Obtain a Security Freeze" any time a New Jersey employee is required to receive a summary of rights form under the Fair Credit Reporting Act.

Second, the Act requires businesses seeking to destroy a customer's records containing personal information to do so by shredding, erasing or otherwise modifying the information so that it is no longer readable or able to be reconstructed. "Personal information" is defined as an individual's first name or first initial and last name when linked with the individual's Social Security number, driver's license number or state identification card number or account number or credit or debit card number. Since the Act defines "customer" as "any individual who provides personal information to a business," it most certainly applies to New Jersey employers. While the Act does not affirmatively require destruction of records, New Jersey employers need to ensure that all personnel information is appropriately destroyed, whether by shredding or other means, when that information is discarded. For some companies, compliance with this provision may be as simple as implementing a document shredding policy for all personnel files and human resources documents, rather than determining whether particular documents contain personal information.

Third, companies that conduct business in New Jersey and that compile or maintain computerized records are required to disclose all breaches of security of those records to any customer who is a New Jersey resident whose personal information was accessed, or reasonably

believed to be accessed, by an unauthorized individual. Notice must be provided in one of three ways: in writing, by electronic means or by substitute notice, if particular conditions are met. Thus, if a New Jersey employer suspects that its human resources computer system has been compromised, the employer needs to comply with the new obligations under the Identity Theft Protection Act and ensure that it provides proper notice to the affected employees.

Fourth, the Act imposes particular limitations on companies' ability to use Social Security numbers. Businesses are prohibited from:

- Publicly posting/displaying an individual's Social Security number or any four or more consecutive numbers taken from the individual's Social Security number
- Printing an individual's Social Security number on any materials that are mailed to the individual, unless otherwise required by law
- Intentionally communicating or making an individual's Social Security number available to the general public
- Requiring an individual to use his/her Social Security number to access an Internet website, unless a password or unique personal identification number is also required

The Act, however, does not prohibit companies from using Social Security numbers for internal verification and administrative purposes.

Accordingly, New Jersey employers need to examine carefully their current policies and practices. Employers who use Social Security numbers as identification numbers for their employees are advised to switch to separate employee identification numbers to the extent that such numbers are posted on employee badges and/or building security passes or are required for employees to access their employer's servers or computer networks.

In conclusion, the Act imposes additional obligations on New Jersey employers. While many employers already comply with some of the new obligations, all New Jersey employers should carefully review their policies and practices to ensure that they are in compliance with all of the relevant provisions of the new Act.

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## TENTH CIRCUIT IMPOSES STRICT STANDARDS FOR THE OLDER WORKERS' BENEFIT PROTECTION ACT

### RELEASE REQUIREMENTS

The U.S. Court of Appeals for the Tenth Circuit recently decided a case interpreting the Older Workers' Benefit Protection Act (OWBPA) in a manner different from how most employers have. In *Kruchowski v. The Weyerhaeuser Company*, 423 F. 3d 1139 (10th Cir. 2005), a group of plaintiffs, whose employment with Weyerhaeuser was terminated in a reduction-in-force (RIF), filed an age



discrimination lawsuit under the Age Discrimination in Employment Act, (ADEA), despite the fact that each plaintiff signed a release of claims in return for severance payments they had received in connection with the RIF. Because the Court held that the release did not comply with the OWBPA, it permitted the lawsuit to go forward.

Specifically, the Court found that the Weyerhaeuser release did not comply with certain informational requirements of the OWBPA. Section 626(f)(1)(H) of the OWBPA provides that, in connection with releases sought in the context of a RIF, the employer must:

[inform] the individual in writing in a manner calculated to be understood by the average individual eligible to participate, as to - (i) any class, unit, or group of individuals covered by such a program, any eligibility factors for such program and any time limits applicable to such program . . . .

The Court first determined that because Weyerhaeuser initially told the plaintiffs that one group of employees was “covered by the program” (meaning the employment termination program) and later limited that group to a smaller number of employees, it failed to provide the “correct, mandated information.”

Next, the Court determined that Weyerhaeuser did not properly inform the plaintiffs as to the “eligibility factors” for participation in the severance program. Specifically, it found that the employer was required to do more than announce “program-wide parameters for selecting employees for severance.” The Court held that the term “eligibility factors” refers to those factors used

to determine who is subject to the employment termination program and not just the factors used to determine who is eligible for severance pay after employment terminates. In the litigation, Weyerhaeuser stated that in selecting employees for termination, it considered leadership, technical skills, abilities and behavior and whether employees’ skills matched its needs. It had not disclosed these “eligibility factors” to the plaintiffs at the time it provided them with the release to sign. The Court found that Weyerhaeuser’s failure to disclose these factors rendered the plaintiffs’ releases unenforceable and allowed the plaintiffs to pursue their claims.

The decision is somewhat surprising. It has not been the norm for most employers, in reductions-in-force, when seeking releases in return for severance payments, to provide what Weyerhaeuser argued amounted to “an individualized personnel review” of eligible employees. In fact, many employers hope to avoid the necessity of doing exactly that when they design such programs and seek releases in return for severance payments. Nonetheless, employers need to be mindful of this decision and are advised to seek counsel on how best to comply with the OWBPA’s requirements, so as not to end up in Weyerhaeuser’s position of having paid out severance to “buy peace” from lawsuits, while defending a multi-plaintiff claim.

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## EMPLOYEES NOW FREE TO BRING RETALIATORY HARASSMENT CLAIMS

A January 31, 2006 decision by the U.S. Court of Appeals for the Third Circuit, *Jensen v. Potter*, paves the way for employees to bring “retaliatory harassment claims” against employers based on exposure to hostile work environments. To the great dismay of employers (and defense counsel), this decision gives plaintiffs’ attorneys additional tools for their litigation war chests.

In *Jensen*, the plaintiff claimed that she was subjected to sexual harassment and retaliation after reporting that she was harassed by her supervisor. Ms. Jensen’s supervisor called her after an apparent night of heavy drinking and propositioned her for sex. After refusing her supervisor’s “offer,” she reported his inappropriate conduct to a branch manager. Soon after Jensen’s report, the harassing supervisor was transferred - and subsequently fired.

After the supervisor was fired, Jensen claimed that co-workers began to harass her for getting the supervisor in “trouble.” Jensen was subjected to taunts and insults, as well as damage to her automobile. Despite a number of complaints to her new supervisor, at least one co-worker continued to harass Jensen by making a few unwelcome comments per week for the next 19 months. Because of this ridicule, Jensen suffered from stress and had panic attacks.

After acknowledging that the federal courts of appeal are split on the issue, the Court concluded that Jensen could

maintain a suit for retaliation based on the harassment she experienced for reporting her supervisor. This is because Title VII is intended to prevent discriminatory conduct from altering the terms or conditions of the plaintiff’s employment. Furthermore, the Court determined, with respect to Jensen, that the severity and frequency of the insults directed towards her raised a material issue of fact as to whether retaliatory harassment permeated her workplace.

Importantly, the Court also discussed the impact that such retaliatory harassment may have on a sexual discrimination claim:

Retaliation against a person based on the person’s complaint about sexual harassment is not necessarily discrimination based on the person’s sex. If the individuals carrying out the harassment would have carried out a similar campaign regardless of the sex of the person making the complaint, the harassment, while actionable as illegal retaliation, would not also be actionable as discrimination based on sex.

The Court further explained, however, that a woman who is subjected to sexual harassment and is then harassed based on that complaint, will almost always raise a question of fact for a jury as to whether the harassment constituted sex discrimination.

Now that *Jensen* is the law in the Third Circuit, Pennsylvania, Delaware and New Jersey, employers may be held liable for retaliation claims based on co-worker

harassment that does not rise to the level of a discharge or demotion. Moreover, summary judgment may be more difficult to achieve for a defendant employer in sexual harassment cases involving retaliatory co-worker harassment. This will unfortunately increase the cost of litigation in such cases.

*Please contact Charles J. Kawas, Esquire for further information and assistance at [ckawas@cozen.com](mailto:ckawas@cozen.com) or (215) 665-2735.*

## LABOR & EMPLOYMENT ATTORNEYS "IN THE SPOTLIGHT"

Cozen O'Connor's Labor and Employment Law Practice Group presented "Hiring Without Hazard," an educational seminar focused on common hiring questions and issues, at The Four Seasons Hotel in Philadelphia. The seminar examined several hiring-related issues, including: questions one can ask a prospective applicant during a job interview, the type of information that should be included on a job application and the legal consequences of speaking with an applicant's former employer. Speakers were **Jeffrey L. Braff** and **Charles J. Kawas**.

**Joy F. Grese** recently joined the firm's labor and employment law group, practicing in the Philadelphia office. A resident of Bryn Mawr, Pa., Joy earned her undergraduate degree from the University of Georgia (A.B., *summa cum laude*, 2002), where she was a member of Phi Beta Kappa, and her law degree from Columbia University School of Law (J.D., 2005), where

she was a Harlan Fiske Stone Scholar, managing editor of the *Columbia Journal of Law and Social Problems*, and a clinic student for the Prisoners & Families Clinic. She is admitted to practice in Pennsylvania.

**Carrie B. Rosen** and **David J. Walton** (Philadelphia) were named 2005 Pennsylvania "Rising Stars" by *Law & Politics* and were listed in the December 2005 issues of *Philadelphia* magazine and *Pennsylvania Super Lawyers – Rising Stars Edition*. **Ramona Hunter** (Seattle) was also selected as a "Rising Star" and was featured in *Washington Law & Politics* magazine. Rising Stars is a listing of outstanding emerging attorneys, age 40 and under or practicing 10 years or less.

**Jeffrey L. Braff**, **Sarah A. Kelly**, and **Jeffrey I. Pasek** were named to Pennsylvania's Super Lawyer list, which was compiled from the results of an independent balloting survey sent to lawyers across the state. The firm is especially proud of this honor because only five percent of Pennsylvania attorneys were named.



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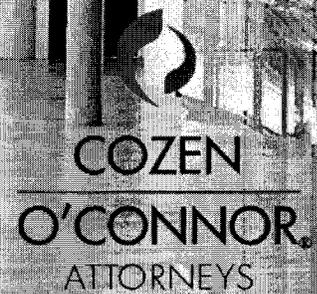
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# BUSINESS LAW OBSERVER

NEWS ON CURRENT ISSUES

Spring 2005

Dear Friends:

Our Spring 2005 issue covers topics ranging from taxation to estate planning, and Sarbanes-Oxley to compensation committee exposure. The topics cover recent legislation and developments affecting businesses, personal financial and tax planning, and cases recently in the news, which should provoke your thinking on how best to conduct your affairs.

We have also described an unusual transaction in which we represented the buyer of a business involved with complicated insolvency issues, to illustrate how our lawyers creatively solved the problems involved. We hope to present similar case studies in the future.

Our Business lawyers are ready to help with your problems and transactions, from the routine to the complex. We welcome your comments on the content of this issue and encourage you to suggest future topics of interest.

Sincerely,

Larry P. Laubach, Esquire  
Chair, Corporate Practice Group  
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## AMERICAN JOBS CREATION ACT OF 2004

### General Observations

The American Jobs Creation Act of 2004 (the "Act"), signed into law on October 22, 2004, is the fifth major piece of tax legislation of the Bush Administration. The Act is extremely broad in scope and, unlike recent legislation, deals primarily with business taxation.

### Brief Summary of the Major Provisions of the Act

The extraterritorial income tax regime, which benefited American exporters and which had been ruled to be in violation of the General Agreement on Tariffs and Trade, is repealed. In its place, the Act allows a deduction against "qualified production activities income" which, in general, is the net income from a large variety of domestic activities. The deduction, when fully phased in, produces the equivalent of a 3% tax rate cut.

The Act also makes a number of changes to the foreign tax provisions of the Code. Perhaps the most important of these provisions permits U.S. taxpayers an 85% deduction against dividends received from their non-U.S. subsidiaries, thereby resulting in an effective Federal income tax rate of 5.25% on such dividends. This is a limited time provision which is expected to result in the repatriation to the United States of billions of dollars of foreign source income accumulated by major U.S. corporations which are required to use the repatriated funds for certain prescribed U.S. purposes.

The income tax treatment of nonqualified deferred compensation plans has been significantly altered by the imposition of important new restrictions on the design features of these programs. As a result, every existing deferred compensation plan will have to be examined to insure compliance with the new rules.

The Act advances the current Internal Revenue Service campaign against tax shelters by greatly increasing

penalties on taxpayers who invest in abusive shelters and their "material advisors."

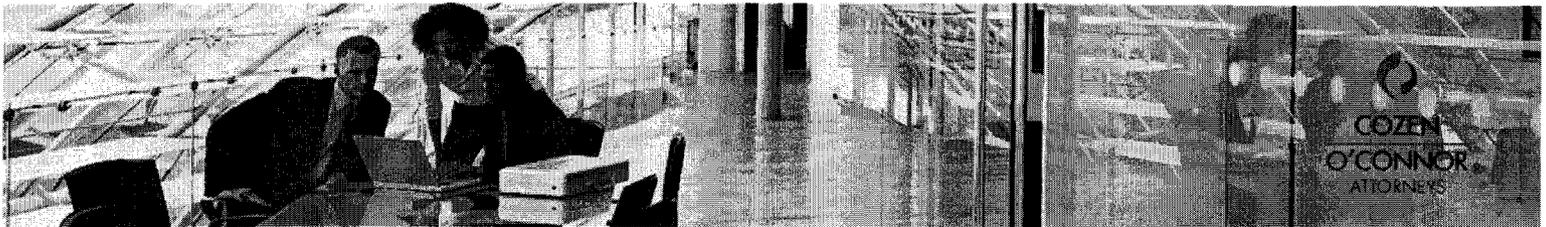
Several rules dealing with corporations have been liberalized.

The Act adds a number of business tax incentives, some of which are targeted to specific industries (e.g., energy, agriculture, timber, real estate, and banking, etc.) and others which are of general applicability. Several of the more important of these provisions are discussed below, together with some individual income tax changes.

### Deduction For Qualified Domestic Production Activities Income

Beginning in 2005, taxpayers are permitted to deduct a portion of their qualified production activities income ("QPAI"). The deduction percentage, which is 3% in years 2005-2006 and 6% for years 2007-2009, increases to 9% in 2010 and thereafter. For example, if X Corporation has \$100 of qualified production activities income, once the provision is fully phased in, X Corporation would be able to deduct 9% of its QPAI, resulting in taxable income of \$91.00. Assuming a 35% tax rate, the resulting tax would be \$31.85, versus \$35.00 in tax under current law, or an approximately three percentage points savings.

