THOMPSON HINE

Business Law Update

Fall 2017

Business Perspectives

Rebound: M&A After the Fall

By Frank D. Chaiken, Practice Group Leader, Corporate Transactions & Securities

Sometime in the next year we will reach the 10th anniversary of the start of the Great Recession. I took over as practice group leader of Thompson Hine's Corporate Transactions & Securities practice group at about that same time. The financial crisis created significant challenges – and opportunities – for our clients and for our firm. It seems appropriate at the 10-year mark to reflect on what has changed, and what has not, during that period, and on how our firm's Corporate practice has adapted to these market conditions.

Middle-market and upper middle-market mergers and acquisitions certainly have been a mainstay over the past decade. Several complementary factors have fueled the strength of the M&A practice and, barring another systemic shock, there are no obvious signs of it abating anytime soon.

Immediately following the crash, government policy, in the form of sustained record-low interest rates and other measures, such as quantitative easing, helped assure access to credit for our clients. Public and private companies with strong financials were able to obtain credit to execute their strategic growth plans. Private equity funds also grew dramatically during this period as many had capital and credit available in the early years of the crisis with which to take advantage of the initial decline in company valuations.

Continued low interest rates and increased market liquidity led to record amounts of debt and equity available for acquisitions, the overhang of so-called "dry powder." This in turn led to steadily increasing company valuations and competition for deals. Many business owners who

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For more details on any of the topics covered in this *Business Law Update*, please contact the authors via the links at the end of each article or David R. Valz, editor-in-chief. For information on our Corporate Transactions & Securities practice, please contact Frank D. Chaiken, practice group leader.

delayed their retirement and business transition plans as a result of the initial decline in values gradually reentered the market as prices rose.

All this growth had a flip side. In both the early and later stages of this M&A cycle, our clients, and we along with them, had to adapt our approaches to transactions. In response to initial cost cutting and staffing constraints, we all were trying to do more with fewer resources. Clients' deal teams were stretched; they likewise challenged us to do more with less and find ways to reduce transaction costs. The current climate demands even more from law firms. Faced with the run-up in valuations and increased competition for deals, clients increasingly place a tremendous premium on speed of execution, cost-efficiency and risk sharing.

Our firm has responded accordingly. A while back my partner Tony Kuhel and I published an article on the use and growth of legal project management approaches in M&A titled "M&A Transactions a Natural Fit for Legal Project Management." These insights have only grown in importance in the intervening years.

We have implemented a firmwide policy that requires all M&A transactions to be managed under budgets developed using our SmartPaTH® legal service delivery model. SmartPaTH allows us to plan the engagement for maximum efficiency, deploying staff at the right level for each task. We also are able to break down a transaction into its component phases (e.g., letter of intent, due diligence, negotiation and drafting, closing, post-closing) and to price each phase accordingly. This is especially useful in the current competitive environment, where a client may not make it into successive rounds of bidding for a transaction. We are continuing to build our database of transaction experience, categorized by deal size and type, which furthers our ability to develop more accurate and reliable budgets. In this way we plan to remain well-positioned to respond to current and future market demands for legal services in the M&A arena.

A related trend has been diversification in the choice of legal services providers. Our firm, for example, maintains a strong presence in major commercial and financial centers such as New York and Washington, D.C., while our center of gravity (and much of our overhead) remains in the Midwest. This, combined with our project management approach and tools we have developed to advance predictability and efficiency, affords us flexibility to handle transactions in a wide range of values, including large-scale deals exceeding $1 billion in value that formerly may have been handled by other firms.

Our Corporate practice has witnessed other notable developments stemming from the events of 2008, many of which already were well underway at that time: increased demand for contract management and negotiation services; tremendous growth in digital and other new business models; rise of venture-style investing outside the coastal markets; innovation in the investment management industry and financial products; evolution of public securities markets and corporate control contests in response to market conditions and regulatory changes; developments in the provision of health care products and services; growth in cross-border activity, especially in M&A; changes in trade and other government policies; and increased interest in alternative staffing and working models for lawyers. Our practice continues to evolve in response to these developments, and we see opportunities to deploy our SmartPaTH approach in all of them.

Frank Chaiken leads the firm's highly regarded Corporate Transactions & Securities practice, which comprises more than 100 professionals who represent clients of all sizes across virtually every industry. If you have questions or would like to share your thoughts on how things have changed for you since the recession, please contact Frank at 513.352.6550 or Frank.Chaiken@ThompsonHine.com.