QPAI is defined as revenue from certain domestic production activities, less the expenses allocable to such receipts. Domestic production gross receipts are defined as revenue from the sale, lease, license, exchange or other disposition of (i) qualified films produced in the U.S.; (ii) electricity, natural gas or potable water produced in the U.S.; and (iii) most importantly, "qualifying production property," which consists of tangible personal property, computer software, and sound recordings that are manufactured, produced, grown or extracted in whole or in significant part within the United States. In addition, construction services performed in the U.S. and engineering or architectural services performed in the U.S. in connection with U.S. construction services also qualify as domestic production gross receipts. Inasmuch as the



foregoing definition is so expansive, numerous U.S. business will benefit from this new provision, even though they are not manufacturers or exporters.

There are several limitations to the U.S. production activities deduction. First, receipts from transactions with related persons are excluded. Second, food and beverages sold at a retail establishment, whether for take-out or dining in, are excluded. Third, if the taxable income of the business is less than its qualified production activities income, the applicable deduction percentage is applied to the taxable income. Finally, the deduction is limited to 50% of the taxpayer's W-2 wages for the year.

#### **Nonqualified Deferred Compensation Plan Changes**

The Act imposes several important new requirements with respect to nonqualified deferred compensation arrangements. These new rules will significantly restrict the flexibility which practitioners can build into such plans.

Thus under the Act (i) requirements are prescribed for when deferral elections must be made; (ii) distributions can only be made at certain times or upon the happening of certain events; (iii) the ability to further defer distribution of plan benefits beyond the initial date called for by the plan is severely curtailed; (iv) the acceleration of the payment of deferred compensation amounts is, in general, prohibited; (v) plan assets cannot be held, in trust or otherwise, outside of the United States; and (iv) new limitations are imposed with respect to Rabbi Trusts.

The violation of any of these rules will produce significant adverse tax consequences to the plan participant.

Importantly, the new rules apply to amounts deferred after 2004 and, in general, do not apply to amounts which were deferred and vested before 2005 unless the deferred compensation plan is materially modified. Accordingly, it may make sense as a planning matter for employers to "freeze" existing plans which contain non-conforming provisions and to create new, conforming plans for post-2004 deferrals.

#### **Certain Other Business Provisions**

A number of favorable tax provisions relating to real estate have been enacted. First, "qualified leasehold improvement property" placed into service after October 22, 2004 and before January 1, 2006 will be depreciated on a 15-year straight-line basis, rather than over 39 years. Similarly, a 15-year straight-line depreciation deduction regime applies to "qualified restaurant property." Next, outright sales of standing timber will qualify for capital gain treatment even if the owner does not retain an economic interest in the timber. Finally, several liberalizing changes have been made to the rules which govern REITs.

Several beneficial changes are also made to the S corporation rules, notably the increase in the number of permitted shareholders from 75 to 100 and allowing, for this purpose, numerous family members to be treated as one shareholder.

The rules permitting the expensing of otherwise depreciable property up to \$100,000 a year, adjusted for inflation, have now been extended to last through the end of 2007.

Certain start-up and organizational costs incurred after the date of enactment can be deducted rather than amortized. The limitation on the deductible amount is \$5,000 for each of these categories, subject to a phase out if the start-up costs or the organizational costs exceed \$50,000. Eligible costs which do not qualify for the deduction must be amortized over 180 months, rather than 60 months as is the case under current law.

Under the Act, if a partnership transfers a partnership interest to a creditor in satisfaction of a debt, the partnership will recognize cancellation of indebtedness income to the extent that the debt exceeds the fair market value of the partnership interest.

#### **Selected Individual Income Tax Changes**

For years 2004 and 2005, taxpayers can elect to deduct either state or local income taxes or state and local sales

*Continued on page 4*



NEWS ON CURRENT ISSUES

### **American Jobs Creation Act** *Continued from page 3*

taxes. The sales tax deduction will generally be calculated using IRS tables. As with state and local income taxes, sales tax deductions will have to be added back for alternative minimum tax purposes.

New restrictions are imposed for the charitable donation after December 31, 2004 of motor vehicles, boats or aircraft. In general, the donor's deduction will be limited to the amount of proceeds which the charity receives from reselling the vehicle. Other rules are added for those situations in which the charity retains the donated vehicle for use in its activities.

New provisions have been added to enhance Internal Revenue Service collection efforts from delinquent taxpayers. Thus, IRS is now permitted to enter into an installment agreement with a taxpayer, even though the agreement will not result in full payment of the liability. In addition, IRS is given the authority to hire private debt collection agencies and is expected to do so once provisions dealing with protection of taxpayer privacy can be devised.

*For a more detailed explanation of these and other provisions of the Act, contact Dennis L. Cohen (Philadelphia) at 215-665-4154 or [dcohen@cozen.com](mailto:dcohen@cozen.com).*

### **IMPACT OF SARBANES-OXLEY ON PRIVATE COMPANIES AND NONPROFITS**

It has been almost 2-1/2 years since the President signed into law the legislation known as Sarbanes-Oxley, or SOX, which contains sweeping reforms covering reporting requirements to the Securities and Exchange Commission (SEC) as well as accounting and corporate governance matters. Congress passed the legislation in the wake of a number of high-profile corporate scandals such as Enron and WorldCom.

SOX is the most significant securities legislation in the last 50 years, and perhaps the most comprehensive federal

legislation ever on corporate governance. The legislation has significantly changed the climate for the way public companies govern themselves.

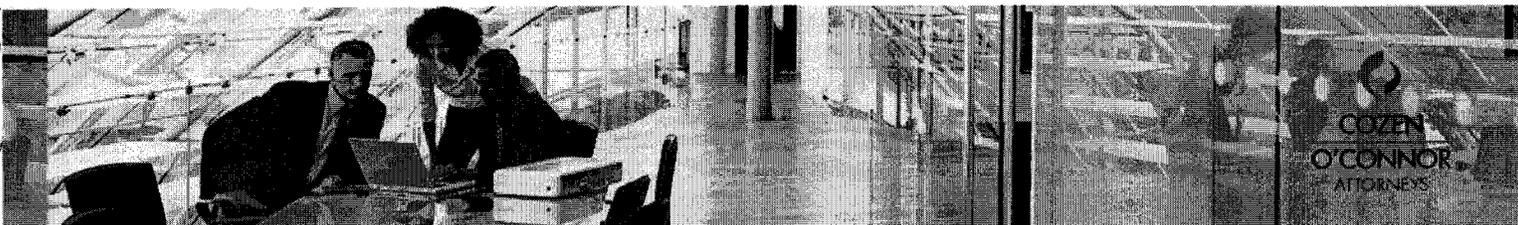
In addition, with the stated goal of creating more "transparency" in financial reporting, the legislation has created a new oversight board for accountants auditing public companies, has changed fundamentally certain financial reporting rules and, perhaps most significantly to many companies, has altered dramatically the way accountants conduct themselves and interact with their clients. Many companies now feel their outside auditors are in almost an adversarial role rather than being part of their team.

By its terms, virtually all of SOX applies only to public companies and accountants and lawyers providing services for public companies. There are a few provisions, discussed below, that amend criminal statutes and apply not just to public companies.

Since most of the provisions of SOX apply only to public companies, what's the big deal for private companies and nonprofits?

### **Changes the Way of Thinking about Corporate Governance**

Besides a great many technical changes to the disclosure rules applicable to public companies and administered by the SEC, SOX contains a substantial number of rules on how public companies must govern themselves. For example, under the new SEC rules and related New York Stock Exchange and Nasdaq listing requirements, a majority of the board of directors of a public company must be "independent." (Note that the definition of what constitutes independence is not always so clear.) Similarly, public company boards must have an audit committee comprised solely of independent directors. The role of the audit committee (and that of other committees, such as the nominating and corporate governance committees) has been substantially enhanced. For example, the audit committee must now approve all non-audit related services provided by an outside auditor.



### **Parts of SOX Becoming "Best Practices" for Private Companies**

While SOX applies only to public companies, there is much talk of some of these rules becoming "best practices" for private companies and nonprofits. In fact, a number of non-public companies are starting to adopt or work towards adopting some of the SOX-type corporate governance procedures. The following concepts have received the most attention:

- Increased number of independent directors
- More transparency in financial reporting and disclosure
- Strengthened internal audit function
- Adoption of a code of ethics
- Creation of corporate governance policy guidelines

Besides being deemed "best practices," private companies may feel pressure to adopt some of these provisions under specific circumstances. For example, any company contemplating an initial public offering or a sale to a public company would need to be sensitive to many of these items. In such a case, the internal audit and other financial controls would be critical to the company's ability to comply with public reporting requirements after the IPO or when the company is part of a larger public company. In addition, some lenders, equity investors (or, in the charitable sector, donors) and insurers have begun to apply subtle, or in some cases not so subtle, pressure on companies to adopt some of the accounting and corporate governance provisions. We are also aware of a few private companies that have been asked about their compliance with SOX in the context of contracting with a public company or government agency.

In a recent survey of private organizations, more than three-quarters of the respondents indicated that SOX or similar corporate governance reforms had an impact on their organization, albeit the majority of the influence being self imposed.

### **SOX-Like Provisions Mandated for Nonprofits**

Many nonprofits are experiencing the same type of pressure as private companies to improve their corporate governance and financial reporting. In addition, a number of states have either proposed or are considering enacting legislation that would impose on nonprofits certain corporate governance rules and financial reporting guidelines that are derivative of SOX. For example, effective January 1, 2005, California enacted legislation which mandates that charities required to file reports with the California Attorney General adopt certain financial reporting and corporate governance rules. Also, New York Attorney General Elliot Spitzer recently announced that he was advocating more SOX-like education for nonprofit board members. Towards this end, many nonprofits are creating handbooks for their directors designed to help the directors responsibly discharge their various fiduciary duties. In addition, certain Congressional committees have held hearings on the advisability of bringing some SOX-like reforms to the charitable sector.

### **Provisions of SOX Applicable to Private Companies and Nonprofits**

Certain provisions of SOX - dealing with document destruction and whistleblower protection - are not limited to public companies. SOX makes it a crime to knowingly alter, destroy, conceal or falsify any records with the intent to impede, obstruct or influence an investigator or the proper administration of any matter within the jurisdiction of a federal agency. Similarly, it is now a crime to corruptly alter, destroy or conceal a document or other object with the intent to impair the object's integrity or availability for use in an official proceeding. In addition, SOX protects the right of a whistleblower to report wrongdoing to federal investigators without the risk of retaliation.

As a result, private companies and nonprofits should be reviewing their document retention policies and policies that encourage people to report potential wrongdoing. Organizations that don't have such policies should be adopting them.

*Continued on page 6*

### **Sarbanes-Oxley** *Continued from page 5*

Finally, as a result of SOX, the Department of Labor has issued regulations that require any company with retirement and profit sharing plans subject to ERISA (the Employee Retirement Income Security Act of 1974) to provide notice of any "blackout periods" with respect to such plans.

#### **Lessons Learned**

While most of SOX is unlikely to be imposed on private companies and nonprofits by statute, many of these organizations will want to adopt portions of SOX as a demonstration of their corporate responsibility and citizenship. In addition, certain provisions may become standard or imposed on private companies and nonprofits by their lenders, investors or D&O insurance carriers.

Accordingly, private companies and nonprofits should be addressing in some fashion the following principles:

- A strong system of internal controls
- Financial statements need to be more transparent (i.e., more clearly represent the true financial condition of the organization)
- Organizations need to create a strong system of internal controls to ensure the quality of financial information
- Boards of Directors need to be more independent from management
- Organizations need to have a demonstrated commitment to an ethical business culture from the top down

As standards progress, it is likely that most of the principles listed above will somehow be incorporated into notions of fiduciary duties for officers and directors of all organizations.

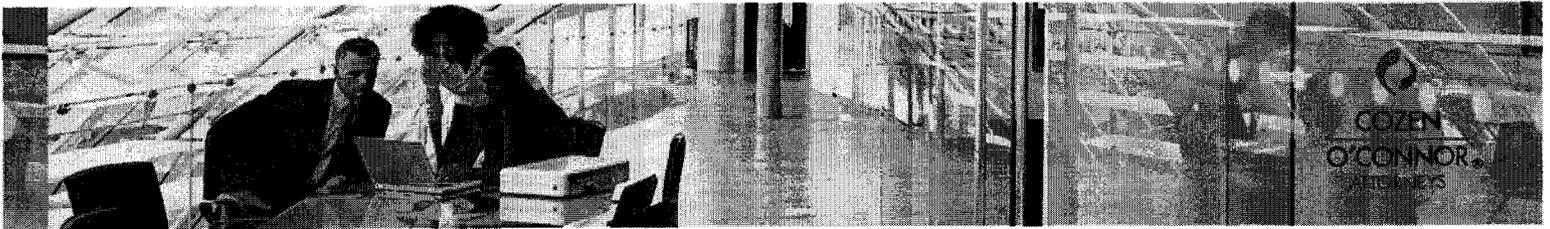
*For more information, contact Richard J. Busis (Philadelphia) at 215-665-2756 or [rbusis@cozen.com](mailto:rbusis@cozen.com).*

### **UPDATE ON ESTATE PLANNING WITH FLPs AND LLCs**

For many years, family limited partnerships ("FLPs") and limited liability companies ("LLCs") have been a staple of sophisticated estate plans, particularly for owners of closely-held businesses and families with large securities portfolios. Over the last two years, however, several courts have issued decisions calling into question some of the most fundamental and popular premises of FLPs and LLCs. Although these decisions will impact the use of FLPs and LLCs in estate planning, they do not sound a death knell for these vehicles. Rather, the decisions serve as a reminder that FLPs and LLCs, like all tax-planning techniques, must be grounded in substance.

An FLP or LLC is, first and foremost, a business, and must be structured and operated as a business in substance, not merely in form. FLPs and LLCs are typically designed with the senior generation as the initial general partners or managers. Children and grandchildren typically start out as limited partners or members. The FLP or LLC may hold operating business interests, real estate holdings, or even investment interests, and serve as a type of umbrella company for the family's assets. In the case of any limited partnership or limited liability company, the general partner or manager of an FLP or LLC has absolute authority to manage the assets (i.e., run the business) and absolute control over whether and when distributions are made.