Mergers & Acquisitions

Caveat Emptor: Key Considerations for Acquiring a Business

By William M. Henry and Courtney A. Flowers*

The role of the M&A lawyer is to step in and "paper the deal": The client has already decided to buy a company, and the lawyer's job is to draft the purchase agreement and get the deal done. However, one of the benefits of being an M&A lawyer is the sheer volume of transactions we see, which presents an opportunity to learn from myriad successful companies and acquisitions as well as various not-so-successful ones. In that vein, the purpose of this article is to highlight some of the key patterns and considerations (setting aside the supreme consideration: purchase price!) we've observed in connection with acquisitions. While the weight of these considerations can vary across buyers and deals, they should be taken into account with each buyer and each deal.

Contracts With Customers and Employees

While this article does not address the scope of legal diligence considerations (we will leave that for another day), we do note that with regard to contracts, in successful companies, patterns quickly emerge. First, think about how the target company negotiates and abides by its contracts with its customers. Specifically, does it insist on longer terms (with limited termination rights) or accept shorter terms (in exchange for some other benefit, such as higher pricing)? Once a contract is executed, does the company hold customers to payment terms, or does it often go "off contract" and grant discounts to customers? Second, although it's unavoidable in certain industries where there are only a few, big customers (e.g., the automotive space), a company whose top five customers constitute 90 percent of revenue or more faces significant risks if its contracts are not long-term and locked in. Regarding employees, especially for companies in technology-based industries, consider whether key employees have work-for-hire, non-competition and/or non-solicitation agreements. Companies that allow key individuals to develop software or other intellectual property and then take that intellectual property to a competitor do so at their peril.

Management

Whether your client is a strategic or private equity buyer, time and time again, one of the foremost considerations is the quality of the target company's management. Successful acquirers ask the following question when evaluating the relationship between the company's success and its management: Is the company successful *because of*, or *in spite of*, its leadership? A buyer's thoughtful assessment of the quality of the company's leadership will include determining its management style and willingness to support your goals as the buyer. Find ways to integrate current management into the process to illuminate and mitigate issues that could otherwise hold up the deal or result in inconvenience, liability or losses down the road. Key questions include: Is the management team organized? Do they get along? What are their short- and long-term goals? Are they onboard with the notion of being acquired or will egos get in the way?

Organizational Culture

Though it may seem like a "soft" or inconsequential detail, a target company's culture is vital to its potential as a successful acquisition. A culture dominated by short-cuts or sloppiness will be marked by slow response times when seeking records, a lack of quality control procedures (as discussed below), an absence of timely employee evaluations or other indications the company doesn't encourage organizational growth. Further, other indicators such as employee turnover rates, employee evaluations and employee complaints often reveal how satisfied employees are. Additionally, read between the lines when tracking employee benefits and pensions. You want to look at these not only to get a sense of liability—for example, are the benefit plans consolidated between different entities or is there a mess of complex plans?—but also to infer how loyal employees will be in light of an acquisition. Unsatisfied employees with poor benefits may be less likely to put up with the sweeping changes that often accompany an acquisition.

Regulations

More applicable for highly regulated businesses (health care and food industries among them) or for international acquisitions, consider the additional risk, time and costs associated with regulatory and statutory compliance post-acquisition. For instance, in highly regulated industries, is there a nuance in the target's business that will require an entirely different set of permits or subject you to completely new regulations? In international acquisitions, what are the accounting standards, labor laws or other regulations (e.g., environmental, health care) that inhere in the new market? Failing to understand these challenges at the outset can cause meaningful growing pains post-acquisition.

Reporting

Red flags often appear when a buyer delves deeply into accounts and reporting. If the company is a manufacturer, you want to investigate its work in progress (WIP) reporting practices. If it deals in services or licensing, you want to make sure the company is recognizing revenue appropriately. Additionally, new revenue recognition guidelines such as ASC 606 are coming soon; is the company on top of these industry standards and requirements? If not, not only might you wind up with expensive business costs as you attempt to fix problems, but you might also be stuck in lengthy, costly litigation as you try to recover from noncompliance sanctions. If auditors have observed material weaknesses or gaps in financial reporting, the numbers may be inflated and the company might not be as great as it first appeared.

Organizational Structure and Internal Controls

You can discern compliance risks from the structure and organization of the company. Also, look at the company's approach to segregation of duties: Are there redundancies or gaps in management? What are the internal controls to promote accountability and reliability? Successful companies often have established quality control procedures and methods for receiving complaints, from employees and customers alike. Companies that don't have such procedures and methods in place are not only unable to report problems they're not aware of, they also leave themselves (and by corollary, the buyer) open to potential sanctions, lawsuits or criminal charges. In a business showing signs of, say, sexual

harassment issues, unethical supply chain practices, lackadaisical or noncompliant accounting, undocumented corporate decisions or disorganized records, there will likely be ongoing post-closing risks even if a smart buyer has robustly indemnified itself in the purchase agreement.