When used for tax planning, the senior generation typically contributes most, if not all of the FLP/LLC assets, and holds most, if not all, of the initial interests in the FLP or LLC. The senior generation then makes gifts of minority limited partnership/membership interests to their children and grandchildren. The value of these gifts may be deeply discounted for gift and estate tax purposes because the interests cannot be readily transferred and have no market outside of the family. This has allowed the senior generation members to remove substantial value from their



taxable estates at very low gift tax price, while retaining control of the family business.

FLPs and LLCs also offer important non-tax benefits that are attractive to the senior generation. For example,

- Children and grandchildren have the opportunity to learn and participate in the family business without gaining control of the business before they are ready;
- Family assets can be consolidated into one central business for management and investment purposes;
- Family assets held inside an FLP or LLC are provided a level of protection from creditors, outsiders, and divorcing spouses; and
- FLPs and LLCs provide flexibility to respond to family disputes and changes in the law.

Gifts of limited partnership/membership interests is a straightforward process, readily accomplished through simple assignments -- no need for deed transfers or stock powers as would be required if gifts were made of the underlying assets. Further, if the value of the gift is limited to the "annual exclusion" (\$11,000 to each recipient from each donor, or \$22,000 for married donors), the gift need not be reported on a gift tax return, and none of the donor's lifetime gift tax exemption is used.

In light of the foregoing, it is easy to understand the popularity of FLPs and LLCs. Prior to 2003, much of the case law involving FLPs and LLCs focused on valuation discounts and whether the senior generation's initial transfer to the FLP or LLC was itself a gift. Most of these cases ended favorably for the taxpayer. In 2003, however, the decisional trend began to change. Although the cases decided in 2003 and 2004 are factually and legally complex, and defy easy categorization, two main themes surfaced that directly affect the structure and use of FLPs and LLCs in the future. First, gifts of limited partnership/membership interests will not qualify for the annual exclusion from gift tax unless the partnership or

operating agreement confers specific immediate rights upon the recipient. Second, and most critically, it appears that assets transferred to an FLP or LLC during the senior generation member's lifetime will not be excluded from the transferor's taxable estate unless the circumstances indicate that the FLP/LLC operates, in fact, as a business, and the transferor has, in fact, relinquished personal control of the business assets.

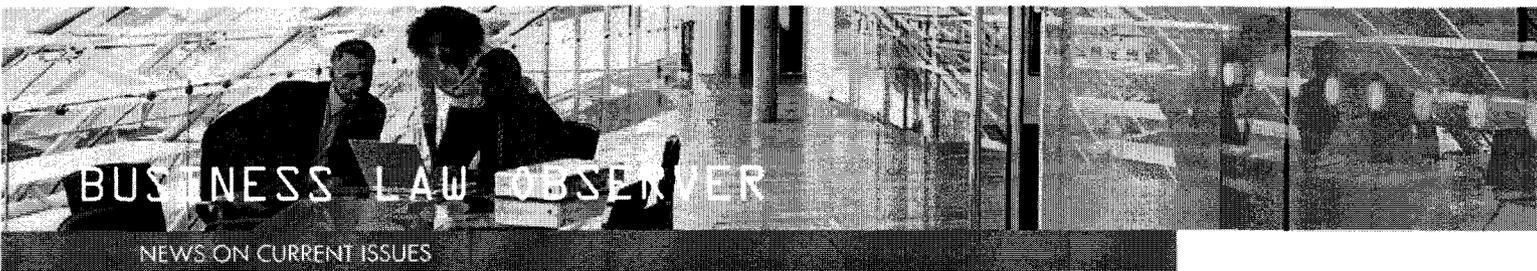
### **Making Annual Exclusion Gifts of FLP and LLC Interests**

Under the Internal Revenue Code, gifts to children (or to any donee other than a spouse or charity) are subject to the gift tax unless the child actually receives a current economic interest in the asset ("Present Interest Rule") and the value of the gift is not greater than the annual exclusion of \$11,000 per child per year. Estate planning experts have long advised clients to take maximum advantage of the annual exclusion because such gifts neither use up any of the donor's lifetime gift tax exemption (currently \$1 million) nor do they count against the decedent's combined gift and estate tax exemption (currently \$1.5 million). Further, annual exclusion gifts need not be reported on a gift tax return. Many families have used FLPs and LLCs to make annual exclusion gifts valued at or less than \$11,000 based on a deeply discounted valuation.

In 2003, however, in the case of *Hackl v. Commissioner*<sup>1</sup>, an appeals court agreed with the IRS position that the parents' gifts of LLC units to their children and grandchildren did not qualify for the annual exclusion. According to the IRS and the court, the gifts did not satisfy the Present Interest Rule because the LLC's operating agreement did not allow the members of the LLC to sell their LLC units, redeem their LLC units, force dissolution of the LLC, or force a distribution from the LLC. In short, the court concluded that the children and grandchildren did not receive a present economic interest in the LLC because of all of these restrictions. As a result, the transfers by the parents of the LLC units were treated as taxable gifts not protected by the annual exclusion.

*Continued on page 8*

1. *Hackl v. Commissioner*, 335 F.3d 664 (7th Cir. 2003), *aff'g*, 118 T.C. 279 (2002).



### Estate Planning *Continued from page 7*

Although *Hackl* sent a shockwave through the estate planning community, the case does not preclude the use of FLPs and LLCs for annual exclusion gifting. Gifts of interests in FLPs and LLCs under agreements that permit limited partners or members to transfer or redeem their interests should qualify for the annual exclusion. Moreover, as noted above, FLPs and LLCs are extremely flexible tools. As an example, partners and members can amend their partnership/operating agreements to allow partners and members to "put" or redeem the gifted interests for a limited period of time after the gift.

### Keeping the Gifted FLP/LLC Interest Out of Your Estate

Under the Internal Revenue Code, a taxable estate does not include the value of gifts made during the decedent's lifetime unless the decedent retained control of the gifted asset or continued to benefit from the gifted asset. Prior to 2003, estate planning experts typically advised business owners that gifts of FLP or LLC interests would not be included in their estates after death because the gifts were final and complete transfers of actual equity ownership in the business, even though the donor (as general partner or manager) continued to control the business.

In 2003, however, the U.S. Tax Court upended this principle in *Estate of Strangi*<sup>2</sup>. In the 2003 *Strangi* Tax Court decision, a complex case with unusual facts, the Tax Court held that assets transferred by Mr. Strangi to an FLP and the FLP's corporate general partner were included in his taxable estate because Mr. Strangi, together with the other partners of the FLP and the shareholders of the corporate general partner (the Strangi children), could vote to control distributions and liquidate the businesses (which would result in most of the business assets going back to Mr. Strangi).

The 2003 *Strangi* Tax Court decision is on appeal in the United States Court of Appeals for the Fifth Circuit, and it could be overturned or limited to its facts. Mr. Strangi

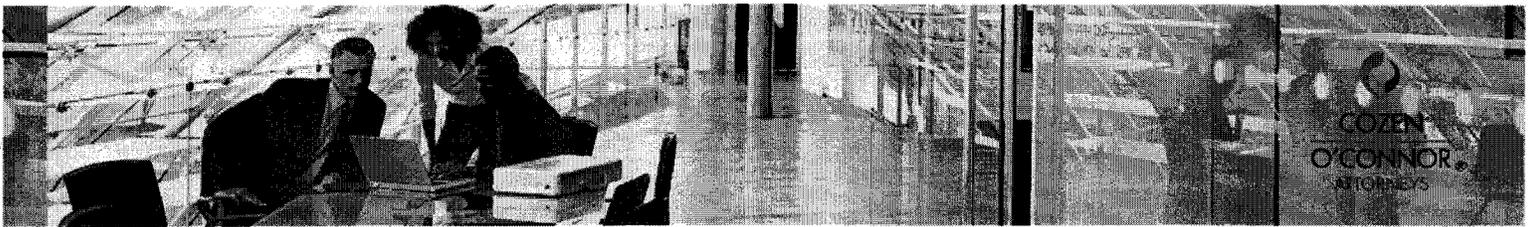
pushed the legal envelope further than most business owners would. For example, two months before his death, Mr. Strangi transferred virtually everything he owned, including his home, to the FLP, and he did not pay rent during his lifetime. Moreover, Mr. Strangi paid personal expenses, including medical expenses, from the partnership.

In September 2004, the U.S. Third Circuit Court of Appeals issued another troubling decision in favor of the IRS in *Estate of Thompson*<sup>3</sup>. As in *Strangi*, the Thompson family pushed hard at the legal envelope. The decedent in *Thompson* had transferred virtually all of his assets to two FLPs. His contributions to the FLPs consisted of marketable securities, which were not actively managed and traded within the FLPs. The decedent used the partnership assets for his own expenses and to make lifetime gifts. The U.S. Tax Court, during the initial trial phase, acknowledged that the FLPs were properly-formed legal entities. Nonetheless, the Tax Court held that the assets transferred to the partnerships by the decedent were taxable in his estate. The court concluded that there was an implied agreement among the partners that the decedent would continue to use the assets for his own benefit after transferring them to the FLPs. The Third Circuit Court of Appeals not only affirmed the Tax Court decision, but also concluded that the transfer of the decedent's assets to the partnerships was not a "bona fide sale" because the partnership assets consisted primarily of untraded securities, and the partnerships did not engage in any real business activity.

The bad facts of *Strangi* and *Thompson* arguably gave the courts both the ammunition and the opportunity to issue decisions that may adversely impact well-meaning families who wish to benefit from the tax advantages of FLPs and LLCs while respecting the business entity. Nonetheless, FLPs and LLCs will remain a viable estate planning option for business owners who manage and operate them under the same principles as any non-family

2. *Estate of Strangi v. Commissioner*, TC Memo 2003-145 (2003), on remand from *Estate of Strangi*, 115 T.C. 478 (2000), aff'd in part and rev'd and remanded in part, 293 F.3d 279 (5th Cir. 2002) (currently on appeal to the Fifth Circuit).

3. *Turner v. Commissioner*, 382 F.3d 367 (3rd Cir. 2004), aff'g *Estate of Thompson v. Commissioner*, T.C. Memo 2002-246 (2002).



business. At a minimum, partners and members must subscribe to the following basic rules:

1. The FLP/LLC must maintain accurate business records, hold partner/member meetings, and actively manage FLP and LLC assets.
2. All business assets must be properly titled to the FLP/LLC.
3. All partners/members should participate in negotiations and decision-making regarding the formation, purpose and management of the business.
4. All partners/members should seek independent legal advice regarding the terms of the partnership/operating agreement.
5. Partners and members should not transfer the bulk of their assets to an FLP or LLC. They must retain sufficient assets outside of the business to maintain their standard of living.
6. Partners and members should not transfer personal-use assets, like their homes, to an FLP or LLC.
7. If possible, all partners/members should contribute capital to the FLP or LLC.
8. The FLP/LLC must not make non-pro rata distributions to partners or members.
9. Ideally, the senior generation should share or relinquish voting rights on decisions involving distributions or liquidation.
10. The senior generation should transfer gifted limited partnership or membership interests to a trust with a completely independent trustee.

In a nutshell, the facts and circumstances will determine whether an FLP or LLC is honored for tax purposes. Even in the current legal environment, careful planning, sound

advice, and good business sense should allow families to continue to benefit from all of the advantages, including the tax savings, of using FLPs and LLCs in their estate plans.

*For more information, contact Margaret Gallagher Thompson (Philadelphia) at 215-665-6959 or [mthompson@cozen.com](mailto:mthompson@cozen.com).*

## **HARD WORK FOR THE MEMBERS OF A COMPENSATION COMMITTEE**

Compensation committees have come under increasing scrutiny following the recent spate of corporate scandals. Recent cases have suggested that even in the largest of corporations, with sophisticated directors, the most rudimentary of steps in evaluating executive compensation are frequently not taken. The plaintiffs' bar and government regulators are actively pursuing compensation committee members for allegedly failing to carry out their duties. Consequently, compensation committee members should evaluate how they operate to minimize their exposure to suit. This article will provide some of the key operational issues and recommendations that a compensation committee should consider.

### **What's Been Happening**

In a case that many of us have heard about in the media, the members of the compensation committee of the Board of Directors of Walt Disney Co., as well its entire Board of Directors, were sued for allegedly failing to properly evaluate the compensation package of its former president. The complaint alleged that the president's compensation package was approved without the compensation committee having analyzed its terms and the impact it might have on the company. The Chancery Court in Delaware required the defendants to address the claim for fiduciary breach and waste.

Under a recently reported settlement in the WorldCom shareholders' lawsuit, former directors were required to

*Continued on page 10*



### **Compensation Committee** *Continued from page 9*

pay \$18.0 million out of their own pockets. The U.S. Securities and Exchange Commission has also begun to use its authority to force executives to disgorge compensation and freeze termination pay. *The Wall Street Journal* recently reported that the State of Wisconsin Investment Board in 2003 paid an extra contingency fee for settlement proceeds paid by ex-company officials, as opposed to what was recovered by insurance.

Many board members have taken comfort in the fact that they are covered by directors & officers insurance. These policies, however, may not provide coverage when there is a lack of "good faith" in a director's or officer's actions. Similarly, Delaware corporate law precludes a corporation from indemnifying its board members when it is shown the director did not act in "good faith." By showing the appropriate due diligence was undertaken, a compensation committee is more likely to withstand an investigation of its actions and, if needed, increase the likelihood of being covered under a D&O policy. What follows are several practices compensation committees may want to consider:

#### **Director Education**

If an individual agrees to become a compensation committee member, he or she should either have a background that will facilitate the ability to evaluate the types of compensation matters that are typically brought before a compensation committee or he or she should be committed to obtain the necessary education to develop the expertise. This goes to the heart of the credibility of a compensation committee's decision. While the compensation committee may hire outside experts to assist the members in their analysis, the compensation committee members need a base level of knowledge to be able to evaluate and challenge an expert's findings. Accepting an expert's analysis on its face without vigorously probing the expert's findings will significantly dilute the protections hiring an expert might otherwise provide.

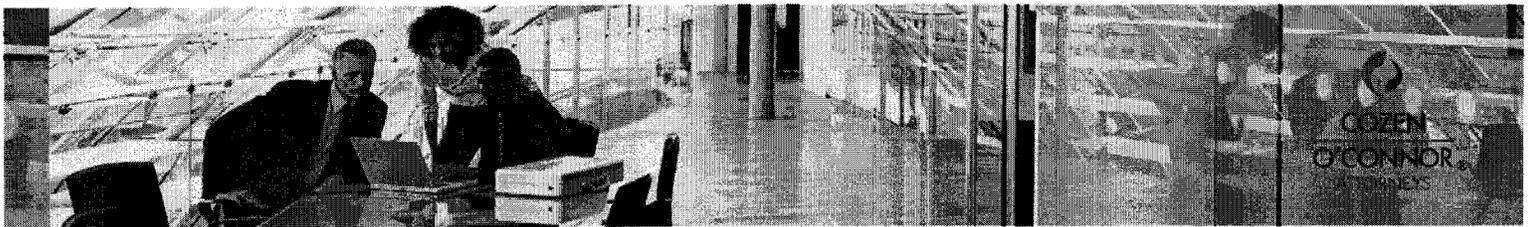
Consideration should be given to setting aside funds to permit committee members to attend a seminar or in-house program on executive compensation once a year.

#### **Independence**

There are two separate areas of independence that should be addressed: (1) the independence of compensation committee members and (2) the independence of outside advisors and counsel. The compensation matters considered by a compensation committee will include matters that affect senior management, who may have been responsible for or had significant influence on the appointment of one or more of the committee members as board members. Moreover, the decisions of a compensation committee are also likely to affect the compensation of the inside directors on the board of directors. Consequently, the membership of the compensation committee should include individuals who have sufficient independence to be able to (i) make objective determinations on compensation issues, (ii) challenge the CEO's actions, and (iii) be a "pain in the neck" when necessary. In the absence of independence, plaintiffs' counsel will attempt to prove the existence of a close personal or economically tied relationship between compensation committee members and management to prove the existence of undue influence and/or bias in the committee's actions. The more care that is taken to insure the independence of directors on a compensation committee, the greater the credibility of their decisions.

If the committee needs legal counsel, then the attorney should be independent of the company. Company counsel represents the corporation, not the individual directors. Independent counsel will represent the interests of the committee members, not the corporation.

If a compensation committee uses a consultant who was engaged by the corporation, the consultant starts off with a major conflict of interest. The objectivity of the consultant's findings may be tainted by its concern for future work from the corporation. If the compensation



committee's consultant is hired by management, then the consultant may feel constrained to make findings detrimental to those who were responsible for the consultant's engagement in the first place. It would be better for the compensation committee to engage its own consultant, taking the time to ensure the consultant is not otherwise " beholden to the company." The consultant should be given assurance that the committee wants unbridled analyses, without any "sugar coating," and that anything less would not be acceptable.

#### **Engage An Expert**

The area of executive compensation has become increasingly complicated over the years. Engaging an executive compensation consultant will not only provide the compensation committee with additional information and technical expertise, but will also help substantiate that the compensation committee is taking its job seriously and is undertaking the necessary due diligence. A good consultant will also serve as an educator for the committee members, not only with respect to how the compensation program and pay package work, but also how they may impact the company's financial statements and SEC reporting requirements. The compensation committee should insure the consultant addresses the severance and bonus components of pay packages; these items have increasingly been finding their way onto the pages of *The Wall Street Journal*.

#### **Do the Hard Work**

It may seem obvious that the compensation committee members must take the time needed to fully analyze the compensation program and pay packages brought before the committee. The complaint in the Disney case alleged the president's pay package had been approved by the compensation committee even though the only information they had received was an incomplete summary. Each of the components of an executive pay package should be reviewed and the potential impact on the company assessed. This should include a computation which

specifies the dollar value for each of the compensation components, including the non-cash perks (i.e. car, apartment, special health care) and the cash flow impact on the corporation. When possible, the underlying documents (i.e., plans, contracts, summaries, the consultant's findings) should be provided to committee members in advance of their meeting to allow for careful study.

Approving a compensation package or program that has high benefits, high termination pay and/or high bonuses should not in and of itself be an act in "bad faith." A significant factor in assessing whether the compensation committee's decision was in "bad faith" will be the process used by the compensation committee to evaluate the compensation under consideration. This is an area where the greater the effort put into the process, the less likely will there be a need to have the directors reach into their own pockets.

*For more information, contact Jay Dorsch (Philadelphia) at 215-665-4685 or [jdorsch@cozen.com](mailto:jdorsch@cozen.com).*

## **ESTABLISHING A BUSINESS IN CANADA - PART II**

In the Summer 2004 edition of the *Business Law Observer*, we addressed general Canadian corporate law issues when establishing a business in Canada, such as possible corporate structures and certain tax considerations. There are other considerations that should be contemplated by individuals and entities seeking to establish a business in Canada, including immigration requirements, anti-trust regulations and intellectual property protections. Part II of this article will delve into these key areas along with some others that should be taken into consideration.

### **1. Immigration Requirements for Business People**

Canadian immigration law imposes certain requirements on foreign individuals wishing to work in Canada. These requirements are of particular interest to corporations who wish to transfer personnel to their Canadian branch or subsidiary. Individuals who are to be temporarily employed

*Continued on page 12*



## **Canada** *Continued from page 11*

in Canada must apply through a Canadian government visa office abroad for a work permit, or at the Canadian border or port of entry if they are citizens of the U.S.

In order to obtain a work permit, the Canadian employer must usually apply to Human Resources Skills Development Canada (HRSDC) for an HRSDC Confirmation or Opinion. Special provisions permit non-Canadians to work in Canada without first obtaining an HRSDC confirmation in some circumstances. The requirement may be waived in the case of intra-corporate transfers where an employee of a corporation located outside Canada seeks to enter Canada to work in the corporation's Canadian branch or subsidiary at a senior executive or managerial level for a temporary period. The requirement may also be waived when an employee has specialized knowledge of the company's product or service and its application in the marketplace.

When an individual's employment will involve a permanent transfer to Canada, he or she should make application for permanent residence in Canada. It is possible to apply for permanent residence after arriving in Canada on a work permit. Applicants are assessed under a point system which allocates units of assessment based on various selection factors, which include intended occupation, experience in the intended occupation, education, age, knowledge of English or French, and personal suitability.

There are special rules for individuals who apply for permanent residence as "self-employed" persons. This category applies to individuals who demonstrate the ability and intent to establish a business that would make a positive contribution to specified economic activities (i.e. cultural activities, athletics or farm management) in Canada.

A related category to that of the "self-employed" is the "entrepreneur" class. This category is aimed at successful business persons who intend to establish, purchase, or make a substantial investment in a Canadian business. The

business, which must be actively managed by the applicant, must be one that will make a significant economic contribution to Canada and must employ at least one (1) Canadian. Conditions imposed on visas granted to entrepreneurs usually require that they buy or start a business within two (2) years of arriving in Canada.

The North American Free Trade Agreement ("NAFTA") establishes a special regime for temporary entry of business persons who are citizens of either the U.S. or Mexico. NAFTA, however, does not contemplate changes in the immigration policies of each country regarding the granting of permanent residence status. Temporary business visitors are classified under NAFTA into four categories: (i) business visitors, (ii) traders and investors, (iii) professionals, and (iv) intra-company transferees. NAFTA grants temporary entry, without the necessity of a work permit, to any U.S. or Mexican citizen who is engaged in trade in goods, the provision of services, or the conduct of investment activities.

## **2. "Anti-Trust" Considerations**

All businesses operating in Canada are subject to the provisions of the Competition Act ("CA"), which is Canada's anti trust legislation. Foreign investors purchasing a Canadian company may be subject to the notification provisions of the CA pertaining to mergers and acquisitions. The CA characterizes anti competitive practices into two (2) categories: criminal law prohibitions and civil law matters. The criminal law regime includes such practices as resale price maintenance, discriminatory and predatory pricing, disproportionate advertising allowances, bid rigging, pyramid and referral selling, and various misleading advertising offenses. The civil law regime deals with matters that could potentially have an impact on competition in the marketplace, such as refusal to deal, consignment selling, exclusive dealing, tied selling and market restrictions, refusal to supply by a foreign supplier, and foreign judgments, laws and directives. A branch operation in Canada of a foreign enterprise should be particularly mindful of the last of these civil matters.



### 3. Intellectual Property Considerations

#### Patents

The maximum term of patent protection is twenty (20) years from the date of filing or deemed date of filing the application in Canada. The previous "first-to-invent" system for determining entitlement to grant has now been replaced with a "first-to-file" system having a qualified absolute novelty requirement. Consequently, it is clearly advantageous to an applicant to prepare and file the application at the earliest possible opportunity.

However, Canada is a member of the Paris Convention, which enables foreign applicants based in a Convention country to file an application in Canada and claim priority based on their first filed corresponding foreign application. To claim priority, the Canadian application must be filed within twelve (12) months of the first filed foreign application. Applications accorded priority under the Paris Convention are given an effective Canadian filing date which is the same as the date on which the first filed corresponding foreign application was filed.

#### Industrial Designs

Designs may be protected in Canada by registration under the Industrial Design Act. The proprietor of an industrial design may obtain exclusive rights to the use of the design in Canada for a period of five (5) years, subject to renewal for an additional five (5) year period, by registering the design within one (1) year of its first publication.

As noted above, Canada is a member of the Paris Convention, which may enable a foreign based applicant to obtain an effective filing date that is the same as the date of filing the first filed corresponding foreign application to register the design. In order to claim priority, the Canadian application must be filed within six (6) months from the date of the first filed corresponding foreign application. Again, it is clearly to the proprietor's benefit to prepare and file the application to register the design at the earliest possible opportunity.

#### Trademarks

Registration of a trademark in Canada is available under the Trade marks Act. A number of important advantages are secured by registration of the mark. The owner of a trademark registration has the right to the exclusive use of the mark in Canada, irrespective of whether the mark has been used in all regions of the country. As well, a registration may provide notice to others searching the Canadian Trade-marks Register in contemplation of using or applying to register a confusingly similar trademark.

Unlike many foreign jurisdictions, it is possible to file a Canadian trademark application on an "intention to use" basis. Entitlement to registration of an application filed on this basis is determined from the filing date of the proposed use application.

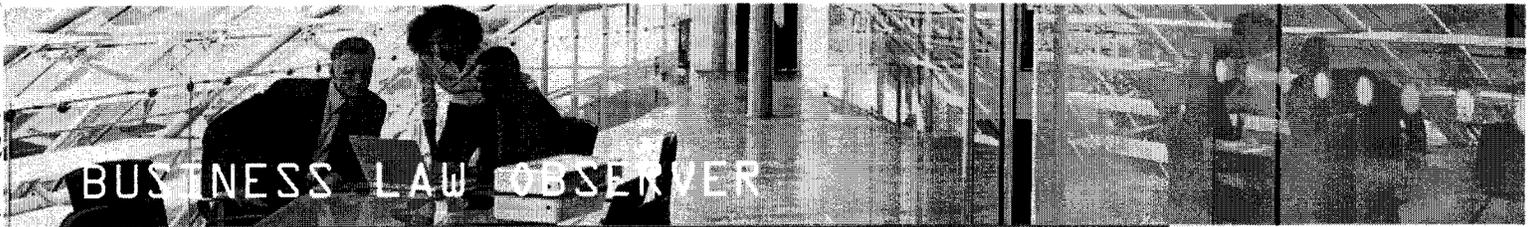
Again, Canada is a member of the Paris Convention enabling applicants in Canada to claim priority on a corresponding foreign trademark application. The Canadian application must be filed within six (6) months from the date of the first filed foreign application.

#### Copyrights

The creative works of authors may be protected under the Canadian Copyright Act. Protection is available for a number of different kinds of works, such as literary (including computer programs), artistic, dramatic, musical and architectural works. Copyright arises automatically upon the creation in Canada of an original work and may be registered in the Canadian Copyright Office. Registration is proof that copyright subsists in the work and that the person named in the registration is the owner thereof. The term of copyright protection in Canada, generally, is the life of the author plus an additional fifty (50) years.

Canada is a member of the Berne Convention, extending substantive protection so that a citizen-author of a Convention country may enjoy copyright protection in

*Continued on page 14*



NEWS ON CURRENT ISSUES

## **Canada** *Continued from page 13*

Canada in an original work that is unpublished or first published in a Convention country.

### **4. Other Considerations**

#### **Commodity Taxes**

Sales taxes are imposed by federal legislation and also by all provincial governments with the exception of the Province of Alberta.

On January 1, 1991, the existing federal sales tax was replaced with a new value-added sales tax on goods and services ("GST"), which is provided for in the Excise Tax Act. GST is imposed on the consideration paid in respect of virtually all goods and services provided in Canada at a rate of 7%, unless such goods and services are specifically exempt or zero-rated under the legislation. Generally, the purchaser of the good or service pays the tax to the vendor who, in turn, collects the tax on behalf of the government. The vendor is entitled to claim a credit for GST paid in respect of its own business inputs, to the extent the good or service is used in a commercial activity in Canada, and remits the difference between the amount collected and the amount paid to the taxing authority.

In the case of goods or parts imported into Canada, GST is paid directly to the taxing authority on imports based on the duty-paid value of the goods. An offsetting credit is available to a registered importer in respect of GST paid, provided the importer uses the goods in a commercial activity in Canada.

Basic groceries, prescription drugs and residential rents receive tax-free treatment. Most health and dental services, daycare services, legal aid services and most educational services are tax exempt, and although no tax is charged on the sale of such services, a business input tax credit relating to such services may not be claimed.

Provincial sales tax rates applicable to goods and services purchased by consumers vary from province to province.

As an example, in Ontario, with certain exceptions, the rate is 8% on most goods and selected services.

#### **Provincial Legislation**

Each province has the power to enact legislation in certain areas. Accordingly, when considering establishing a business in a particular province within Canada, provincial laws should be considered.