A buyer's diligence can seem (to both the buyer and the target company) unending. The above considerations represent a list of key issues that can help a buyer contemplate how the target fits in with its plans and priorities. The best way to minimize cost and risk is to truly understand the business you are buying. Without question, when it comes to acquiring a company, what buyers don't know can hurt them.

With any questions, please contact Will Henry.

**Courtney is not admitted to practice in Ohio. Her practice is supervised by principals of the firm.*

Investment Management

SEC Risk Alert Highlights Cybersecurity Compliance Risks of Broker-Dealers, Investment Advisers and Fund Companies

By Richard S. Heller and Susan D. Kim

The Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) recently issued a Risk Alert highlighting its observations from its examinations of 75 firms, including broker-dealers, investment advisers and fund companies registered with the SEC. The examinations were conducted pursuant to the SEC's previously announced Cybersecurity Examination Initiative. In 2015, OCIE completed its first round of examinations. This second round, conducted between September 2015 and June 2016, examined a different population of firms. The second round of examinations involved more validation and testing of the procedures and controls surrounding cybersecurity preparedness.

OCIE staff focused on the written policies and procedures related to governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response. Notably, in an improvement since its first round of examinations in 2015, OCIE found that all broker-dealers and nearly all advisers examined maintained written cybersecurity-related policies and procedures addressing the protection of customer/shareholder records and information.

OCIE noted that:

- Nearly all broker-dealers and most advisers and funds conducted periodic risk assessments, penetration tests and vulnerability scans, regular system maintenance and vendor risk assessments.
- All firms utilized some form of system or tool to prevent, detect and monitor data loss of personally identifiable information.
- Most information protection programs included relevant cyber-related topics.
- All broker-dealers and most advisers and funds maintained cybersecurity organization charts.

Despite overall advances since 2015, OCIE observed that the vast majority of firms still had some policies that were too general and not reasonably tailored to the respective firm's business. Indeed, OCIE indicated that the use of templates or off-the-shelf manuals is problematic.

Other firms did not appear to adhere to or enforce policies. Lastly, firms struggled with adequate system maintenance, such as the installation of software patches and other operational safeguards.

According to OCIE, best practices include:

- Maintenance of a complete inventory of data, information and vendors, along with classification of risks;
- Maintenance of detailed cyber-security related procedures (e.g., to review the effectiveness of security solutions as part of penetration tests, to track requests for access and to address modification of access rights during onboarding, changing of roles, etc.);
- Maintenance of prescriptive schedules and processes for testing data integrity and vulnerabilities;
- Established and enforced controls to access data and systems;
- Mandatory employee training; and
- Engaged senior staff.

As recent high-profile hacks have shown, cybersecurity remains one of the top compliance risks for financial firms. While the findings of the SEC's Cybersecurity Examination Initiative does not create a regulatory mandate, it provides valuable insight into what may be evolving industry best practices. Effective cybersecurity programs should contain, at minimum, the basic components needed to address the specific deficiencies highlighted in the Risk Alert. The absence of those components in a financial firm's policies and procedures may expose that firm to increased cybersecurity risks. Broker-dealers, investment advisers and funds registered with the SEC would benefit from

considering OCIE's observations in order to assess and improve their policies, procedures and practices. Cybersecurity planning should include maintaining and enforcing detailed policies and procedures, as well as developing rapid response capabilities.

With any questions, please contact Rich Heller or Susan Kim.

Upcoming Events

Central Ohio Franchise Business Network Social
Grove City

Thursday, November 16
5 to 7 p.m.

Please join us for a networking event in the clubhouse at The Courtyards on Hoover (an Epcon Communities Franchising, Inc. community). Come enjoy good company and interesting conversations while enjoying appetizers and beverages. Tours of the model home will also be available.

Attendance is complimentary, but please register by **November 13**. Visit ThompsonHine.com/events for more information or to register.

Sponsored by Epcon Communities, Althans Insurance Agency, Inc., Donatos and Thompson Hine

Professional Conduct Seminar
Cincinnati

Wednesday, December 6
2:15 to 4:45 p.m.

Thompson Hine invites you to attend a complimentary professional conduct seminar. Topics will include:

Too Much of a Good Thing: The Professional Limits of Entrepreneurialism
Robert Johnson, Partner, Thompson Hine

Ethics Considerations in Government Contracting
Tom Mason, Partner, Thompson Hine

Ethics & Professionalism in Elections, Politics & Government
Pavan Parikh, Legislative Counsel & Governmental Relations Officer, Federal Home Loan Bank of Cincinnati and Adjunct Professor, Xavier & University of Cincinnati College of Law

CLE: 2.5 hours of professional conduct credit has been requested in Indiana, Kentucky and Ohio.