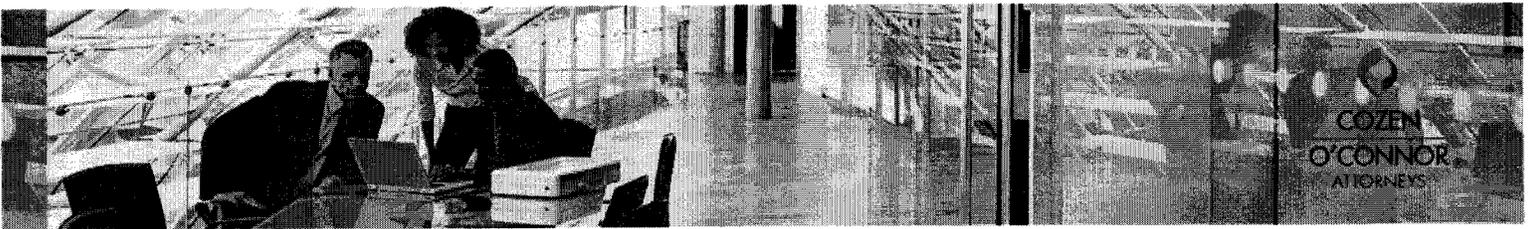
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*Perley-Robertson, Hill & McDougall LLP, based in Ontario, Canada, was founded in 1971 and is one of the largest law firms in Canada's National Capital Region. Through an alliance with Cozen O'Connor, Perley-Robertson, Hill & McDougall LLP offers a range of services and local market expertise across North America and in the U.K.*

### **Transaction of the Year**

In the Spring of 2004, members of Cozen O'Connor's corporate department represented a client in its acquisition of substantially all of the assets of a California-based company. Sounds pretty basic, right? Wrong. What made this transaction unusual was that the target company was insolvent and the target's largest creditor was also its largest shareholder.

The target had secured debt held by its largest shareholder of over \$20 million, unsecured debt (mostly with critical vendors) of approximately \$2.5 million and assets of approximately \$5 million to \$7 million (consisting mostly of patents and other intellectual property). Our client desired to purchase the assets, particularly the intellectual property portfolio, without assuming any liabilities or becoming subject to successor liability lawsuits from the



target's creditors or shareholders. Moreover, the client wanted to minimize the possibility that it could be outbid by a third party seeking to purchase the assets.

We considered a number of possible structures for the acquisition, including a conventional asset acquisition, a "Section 363 sale" under the United States Bankruptcy Code and a purchase of the debt followed by a foreclosure proceeding under California law. We decided that the conventional assets acquisition would not adequately protect our client from successor liability exposure. The Section 363 sale, a process in which the assets of a company in bankruptcy are sold before the plan for allocating the company's assets is approved by the bankruptcy court, and the statutory foreclosure proceeding were ruled out as being too time consuming, too expensive and requiring that the assets be put up for bidding or auction.

Our solution was to have the target make an assignment for the benefit of creditors ("ABC"). In this ABC transaction, the insolvent company's shareholders transfer the company as a whole to a third party known as an assignee, who is charged with selling all or parts of the company to obtain maximum value for its creditors. The process is similar to that in a Section 363 sale except that the insolvent company does not need to go into bankruptcy and be subject to the bankruptcy court process for the actions being taken. The ABC assignee, after liquidating the company's assets, distributes the proceeds to parties-in-interest in accordance with their statutory priorities (i.e., secured creditors, taxing authorities, employees, unsecured creditors and, if any assets remain, shareholders).

As part of the ABC transaction, our client, through a wholly-owned subsidiary, initially acquired the secured indebtedness of the target at a significant discount off the face amount of the secured debt. Under the debt purchase agreement, the secured debt holder agreed to cause the target, in its capacity as the majority shareholder, to make an assignment for the benefit of creditors, which it did immediately following the discounted sale of its secured

debt to our client. Our client and the secured debt holder also agreed that if our client was successful in acquiring the target's assets, the debt holder would receive additional consideration for the debt in the form of royalty payments and a negotiated equity position in our client.

After the assignment, the assignee conducted a brief "auction" of the target's assets. Our client, as the new holder of the secured debt of the target, "credit bid" a portion of the face amount of its secured debt for the assets (meaning that it offered to cancel a portion of the secured debt, which would be treated as though it were a cash offer of the same amount). No higher bidder was found (our client could have raised its offer by credit bidding more of the secured debt since the \$20 million secured debt was in excess of the value of the assets), and within a few hours of the assignment being made, the assignee accepted the bid of our client, and the assets of the target were sold to our client, free of liability, in exchange for the cancellation of the amount of the secured debt credit bid. Other than the discounted amount our client paid for the secured debt, our client did not have to make any additional payments for the assets. All liabilities and claims remained with the target to be administered by the assignee much in the way a trustee administers claims in a bankruptcy proceeding. In addition, because our client did not credit bid all of the secured debt in purchasing the assets of the target, it remained the target's largest secured creditor, allowing it to participate in the liquidation process of the target and to receive potential cash distributions in connection with the liquidation.

While a purchase of a business using an ABC transaction is not appropriate in most circumstances, it is an alternative that should be considered where the target is insolvent. Of course, the key with any transaction is finding the structure that best fits the circumstances and the objectives of the parties.

*For more information about this transaction, contact Scott E. Brucker (Philadelphia) at 215-665-3710 or [sbrucker@cozen.com](mailto:sbrucker@cozen.com).*



# Securities Offerings and Regulations Alert!

News Concerning Recent Securities Issues

February 23, 2006

## SEC PROPOSES AMENDMENTS TO SIGNIFICANTLY ALTER EXECUTIVE COMPENSATION AND RELATED DISCLOSURE REQUIREMENTS

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On January 27, 2006 the U.S. Securities and Exchange Commission (the "SEC") released proposed amendments to the disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters and security of ownership of officers and directors.<sup>1</sup> The proposed amendments are intended to provide investors will have a better understanding of the compensation earned by a company's directors and executive officers, as well as information related to key financial relationships among the company and its executive officers, directors, significant shareholders and their respective immediate family members.

Comments on the proposed amendments must be received by the SEC by April 10, 2006. Because it is unlikely that these amendments will be enacted in time for the 2006 proxy season, they likely will first apply, if at all, to disclosures of 2006 compensation in 2007 proxy statements. A summary of the proposed amendments is set forth below.

### I. Executive and Director Compensation Disclosure

The proposed amendments build on the strengths of the current compensation disclosure requirements by combining a broader-based tabular presentation with improved narrative disclosure to supplement the tables. The proposed amendments would require an all-encompassing approach to the compensation disclosure. Specifically, the compensation

<sup>1</sup> See SEC Release No. 33-8655.

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disclosure would begin with a narrative overview of the compensation that included a discussion and analysis of the material factors underlying compensation policies and decisions reflected in the data presented in the tables. A three-part disclosure, including tables, of executive compensation would follow the overview. Finally, a director compensation table would be included.

A. Compensation Discussion and Analysis

Under the proposed amendments, the compensation discussion and analysis would provide a narrative overview of the compensation disclosure provided elsewhere in the disclosure document. This overview would address certain material elements of a company's executive and director compensation by answering the following questions:

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward and not to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount of each element?
- How does each element and the company's decision regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?

Boilerplate responses to these questions would not be acceptable. Additionally, because the discussion is intended to be comprehensive, it would require a company to discuss post-termination as well as in-service compensation arrangements. Where the company's compensation policies are materially similar with respect to multiple officers, the officers could be grouped together in one discussion. On the other hand, where such policies differ materially for certain officers, separate discussions would be required with respect to each of them.

The Compensation Discussion and Analysis would be considered a part of the proxy statement and any other filing in which it is included. Therefore it would be subject to Regulations 14A or 14C and to the liabilities of Section 18 of the Securities Exchange Act of 1934 (the "Exchange Act"). In addition, to the extent that such compensation discussion is incorporated into a periodic report, the disclosure would be covered by the certifications that the principal executive officers and principal financial officers are required to make under Section 302 of the Sarbanes-Oxley Act of 2002.



The SEC proposes eliminating the Performance Graph and the Compensation Committee Report that are required under the current rules. It believes that the graph and report are of little benefit to investors, as they often contain meaningless, boilerplate disclosure.

B. Compensation Tables

The proposed amendments are designed to reorganize and streamline the tabular approach to compensation disclosure to provide a clearer and more logical picture of the total compensation and its elements for named executive officers. Under the amended rules, the compensation tables and their related narrative disclosure would be organized based on the following 3 broad categories<sup>2</sup>:

- **Summary Compensation Table** containing all compensation paid during the last three fiscal years and two supplemental tables;
- **Equity Based Compensation Table** containing equity-based interest holdings that relate to compensation or are potential sources of future compensation; and
- **Post-Employment Compensation Table** containing retirement and other types of post-employment compensation and benefits.

1. *Summary Compensation Table.* This table would provide investors with the principal disclosure regarding executive compensation. It would show each named executive officer's compensation for each of the last three fiscal years, whether or not actually paid out. In addition, two tables disclosing information about grants of performance-based awards and all other equity awards would supplement the Summary Compensation Table. Narratives would follow the three tables to explain the disclosure contained therein.

The Summary Compensation Table would be comprised of the following 9 columns: (i) Name and Principal Position; (ii) Year; (iii) Total; (iv) Salary; (v) Bonus; (vi) Stock Awards; (vii) Option Awards; (viii) Non-Stock Incentive Plan Compensation; and (ix) All Other Compensation.

i) Total Compensation. The "Total Compensation" column would show the aggregate dollar value of each form of compensation quantified in the other table columns.

ii) Salary and Bonus. The salary and bonus columns would be retained substantially in their current form. However, the proposed amendments would require the disclosure of

<sup>2</sup> The SEC acknowledges that this three category approach may result in the "double counting" of some elements of compensation. Nevertheless, the Staff believes that this risk is outweighed by the clearer picture of executive compensation that this approach would provide to investors.



compensation that has been deferred, no matter what the reason. Currently, only compensation that is deferred at the election of the executive must be disclosed. A second change effects the disclosure of salaries and bonuses that cannot be calculated as of the most recent practicable date. Under the current rules, such a salary or bonus would not be disclosed until the company's following fiscal year. The proposed amendments would require a footnote indicating that a salary or bonus is not calculable and provide the date on which the salary is expected to be determined. A report under Item 5.02 of Form 8-K would be triggered by the payment of such salary or bonus.

iii) Stock Awards and Option Awards. The Stock Awards Column would disclose stock-related awards that derive their value from the company's equity securities or permit settlement by issuance of the company's equity securities. Valuation of these awards would be based on the grant date fair value of the award determined pursuant to Financial Accounting Standards Board Settlement of Financial Accounting Standards No. 123 (revised 2004) ("FAS 123R"). In addition, the amendments would change the disclosure of stock awards subject to performance-based conditions from optional to mandatory.

Option awards, stock appreciation grants, and similar stock-based compensation instruments that have option-like features would be disclosed in a manner similar to the proposed treatment of stock and other stock-based awards. Rather than disclosing the number of securities underlying the options, the amendments would require disclosure of the grant date fair value of the award as determined pursuant to FAS 123R.<sup>3</sup>

The amendments would require footnote disclosure of earnings on stock awards and option awards, including the identification and quantification of all earnings, whether (i) paid during the fiscal year, (ii) payable during the period but deferred or (iii) payable by their terms on a later date but earned during the year.

iv) Non-Stock Incentive Plan Compensation. The Non-Stock Incentive Plan Compensation column would show the dollar value of all other amounts earned by a named executive during the fiscal year pursuant to incentive plans. Performance-based compensation under a long-term plan that is not tied to the performance of the company's equity securities would be disclosed in the Summary Compensation Table in the year when the relevant specified performance criteria are satisfied and the compensation earned, whether or not payment is actually made in that year. Because there is no one clear method of determining the value of

<sup>3</sup> Under FAS 123R, the compensation cost calculated as the fair value is generally recognized for financial reporting purposes over the period in which the employee is required to provide service in exchange for the award. Under the amendments, the compensation cost calculated as the grant date fair value will be shown as compensation in the year in which the grant is made.

such a non-stock based performance-based award, the SEC does not propose to include such value in the Summary Compensation Table. Rather, the current disclosure method of reflecting these items of compensation when earned would continue to be applicable.

v) All Other Compensation. This column would include any other compensation not required to be disclosed in any other column of the Summary Compensation Table. Any single compensation amount disclosed in this column that exceeds \$10,000 must be separately identified and quantified in a footnote. Examples of compensation that would be included in this column include, but are not limited to:

- earnings on deferred compensation (currently disclosure of such earnings is only required to the extent of any portion that is “above-market” or preferential);
- increase in pension value;
- perquisites and other personal benefits unless the aggregate amount is less than \$10,000<sup>4</sup>;
- amounts paid or accrued pursuant to a plan or arrangement in connection with any termination of employment or change in control;
- annual company contributions or other allocations to vested and unvested defined contribution plans;
- the dollar value of any insurance premiums paid by the company with respect to life insurance for the benefit of a named executive officer;
- “gross-ups” or other amounts reimbursed during the fiscal year for the payment of taxes; and
- for any security of the company or its subsidiaries purchased from the company or its subsidiaries (through deferral of fees or otherwise) at a discount from the market price of such security at the date of purchase, unless the discount is available generally either to all security holders or to all salaried employees of the company.

<sup>4</sup> The SEC still believes it is inappropriate for Item 402 to define perquisites or personal benefits; however, in the Release it provides interpretive guidance that among the factors to be considered in determining whether an item is a perquisite or other personal benefit are the following:

- an item is not a perquisite or personal benefit if it is integrally and directly related to the performance of an executive’s duties.
- otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees.

2. *Supplemental Annual Compensation Table.* The proposed amendments call for 2 supplemental tables to the Summary Compensation Table, namely, the Grants of Performance-Based Awards Table and the Grants of All Other Equity Awards Table. These supplemental tables are intended to facilitate investors' understanding of the Summary Compensation Table.

i) Grants of Performance-Based Awards Table. This table would include information regarding non-stock grants of incentive plan awards, stock-based incentive plan awards and awards of options, restricted stock and similar instruments under plans that are performance-based (and thus provide the opportunity for future compensation if conditions are satisfied).<sup>5</sup> The table would provide the terms of each grant made during the current year.

ii) Grants of all Other Equity Awards Table. This table would show the equity-based compensation awards granted in the last fiscal year that are not performance-based, such as stock, options or similar instruments where the payout or future value is tied to the company's stock price and not to other performance criteria.

3. *Narrative Disclosures.* To help investors better understand the tables discussed above, the amendments also would require narrative disclosure of any additional material factors that would be essential to understanding the three tables. This narrative would differ from the Compensation Discussion and Analysis in that it would provide context for the quantitative disclosures made in the tables, rather than describe the policies and objectives underlying the company's executive compensation.

4. *Exercises and Holdings of Previously Awarded Equity.* This next section of disclosure would provide investors with an understanding of the compensation in the form of outstanding equity awards that remain unexercised or unvested. This disclosure section would consist of 2 tables. The 1<sup>st</sup> table would set forth the amounts of prior awards outstanding as of the company's most fiscal year end, as well as the market-based values of the options, rights, shares or units underlying such awards. The 2<sup>nd</sup> table would set forth the exercise or vesting of equity awards during the most recent fiscal year, including the amounts realized.

5. *Post-Employment Compensation.* Because executive retirement compensation packages and other post-termination compensation sometimes represent a significant commitment of corporate resources and a significant portion of overall compensation, the proposed amendments make considerable changes to the disclosure requirements for such compensation. The amendments would require 2 tables in place of the current pension plan table, alternative plan disclosure and some of the other narrative descriptions. The 1<sup>st</sup> table

<sup>5</sup> For purposes of this table, awards would be considered performance-based if they are subject to either a performance condition or a market condition, as those terms are defined in FAS 123R.



would contain information regarding defined benefit pension plans and the 2<sup>nd</sup> table would disclose information regarding non-qualified defined contribution plans and other deferred compensation. In addition, the amendments make significant changes to the disclosure regarding compensation paid pursuant to termination and change of control provisions.

i) Defined Benefit Pension Plans. The SEC's view is that the current disclosure requirements do not afford investors adequate information regarding the potential payment of pension benefits. Accordingly, the amendments propose a new table disclosing estimated annual retirement payments under defined benefit plans followed by a narrative description. If an executive officer is not yet eligible to retire, the dollar amount of the annual benefits to which he would be entitled would be computed assuming that the executive continued to earn the same amount of compensation as reported for the company's last fiscal year.

ii) Nonqualified Defined Contribution and Other Deferred Compensation Plans Table. This new table would disclose contributions, earnings and balances under nonqualified defined contribution and other deferred compensation plans. The current rules only require disclosure of the compensation when earned and only the above-market earnings on nonqualified deferred compensation. Footnotes required in this table would prevent investors from double-counting certain compensation disclosed in the Summary Compensation Table by clarifying the extent to which amounts payable as deferred compensation represent compensation previously reported, rather than additional currently earned compensation. The table would be followed by a narrative description.

6. *Officers Covered*. The proposed amendments would change the scope of the disclosure requirements. Currently the disclosure requirements apply to the company's chief executive officer and the four most highly compensated executive officers excluding the chief executive officer. Under the proposed amendments, the requirements would apply to the chief executive officer, chief financial officer and the three most highly compensated executive officers excluding the chief executive officer and chief financial officer.<sup>6</sup> The determination of the most highly compensated executives would be made based on total compensation for the most recent fiscal year.

7. *Director Compensation*. In light of the complex compensation packages granted to directors, the SEC proposes requiring a formatted tabular disclosure for director compensation, accompanied by narrative disclosure of additional information. The same instructions that apply to the Summary Compensation Table would govern analogous matters in the Director

<sup>6</sup> The disclosure requirements for the most highly compensated officers only apply if the officer's total compensation for the last fiscal year is \$100,000 or more.



Compensation Table. However, the two tables that would supplement the Summary Compensation Table would not be required for the Director Compensation Table.

C. Specific Issuers

The SEC recognized that the same disclosure requirements should not apply to all types of issuers. Accordingly, the amendments propose varied disclosure requirements for small business issuers, foreign private issuers, and business development companies.

Small business issuers would be required to provide, along with related narrative disclosure:

- the Summary Compensation Table;
- the Outstanding Awards at Fiscal Year-End Table; and
- the Director Compensation Table.

The Summary Compensation Table would have to disclose information for only the last 2 fiscal years (rather than 3 years as is required for Regulation S-K issuers). In addition, small business issuers would need only to disclose information about their principal executive officer and the two most highly compensated officers other than the principal executive officer. Finally, small business issuers would not be required to provide a Compensation Discussion and Analysis.

**II. Proposed Revisions to Form 8-K and the Periodic Report Exhibit Requirements**

Under the current rules, Item 1.01 of Form 8-K requires an Exchange Act reporting company to disclose within 4 business days, the company's entry into or termination of a material definitive agreement outside of its ordinary course of business, or any amendment of such agreement that is material to the company. The SEC has determined that this disclosure requirement has resulted in disclosure of matters that do not appear always to be unquestionably or presumptively material. Accordingly, the SEC is proposing to amend Item 1.01 and Item 5.02 of Form 8-K to require real-time disclosure of employee compensation events that more clearly satisfy this standard.

The amendments would eliminate the disclosure of employment compensation arrangements from Item 1.01 and would require disclosure of such arrangements under a modified, broader Item 5.02. The amendments would not only relocate disclosure regarding employee compensation arrangements so that such disclosure falls solely under a single item, but the amendments also would modify the overall requirements for this type of disclosure. The modifications would:



- expand the information regarding retirement, resignation or termination to include all persons falling within the definition of named executive officers for the company's previous fiscal year, whether or not included in the list currently specified in Item 5.02;
- expand the disclosure items covered under Item 5.02 beyond employment agreements to require a brief description of any material plan, contract or arrangement to which a covered officer or director is a party or in which he participates that is entered into or materially amended in connection with any of the triggering events specified in Item 5.02, or any grant or award to any such covered person, or modification thereto, under any such plan, contract or arrangement in connection with any such event;
- with respect to the principal executive officer, principal financial officer and other persons falling within the definition of a named executive officer for the company's previous fiscal year, expand the disclosure items to include a brief description of any material new compensatory plan, contract or arrangement, or new grant or award thereunder, and any material amendment thereto; and
- add a requirement for disclosure of salary and bonus for the most recent fiscal year that was not available at the latest practicable date in connection with disclosure under Item 402 of Regulation S-K.

The amendments would extend the safe harbors regarding Section 10(b) and Rule 10b-5 and Form S-3 eligibility in the event that a company fails to timely file reports required by Item 5.02(e) of Form 8-K.

### **III. Certain Relationships and Related Transactions Disclosure**

#### **A. Related Persons and Promoters**

The SEC believes that an investor cannot have a complete and accurate understanding of a company's financial relationships without having access to information regarding certain related party transactions. Accordingly, the SEC is proposing significant revisions to Item 404 of Regulation S-K. The purpose of Item 404 would remain the same; however, the disclosure requirements would be streamlined and modernized. The principal modifications would be as follows:

- Item 404(a) would require broad disclosure of related person transactions, including those involving indebtedness, in which the amount involved exceeds \$120,000;

- Item 404(b) would require disclosure regarding the company's policies and procedures for the review, approval or ratification of related person transactions; and
- Item 404(c) would require disclosure regarding the identify of and transactions with any person who was a promoter of the company within the last five fiscal years.

## B. Corporate Governance

New Item 407 would consolidate current corporate governance disclosure requirements. The amendments would require disclosure identifying each independent director of the company under the definition of board independence applicable to it. In addition, for each independent director, the company would have to provide a description of any transactions, relationships or arrangements not disclosed pursuant to paragraph (a) of Item 404 that were considered by the board of directors of the company in determining that the applicable independence standards were met.

The SEC also is proposing disclosure requirements regarding compensation committees similar to those requirements that apply to audit and nominating committees. The disclosure would need to contain a description of the processes and procedures for the consideration and determination of executive and director compensation. The current disclosure requirements found in Item 402 regarding compensation committee interlocks and insider participation in compensation decisions would be consolidated into this compensation committee disclosure.

## **IV. Plain English**

The SEC is proposing that the plain English requirement apply to most of the disclosure required by proposed Items 402, 403, 404 and 407 of Regulation S-K.

## **V. Transition**

If and when the amendments become effective, the Summary Compensation Table and disclosure required by Item 404(a) would be required only for the most recent fiscal year and companies would not be required to "restate" their prior disclosures to conform to the new disclosure requirements. The phase-in period of these disclosure requirements would occur over a three-year period for Regulation S-K companies and a two-year period for Regulation S-B companies.



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## **The Cozen O'Connor Securities Group**

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*This summary does not constitute legal advice or a solicitation of any particular prospective client. If you have questions or require advice please call your regular contact at Cozen O'Connor or Ralph V. De Martino by telephone at (202) 912-4800 or by e-mail at [rdemartino@cozen.com](mailto:rdemartino@cozen.com).*

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June 2, 2006

**SEC CLARIFIES THE FUTURE OF SECTION 404 OF SARBANES-OXLEY**

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On May 17, 2006 the U.S. Securities and Exchange Commission (the "SEC") issued its long awaited response<sup>1</sup> to the Advisory Committee on Small Public Companies' April 23, 2006 recommendation that small public companies be exempt from Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX").<sup>2</sup> The release stated that "ultimately all public companies will be required to comply with the internal control reporting requirements of Section 404."<sup>3</sup>

The release also described the following series of actions the SEC intends to take to improve the implementation of the Section 404 internal control requirements of SOX. The SEC hopes that these actions will further improve the reliability of financial statements and better protect investors while making the Section 404 process more efficient and cost effective.

**1. Guidance for Companies – In response to numerous requests for guidance regarding management's implementation of its assessment of internal controls over financial reporting as required by Section 404 of SOX, the SEC will:**

1 See SEC Release No. 2006-75 dated May 17, 2006. Located at: <http://www.sec.gov/news/press/2006/2006-75.htm>

2 In September 2005, one of the authors of this Alert, Ralph V. De Martino testified in San Francisco before the Advisory Committee on Small Public Companies. During the course of that testimony, Mr. De Martino made the proposal that ultimately was presented by the Advisory Committee on Small Public Companies to the SEC and that was rejected in the announcement that is the subject of this Alert.

3 On the same day, the Feeney-DeMint Bill, entitled the "Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act," was introduced concurrently in the House and Senate. The Bill, which is not expected to pass in this session of Congress, would exempt public companies under \$700 million in market capitalization and whose revenues do not exceed \$125 million from SOX Section 404.

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- Issue a Concept Release on issues that may be the subject of its guidance for management, and request public comment;
  - consider the usefulness of the additional guidance that the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") is expected to provide on its 1992 Internal Control – Integrated Framework, with respect to Section 404(a) assessments made by smaller public companies;" and
  - Issue guidance to management to assist in it in connection with its performance of a top-down, risk-based assessment of internal control over financial reporting.
- 2. Revisions to Auditing Standard No. 2** – The SEC will work with the Public Company Accounting Oversight Board ("PCAOB") to ensure that proposed revisions to Auditing Standard No. 2 are in the public interest and consistent with the protection of investors. The PCAOB's proposed revisions would:
- Seek to ensure that auditors focus during integrated audits on areas that pose higher risk of fraud or material error;
  - Incorporate key concepts contained in the guidance issued by the PCAOB on May 16, 2005; and
  - Revisit and clarify what, if any, role the auditor should play in evaluating the company's process of assessing internal control effectiveness.
- 3. Oversee PCAOB Inspection Program**– The SEC staff will examine whether the PCAOB inspections of audit firms have been effective in encouraging implementation of the principles outlined in the PCAOB's May 1, 2006 statement.
- 4. Extend Compliance for Non-Accelerated Filers** – The SEC expects to issue a short postponement of the effective date of the SEC's rules implementing Section 404 for non-accelerated filers. Nevertheless, the SEC anticipates that all filers will have to comply with the management assessment required by Section 404(a) of SOX for fiscal years beginning on or after December 16, 2006.

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rities and Exchange Commission and continue to maintain frequent contact with the SEC, take pride in leading our diverse clientele through the labyrinth of federal and state securities law issues in an efficient and cost-effective manner. The Securities Practice Group works closely with many other practice groups in the firm, including those that concentrate in the areas of corporate, banking, public finance, real estate, and tax law, to provide our clients with integrated solutions to their legal issues.

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# Employee Benefits Alert!

News Concerning Recent Employee Benefits Issues

November 4, 2005

## 2006 EMPLOYEE BENEFIT LIMITATIONS

On October 14, 2005 the IRS announced the Pension Plan Limitations for 2006. The following outlines the retirement plan limits that apply to plan years, limitation years or taxable years beginning on or after January 1, 2006. Some of the limits reflect scheduled increases under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and other limits have been increased for cost-of-living adjustments as dictated by prior laws.

**Elective Deferral Limit:** The annual limit on elective deferrals to 401(k) plans, 403(b) plans and 457 plans is raised from \$14,000 to \$15,000 (\$10,000 for SIMPLE Plans) in 2006. In addition, catch-up contributions can be made for individuals who reach age 50 by year-end if the plan so provides. The maximum amount of catch-up contributions under 414(v)(2)(B)(i) for 2006 increased from \$4,000 to \$5,000 (\$2,500 for SIMPLE plans).

**Section 415 Limit for Defined Contribution Plans:** The limitation for defined contribution plans under Section 415(c)(1)(A) is increased from \$42,000 to \$44,000 effective for limitation years beginning after December 31, 2005. For non calendar limitation years beginning before January 1, 2006 and ending after December 31, 2005, the limitation remains at \$42,000.

**Section 415 Limit for Defined Benefit Plans:** The limitation on the annual benefit under a defined benefit plan under Section 415(b)(1)(A) is increased from \$170,000 to \$175,000 for limitation years ending after December 31, 2005.

**Annual Compensation Limit:** The maximum amount of compensation that can be considered for qualified retirement plan purposes under Sections 401(a)(17), 404(l) and 408(k)(3)(C), is increased from \$210,000 to \$220,000. This limit applies to plan years beginning in 2006.

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## Employee Benefits

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**Definitions of Highly Compensated Employee and Key Employee:** The limitation used in the definition of highly compensated employee increased from \$95,000 to \$100,000. Please note, for testing in 2006 the definition of highly compensated employee looks-back to the 2005 limit (\$95,000). The dollar limitation used to define key employee in a top-heavy plan increased from \$135,000 to \$140,000.

**ESOP Limits:** The maximum account balance in an employee stock ownership plan subject to a five-year distribution period is increased from \$850,000 to \$885,000. The dollar amount for lengthening the five-year distribution period is increased from \$170,000 to \$175,000.

**SEP Compensation Threshold:** Employers are not required to contribute to a simplified employee pension plan on behalf of participants who earn less than \$450 in 2006 (unchanged from 2005).

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*Please contact one of the following members of our Employee Benefits & Executive Compensation Department if you would like further information regarding this Alert!*

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## Summary of the Sarbanes-Oxley Act of 2002

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August 2002

## Summary of Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. Quickly passed in the wake of several high profile financial reporting debacles and in reaction to an erosion in market confidence and extreme market volatility, the Act sets forth broad accounting and corporate governance reforms intended to restore confidence in the integrity of public company disclosure and accounting practices. By providing expanded regulation of corporate governance, disclosure, reporting and accounting requirements, the Act will undoubtedly have a significant impact on public companies, their officers, directors and shareholders, and the accounting and legal professions. The Act's rapid passage and sweeping revisions of portions of the federal securities and other laws, including delegation to the Securities and Exchange Commission to make many significant rules over the next year, has resulted in uncertainty about how to comply with, and what will be the real world implications of, many provisions of the Act.

*Set forth below is a summary and, where appropriate, analysis of key provisions of the Act as well as an overview of other parts of the Act. Because many of the Act's provisions become effective at different times, the discussions below will indicate the effective date of the relevant provision. You can obtain the complete text of the Act from the Library of Congress web site at <http://thomas.loc.gov>.*

### **Summary and Analysis of Key Provisions of the Act**

#### ***CEO and CFO Certifications***

The Act contains two separate provisions requiring chief executive officers and chief financial officers of public companies to make certifications with respect to their companies' periodic reports. One provision imposes criminal penalties and became immediately effective upon passage of the Act, while the other directs the SEC to issue rules by August 29, 2002 requiring separate certifications and involving civil penalties. These provisions, together with the SEC's order requiring the 947 largest public companies in the United States (companies with revenues in excess of \$1.2 billion) to make a separate certification, have led to confusion over the certification requirements.

**Section 906 Certification.** Section 906 of the Act, a criminal provision which is now in effect, requires the CEO and CFO of each public company to certify, through a written statement accompanying each periodic report containing financial statements filed by such company:

- that the periodic report fully complies with the SEC's requirements under the Securities Exchange Act of 1934; and
- that the information contained in such report "fairly presents, in all material respects," the financial condition and results of operations of the company.

A CEO or CFO who certifies a statement "knowing" that it fails to comply with these requirements is subject to a fine of up to \$1,000,000 and imprisonment of up to 10 years. If the improper certification is made "willfully," the maximum fine and imprisonment is \$5,000,000 and 20 years, respectively.

This certification requirement applies only to periodic reports (*i.e.*, annual and quarterly reports on Forms 10-K and 10-KSB, 10-Q and 10-QSB and Form 20-F for foreign private issuers and Form 40-F for Canadian

issuers filing under the SEC's Multijurisdictional Disclosure System). Section 906 certification is not required to accompany reports on Forms 8-K or 6-K as such reports are not "periodic reports" within the meaning of the federal securities laws.

The Act does not specifically address the effects of the failure to have the certification accompany a periodic report, although there is a general provision of the Act which states that a violation of the Act shall be treated in the same manner as a violation of the Securities Exchange Act. In addition, the SEC staff has indicated that the Section 906 certification is a matter of concern for the Department of Justice, not the SEC.

We recommend that CEOs and CFOs add a "knowledge" qualifier to their certifications. While such a qualifier is not included in the language of the Act, it does not appear to be prohibited and has already been used by many signing officers. We believe that such a qualification is consistent with Section 906, which imposes penalties for "knowing" and "willful" violations. Again, CEOs and CFOs should evaluate whether including a knowledge qualifier will have any public relations impact.

Finally, in order to permit the CEO and CFO to responsibly make the Section 906 certification, companies need to review their existing procedures relating to the preparation and internal approval of SEC filings. Companies must have in place procedures that provide CEOs and CFOs with appropriate support for their certifications, without merely passing the responsibility down the corporate organizational chart.

#### *How to Make Section 906 Certification*

The Act does not address how the certification is to "accompany" a periodic report. One method would be to file the certification as an exhibit (an Exhibit 99) to the relevant periodic report. In some cases, however, this method may, at least theoretically, create additional liability for the officers signing the certification. This would be the case for companies that have outstanding registration statements, such as on Forms S-3 or S-8, which by their terms incorporate into such registration statements subsequently filed periodic reports. By including the Section 906 certification as part of the report, the certification will be incorporated by reference into such registration statements and could, in theory, create additional liability for the signing officers under the federal securities laws.

An alternative that has been used by some companies is to submit the certification to the SEC as correspondence with the filing. This method would prevent the certification from being incorporated by reference into any registration statements, but would also not make the certification available to the public. We recognize that a company must also consider the public relations implications of how it complies with the certification process, including how to ensure the effective publicizing of such certification. Accordingly, companies submitting the certification to the SEC as correspondence can publicize their certification by also furnishing it to the SEC under Item 9 (but not Item 5) of Form 8-K and by posting it on their corporate web sites. This method would seem to provide the benefit of public dissemination of the fact that the certification has been made without increasing the bases for liability with respect to the certification.

Although the theoretical benefit will remain, once the Section 302 certification discussed below comes into effect, the benefit of the Section 906 certification not being part of the periodic report to which it relates (and therefore not incorporated by reference in registration statements) will be substantially diminished. The Act provides that the Section 302 certification, which in many respects is broader than the Section 906 certification, is to be made "in" (as opposed to "accompany") each annual and quarterly report. Assuming the requires that the Section 302 certification require that it be part of the annual or quarterly report, there will be little benefit, and probably some confusion, from filing the Section 906 certification by means of Item 9 on Form 8-K when the related Section 302 certification is contained in the periodic report. After the SEC issues

its rules on the Section 302 certification, standard practices for making the varying certifications undoubtedly will develop.

*Effective Date:* July 30, 2002

**Section 302 Certification.** Under Section 302 of the Act, the SEC is directed to adopt regulations requiring the CEO and CFO of every public company to certify in each annual and quarterly report that:

- the officer reviewed the report;
- based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made not misleading;
- based on the officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of the company's operations as of and for the periods presented in the report;
- the officers: (a) are responsible for establishing and maintaining internal controls; (b) have designed internal controls to ensure that material information about the company and its consolidated subsidiaries is made known to them, particularly during the time that the report is being prepared; (c) have evaluated the effectiveness of those internal controls as of a date within 90 days prior to the periodic report; and (d) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
- the officers have disclosed to the auditors and the audit committee of the board of directors: (a) all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data, and they have identified for the auditors any material weaknesses in the controls; and (b) any fraud involving management or other significant employees; and
- the officers have indicated in the report whether or not there were any significant changes in the internal controls or other factors that could significantly affect internal controls after the date of their evaluation.

#### *Proposed SEC Rules*

On August 2, 2002, the SEC issued a release confirming that it will issue and make effective final rules on or prior to August 29, 2002 to require the certifications mandated by Section 302 of the Act (Release No. 34-46300). The SEC noted that Section 302 applies not only to U.S. companies but also to foreign private issuers filing reports on Form 20-F and Canadian issuers filing Form 40-F under the SEC's Multijurisdictional Disclosure System.

The SEC also noted that it previously proposed rules that would require maintenance of sufficient procedures to provide reasonable assurance that a company is able to collect, process and disclose the information, including non-financial information, required to be disclosed in SEC reports. In the release, the SEC indicated that it does not intend to modify this proposed requirement, which would be in addition to Section 302 of the Act.

*Effective Date:* The SEC must adopt rules on the Section 302 certification by August 29, 2002.

## ***Prohibitions on Loans***

One of the most significant provisions of the Act is the prohibition on personal loans to directors and executive officers. Subject to certain limited exceptions, Section 402 of the Act prohibits public companies from directly or indirectly extending, maintaining or arranging for personal loans to or for any of its directors or executive officers. This prohibition does not preclude certain extensions of credit in respect of home improvement loans and loans made for manufactured home financing, consumer credit or open end credit plans or charge cards or credit for employees of certain broker/dealer firms to buy, trade or carry securities, in each case so long as such extensions are:

- made in the ordinary course of the consumer credit business of the company;
- of the type that is generally made available by the company to the public; and
- made by the company on market terms or terms that are no more favorable than those offered by the company to the general public.

Any extensions of credit in existence on July 30, 2002 are “grandfathered” and not subject to the prohibition; provided there is no subsequent material modification to any term of or any renewal of such existing extension of credit. The prohibition on making loans does not apply to FDIC-insured banks and savings associations if the loan is subject to the insider lending restrictions of the Federal Reserve Act.

The provision addresses only personal loans between a company and its directors and executive officers (typically, those officers that are subject to Section 16 of the Exchange Act). It should not be construed as limiting reimbursements for business and other related expenses or the direct payment of such expenses. However, officer relocation loans are prohibited.

In particular, public companies should be aware of three important aspects resulting from Section 402. First, each company should examine its policy with respect to loans to directors and officers enabling them to purchase equity in the company. Second, each company should examine its policy with respect to corporate credit cards to make certain that its officers do not use corporate credit cards for personal purchases for which such officers repay the company at the end of a given month. Finally, certain traditional compensation arrangements that have become common place, such as split dollar insurance policies and company-assisted cashless exercises of stock options, must be evaluated to determine whether they could be deemed to be an extension of credit under the Act.

*Effective Date:* July 30, 2002.

## ***Accelerated Section 16 Reporting***

The Act significantly alters the reporting burdens for directors, executive officers and 10% shareholders by shortening the time period for filing statements of changes in ownership under Section 16 of the Exchange Act. Changes of beneficial ownership reported on Form 4 will be required to be filed by the end of the second business day following the execution of a transaction (as opposed to the current rule requiring such reports to be filed by the tenth day of the month following the month in which the transaction occurred). The SEC is authorized to extend or modify this new deadline, but to date it has not suggested it will do so, other than on a very limited basis, such as transactions pursuant to a single order that are executed over a number of days.

In addition, beginning not later than July 30, 2003, such beneficial ownership reports will be required to be filed electronically via the SEC's EDGAR filing system. Also, companies maintaining web sites will be required to make the information available on their web sites no later than the end of the business day following the day the report is filed with the SEC.

It is important to note that this provision does not affect the timing of filings required to be made on Form 3 upon an individual initially becoming a Section 16 reporting person. In addition, the SEC is likely to mandate that certain transactions now reported on a year-end Form 5 be reported immediately on a Form 4. We will inform you if and when any such revisions are made to Section 16. In light of the shortened timeframe set forth above, companies should review their insider trading policies and procedures to ensure that they will be able to assist their directors and officers in complying with the Act's accelerated reporting obligations.

*Effective Date:* August 29, 2002 (except as otherwise indicated with respect to filing forms via EDGAR).

### ***Rules Relating to Audit Committees***

Section 301 of the Act sets forth requirements relating to the audit committees of public companies that, if not complied with, could result in the delisting of the securities of such companies from the New York Stock Exchange, AMEX or NASDAQ.

**Responsibilities.** The Act requires that the audit committee of the board of directors be directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by the company for the purpose of preparing audit reports. The registered public accounting firm is required to report directly to the audit committee.

**Member Independence.** The Act requires that each member of the audit committee be "independent." To be deemed "independent" for purposes of this provision, an audit committee member may not: (a) accept any consulting, advisory or other compensatory fee from the company other than for service as a member of the board; and (b) be an affiliated person of the company or any of the company's subsidiaries. The Act permits the SEC to provide an exemption to the "independent" requirement on a case by case basis.

**Complaints.** The Act provides that each company's audit committee is required to establish procedures for handling complaints received by the company regarding accounting, internal accounting controls or auditing matters and for confidential, anonymous submissions by employees of the company of concerns regarding questionable accounting or auditing matters.

**Advisors and Funding.** In furtherance of its responsibilities, the Act gives the audit committee the authority to engage independent counsel and other advisors. Also, it requires the company to provide appropriate funding, as determined by the audit committee, for payment of compensation for the engagement of the registered public accounting firm and for the employment of any advisors selected by the audit committee.

Congress clearly intended that audit committees have significantly greater responsibilities and authority than has been customary. To meet these responsibilities and assume such authority, an audit committee may determine that it is necessary or appropriate to retain counsel or other advisors for assistance. In many cases, audit committees must amend their charters to reflect these additional responsibilities and authority, adopt

procedures to ensure the continued independence of committee members and establish policies and procedures for handling complaints.

It is important for public companies to note that in addition to the requirements under the Act, the NYSE and NASDAQ have proposed separate rules regarding the composition and functions of audit committees. Included in such proposals are more stringent definitions of "independence" and more specific responsibilities that must be undertaken by audit committees. Such proposals have not yet been adopted, but when they are, they will likely require companies to modify their audit committee charters and other procedures. Until such time, we recommend that companies comply with the Act's requirements and monitor the NYSE and NASDAQ rulemaking notices.

*Effective Date:* July 30, 2002 (however, SEC rules regarding the delisting of non-compliant companies are not due until April 26, 2003).

### ***Whistleblower Protection***

Section 806 of the Act provides whistle-blower protection against retaliatory discharge of or other adverse employment action against employees of public companies who lawfully provide information to their supervisors, agencies of the U.S. government or Congress regarding conduct that the employee reasonably believes violates U.S. securities or antifraud laws. The Act also provides protection to employees who testify at, participate in or file certain securities or antifraud proceedings. An employee whose rights are violated under this provision will be entitled to seek relief, including reinstatement, back pay and special damages, such as attorney fees and litigation costs. The protection afforded by the Act also applies to any contractors, subcontractors or agents of the company.

Companies should conduct a thorough review of their personnel policies in light of the enactment of Section 806, and changes should be made to such policies in order to comply with the Act's requirements. It is not clear how this provision will apply to non-U.S. companies, but it seems likely that the provision will be subject to future interpretation and rulemaking.

*Effective Date:* July 30, 2002.

### ***Forfeiture of Compensation Due to the Restatement of Financials***

Section 304 of the Act requires the forfeiture of certain compensation received by the CEO and CFO of a public company if an accounting restatement is required due to the material noncompliance of the company, as a result of misconduct, with any financial reporting requirement under the securities laws. Specifically, the CEO and CFO will be required to reimburse the issuer for:

- any bonus or other incentive-based or equity-based compensation; and
- any profits realized from the sale of the company's securities,

received during the 12-month period following initial publication of the financials that were restated. The SEC is authorized to exempt any person from this provision as it deems necessary and appropriate.

While the punishment for a violation of Section 304 can be significant, CEOs and CFOs should rest assured that restatements that do not result from misconduct are not within the scope of this provision. Accordingly, restatements of financials not involving misconduct should not subject CEOs and CFOs to this provision.

*Effective Date:* July 30, 2002.

### ***Benefit Plan Blackouts***

Section 306 of the Act makes it unlawful for a director or executive officer of a public company to purchase, sell or otherwise acquire or transfer any equity security of the company during any blackout period relating to that security. This provision only applies to equity securities acquired by a director or executive officer in connection with his or her service or employment as a director or executive officer. Subject to certain exceptions, a blackout period is any period of more than three consecutive business days during which at least 50% of the participants or beneficiaries of all of the company's individual account plans (generally, 401(k) plans, profit-sharing plans and other defined contribution plans) are precluded from purchasing or selling their interests in any equity security of the company held in such plans. Any profits realized on trades in violation of the Act are recoverable by the company. An action to recover the profits resulting from prohibited transactions may be brought either by the company or, on a derivative basis, by any shareholder if the company fails to do so within 60 days after the date of a request to do so or if the company fails to prosecute any such action diligently. Such action must be brought within two years after the profit was realized.

Exemptions may be made available by the SEC, including exemptions for purchases under an automatic dividend reinvestment program or purchases made under an advance election. The company is required to timely notify the SEC and any director or officer subject to a trading ban during a blackout period of such blackout period. Plan administrators are also mandated to provide 30 days' prior written notice to plan participants regarding blackout periods. The Secretary of Labor is authorized to assess civil penalties against plan administrators of up to \$100 a day from the date of an administrator's failure to give proper notice.

The SEC and Department of Labor are directed to issue clarifying regulations in the future.

*Effective Date:* January 26, 2003 (from such date until the issuance of regulations under Section 306, good faith compliance will be treated as compliance).

### **Overview of Other Provisions of the Act**

The Act also includes the following provisions of which you should be aware:

#### ***Public Company Accounting Oversight Board***

**Creation of Oversight Board.** The Act creates a Public Company Accounting Oversight Board to oversee and regulate auditors of public companies and establish auditing, quality control and ethics standards for such auditors. The Oversight Board is to consist of five members, each to be appointed by the SEC in consultation with the Federal Reserve Board and the Treasury Department. The initial appointments must be made by October 28, 2002, and the members of the Oversight Board will serve staggered five-year terms with a two-term limit. Members will be required to serve on a full-time basis. The Oversight Board must be certified by April 26, 2003.

**Registration with Oversight Board.** Under the Act, an accounting firm may not conduct an audit of a public company unless the firm is registered with the Oversight Board.

**Auditing Standards.** The auditing standards that are established by the Oversight Board must require that each accounting firm prepare audit work papers to support the conclusions in the audit reports, and such audit work papers must be maintained for a period of not less than seven years. In addition, the Act requires a concurring or second partner review and approval of audit reports and a description in each audit report of the scope of the auditor's testing of the internal control structure and procedures of the issuer.

**Inspections and Investigations.** The Oversight Board will conduct annual and special inspections of registered accounting firms to assess the degree of compliance with the Act, and it will also have the authority to conduct investigations of any acts or practices of registered accounting firms. The Oversight Board will report its findings to the SEC and each appropriate state regulatory authority, and it may begin a formal investigation or take disciplinary action.

**Sanctions.** The Oversight Board will be authorized to impose both monetary and non-monetary sanctions, including: (a) the temporary suspension or permanent revocation of Oversight Board registration; (b) the temporary or permanent suspension of a person from further association with the firm; (c) the temporary or permanent limitation on the activities of a registered firm; and (d) a penalty for each knowing and intentional violation (up to \$750,000 for an individual or \$15,000,000 for a firm).

**Foreign Accounting Firms.** Foreign public accounting firms that prepare or furnish audit reports for public companies are required to register with the Oversight Board and will be subject to the Act.

**Funding of Oversight Board.** The Oversight Board will be funded by registration fees charged to accounting firms and annual accounting support fees from public companies, which will generally be based on relative equity market capitalization over specified periods.

### *Auditor Independence*

**Non-Audit Services.** The Act prohibits a registered public accounting firm from providing any enumerated "non-audit" services to a company contemporaneously with its conducting an audit. Such prohibited non-audit services are:

- bookkeeping or other services related to the accounting records or financial statements;
- financial information systems design and implementation;
- appraisal or valuation services, fairness opinions or contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker/dealer, investment adviser or investment banking services;

- legal and expert services unrelated to the audit; and
- any other service the Oversight Board determines to be impermissible.

An accounting firm providing audit services may perform non-audit services, such as tax services, which are not enumerated above only after the activity is approved in advance by the audit committee of the company or the Oversight Board grants an exemption from the prohibition.

**Pre-Approval.** The Act provides that, subject to certain *de minimis* exceptions, the audit committee of any company must pre-approve all auditing and non-audit services to be provided to the company, and such pre-approval must be disclosed to the public.

**Audit Partner Rotation.** The Act makes it unlawful for a registered accounting firm to conduct an audit of a public company if either the lead (or coordinating) audit partner (having primary responsibility for the audit) or the audit partner responsible for reviewing the audit performed any audit services for that company in each of the previous five years.

**Reports.** Registered public accounting firms that perform audits must now submit reports to the audit committees of public companies setting forth information relating to, among other things, critical accounting policies and practices and alternative treatments of financial information within GAAP.

**Conflicts.** The Act prohibits a registered public accounting firm from performing any auditing services if a CEO, controller, CFO, chief accounting officer or any person serving in a similar capacity for the company was employed by that accounting firm and participated in any capacity in the audit of that company during the one-year period preceding the date of the initiation of the audit.

**Study of Mandatory Rotation.** The Act requires the U.S. Comptroller General to conduct a study of the potential effects of requiring the mandatory rotation of registered public accounting firms with respect to their engagement by companies. The results of such study are due by July 30, 2003.

**Effectiveness.** Although most of the above provisions became effective on July 30, 2002, they apply explicitly to “registered public accounting firms,” which will not exist until the SEC organizes the Oversight Board (by April 26, 2003) and accounting firms have registered with the Oversight Board (by October 23, 2003). Accordingly, these provisions will not be effective until accounting firms are registered by the Oversight Board.

### ***Corporate Responsibility***

**Fraudulent Influence.** The SEC is directed to adopt rules that will prohibit any director or officer of a public company, or any other person acting under the direction of such a director or officer, from taking any action to fraudulently influence, coerce, manipulate or mislead any accounting firm engaged in the performance of an audit for such company for the purpose of rendering the statements materially misleading. The SEC has the authority to enforce this section through civil actions. The SEC must propose such rules by October 28, 2002, with final rules to be in effect by April 26, 2003.

**Officer and Director Bars.** Effective immediately, the Act broadens the SEC’s power to prohibit individuals from serving as officers or directors of public companies by reducing the standard for the SEC to bar an individual serving in such a capacity from “substantially unfit” to “unfit.” The Act also empowers the

SEC to remove directors and officers in cease-and-desist proceedings, which are faster than the judicial approvals the SEC was required to obtain.

### ***Enhanced Disclosure***

**Disclosure of Material Correcting Adjustments, Off-Balance Sheet Transactions and Pro Forma Figures.** Effective immediately, the Act amends Section 13 of the Exchange Act to require that each financial report filed with the SEC reflect all “material correcting adjustments” identified by a registered public accounting firm. In addition, the Act directs the SEC to issue rules requiring disclosure of “all material off-balance sheet transactions” and relationships of the company and unconsolidated entities or other persons that may have a material current or future effect on, among other things, the company’s financial condition. The Act also directs the SEC to issue rules prohibiting presentation of pro forma financial information in any periodic report filed with the SEC or in any public disclosure or press release unless the pro forma information is reconciled to the company’s financial condition and results of operations prepared in accordance with GAAP. The SEC is required to issue final rules with respect to off-balance sheet transactions and pro forma figures by January 26, 2003.

**Increased Frequency of SEC Review.** The Act requires the SEC to review the periodic reports of public companies at least once every three years. The Act sets forth certain review criteria to be considered in the scheduling and determining the frequency of reviews, including a company’s market capitalization, volatility in stock price, material restatement of financial results, emerging companies with disparities in price-to-earnings ratios and operations that significantly affect a material sector of the economy. This provision became effective July 30, 2002.

**Real Time Disclosure.** Section 409 of the Act requires companies to disclose in “plain English” and “on a rapid and current basis” material changes in financial condition or operations as may be required in future SEC rules. This provision is a significant departure from prior law, which gave companies flexibility in timing the disclosure of material developments. The significance of this provision will depend in large part on the final rules adopted by the SEC. In June 2002, the SEC proposed to expand the items to be reported on Form 8-K from six to 19 and to accelerate the Form 8-K reporting deadline to two business days after occurrence of the reportable event. Based on Section 409, we expect the SEC to adopt most, if not all, of its proposed requirements. To date, plain English disclosures have only been mandated in filings under the Securities Act of 1933 (*e.g.*, registration statements). Section 409 may extend the plain English disclosure requirement into some Exchange Act filings. No date has been specified for the adoption of any such rules.

**Internal Controls.** Under the Act, the SEC must adopt rules requiring each annual report to include an “internal control report” prepared by management that states management’s responsibility to establish and maintain an adequate internal control structure and procedures for financial reporting. The report must also contain an assessment, as of the end of the last fiscal year, of the effectiveness of such internal control structure and procedures for financial reporting. Management’s assessment of the internal control report must be attested to by the registered public accounting firm preparing the audit report for the company. No date has been specified for the adoption of any such rules.

**Code of Ethics.** The Act requires the SEC to adopt by January 26, 2003 rules requiring each company to disclose in its periodic reports whether it has adopted a “code of ethics” for senior financial officers. A code of ethics must have standards that promote (a) honest and ethical conduct, (b) full, fair, accurate, timely and understandable disclosure in periodic reports, and (c) compliance with applicable governmental rules and regulations. If the company fails to adopt or maintain such code, the disclosure must set forth the reasons for such failure. The Act also directs the SEC to revise its regulations concerning matters requiring prompt

disclosure on Form 8-K to require immediate public disclosure of any change in or waiver of the code of ethics.

**Disclosure of Audit Committee Financial Expert.** The Act directs the SEC to issue rules that require each public company to disclose in its periodic report whether the board's audit committee has at least one member who is a "financial expert." The Act provides certain criteria for considering someone to be a financial expert. Such rules must be implemented by January 26, 2003.

### *Analyst Conflicts and Increased Appropriations for Enforcement*

**Analyst Conflicts of Interest.** The Act requires that by July 30, 2003, the SEC (or at the SEC's direction, an appropriate self regulatory organization (SRO)) shall have adopted rules designed to address conflicts of interest that arise when securities analysts recommend equity securities in research reports or public appearances. The rules will be designed to improve the objectivity and independence of analyst research and to foster greater public confidence in such research. Specifically, the rules will be required to:

- restrict the ability of investment bankers to pre-approve research reports;
- limit the supervision and compensatory evaluation of analysts to employees who are not engaged in investment banking activities;
- prevent retaliation against analysts by employers as a result of such analysts' writing a negative research report;
- establish blackout periods for brokers or dealers participating in a public offering during which they may not publish or distribute research reports relating to the relevant security; and
- establish institutional safeguards to assure that analysts are separated by informational barriers within the firm to prevent judgment bias.

The SEC is also required to create rules that will require securities analysts to disclose conflicts of interest that exist at the time of any public appearance or on the date of distribution of a research report.

**Appropriations for Enforcement.** The act provides substantial funding for the SEC, including an appropriation for hiring at least 200 additional individuals to provide enhanced oversight of auditors and to improve the investigative and disciplinary efforts of the SEC.

### *Criminal Provisions*

The Act includes additions to and enhancements of federal "white collar" and other criminal statutes, including the following:

**Altering Documents.** The Act imposes fines and/or imprisonment of up to 20 years on anyone who knowingly alters, destroys or falsifies documents with the intent of impeding, obstructing or influencing an investigation. Auditors are required to maintain all audit or review workpapers for five years (even though the Oversight Board rules will require that such reports be maintained for seven years) after the relevant audit

is concluded. Any auditor who knowingly and willfully fails to maintain such workpapers is subject to fines and up to 10 years imprisonment.

**No Bankruptcy Discharge.** Effective immediately, the Act amends the bankruptcy code by providing that debts incurred as a result of a debtor's violation of securities laws are nondischargeable.

**Securities Fraud Statute of Limitations.** The Act extends the statute of limitations in private securities fraud actions to the earlier of two years after the discovery of the fraud or five years from the date the fraud occurred.

**Review of Federal Sentencing Guidelines.** The Act requires the United States Sentencing Commission to review and revise the Federal Sentencing Guidelines to ensure that the penalties for destruction of documents, obstruction of justice and securities and accounting fraud and related offenses are sufficient. It also requires the Sentencing Commission to review and revise the Guidelines to better reflect the serious nature and growing incidents of serious "white collar" offenses.

**Defrauding Shareholders of Public Companies.** The Act expands the federal mail fraud statute by making it a crime to knowingly defraud or attempt to defraud any person in connection with any security of a public company. The penalty for a conviction includes a fine and/or up to 25 years of imprisonment.

**Attempts and Conspiracies.** The Act establishes a conspiracy action that can be brought against any person who attempts or conspires to commit any securities fraud, and such person will be subject to the same penalties as if the attempt or conspiracy had been successful.

**Mail and Wire Fraud.** The Act increases the maximum penalty for mail and wire fraud from five to 20 years imprisonment.

**ERISA Violations.** The maximum fine for criminal violations of ERISA by an individual is increased from \$5,000 to \$100,000 and the maximum jail sentence is increased from one year to 10 years. For violations committed by businesses, the maximum fine is increased from \$100,000 to \$500,000.

### ***Corporate Fraud and Accountability***

**Tax Returns.** The Act now requires that a company's federal income tax return to be signed by its CEO.

**Temporary Freeze of Payments.** Any "extraordinary payments" proposed to be made by a public company to any of its directors, officers and certain other affiliated parties during the course of an investigation of the company for possible security law violations can be temporarily frozen. A federal court, upon petition by the SEC, is authorized to freeze such payments for up to 45 days (subject to an additional 45-day extension) in an interest-bearing account. If the individual affected by the order is charged with a securities law violation within the 45- or 90-day period, the escrow can continue, subject to court approval, until the conclusion of any legal proceedings. This provision became effective immediately upon enactment.

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