Please visit ThompsonHine.com/events for more information or to register.

International Trade

CFIUS Annual Report Reflects Increased National Security Scrutiny of Foreign Acquisitions

By David M. Schwartz, Samir D. Varma and Scott E. Diamond*

The Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee headed by the Department of the Treasury, is authorized to review mergers, acquisitions or takeovers that could result in a U.S. business being owned or controlled by a foreign person or company. Once a little-known committee, CFIUS has become more widely recognized in the past decade amid growing concern over foreign investment in the United States and any resulting potential national security concerns. In fact, in September 2017, President Trump took the rare step of blocking a transaction: the proposed acquisition of Lattice Semiconductor Corporation by Canyon Bridge Capital Partners LLC, a subsidiary of Chinese state-owned China Venture Capital Fund Corporation Limited. Such a move indicates that the involved parties were unable to allay the national security concerns of CFIUS's agency members. It further highlights the president's "America First" outlook and the likelihood that CFIUS reviews will become more common and stringent under the current administration.

The recently released CFIUS 2015 Annual Report to Congress indicates the following trends:

- In 2015, 143 transactions were reviewed by CFIUS, continuing the upward trend since 2009, when 65 notices were filed. Further, it is believed that filings increased again in 2016, and that 2017 will be a record year with over 200 filings.
- In 2015, 42 percent of reviews were conducted for industries in the Manufacturing Sector; 32 percent in the Finance, Information, and Services Sector; 18 percent in the Mining, Utilities, and Construction Sector; and 8 percent in the Wholesale Trade, Retail Trade, and Transportation Sector.
- For the fourth consecutive year, China led foreign countries in the number of CFIUS reviews, with 29 conducted in 2015. Over the three-year period from 2013 to 2015, Chinese investment in U.S. companies underwent 74 CFIUS reviews; the next closest country was Canada with 49 reviews, followed by the United Kingdom with 47 reviews.
- While the majority of reviews conclude with approval by CFIUS, in 2015 the parties to 11 transactions had to agree to and adopt mitigation measures to address foreign ownership concerns and to remove any national security risks. This included establishing specific security protocols, notifying customers of foreign ownership, assuring the U.S. government of continued supply of goods or services and, in at least one instance, excluding sensitive assets from the transaction.
- Finally, the annual report must highlight any "perceived adverse effects" of transactions reviewed by CFIUS, and the 2015 report for the first time indicates there could be national security concerns regarding potential acquisitions of U.S. companies that hold "substantial pools of potentially sensitive data about U.S. persons and businesses that … could be in any number of sectors, including, for example, the insurance sectors, health services, and technology services."

While not stated in the report, the statistics reveal that in 2015, there was an increase in the length of time a transaction remained active and under review before CFIUS. By law, CFIUS must complete reviews within 90 days; however, historically, most transaction reviews have been concluded within the initial 30-day review period. The 2015 data indicate that nearly half of the 143 transactions went into the more formal 45-day investigation period. With continued pressure from Congress over the national security implications of foreign investment in certain segments of the U.S. economy, and calls for further reforms and updates to the relevant CFIUS statutes and regulations, longer review periods are likely to become common.

For more information on the CFIUS notification and review process and how it may impact a merger, acquisition or takeover transaction, please contact David Schwartz, Samir Varma or Scott Diamond.

**Scott is a senior legislative and regulatory policy advisor and member of the International Trade practice group; he is not licensed to practice law.*

Employment Law

An Overview of the New York Paid Family Leave Law

By Jason Carruthers

The New York Paid Family Leave Law (PFLL) has been described as "the nation's strongest and most comprehensive Paid Family Leave policy." When fully implemented, it will provide eligible employees with up to 12 weeks of paid leave for a qualifying event. Although the PFLL does not take effect until January 1, 2018 and will not be fully implemented until 2021, many employers are already taking steps to prepare.

What Is the PFLL?

Under the PFLL, employers are required to maintain family leave insurance funded by employee payroll deductions. At or around the time of a qualifying event, eligible employees submit claims to their covered employer's family leave insurance carrier for payment.

What Is a Qualifying Event?

Generally, eligible employees may use Paid Family Leave for three reasons, or qualifying events:

- To bond with a newborn, foster or adopted child. However, eligible employees must take Paid Family Leave within 12 months of the child's birth or placement.
- To provide care for a spouse, domestic partner, child, parent, parent-in-law, grandparent or grandchild with a serious health condition.
- To assist loved ones with a qualifying military exigency, such as the active-duty deployment of a spouse, domestic partner, child or parent.

Who Is a Covered Employer, Eligible Employee or Covered Family Member?

Employers and human resources professionals will undoubtedly notice that New York's PFLL applies in many of the same circumstances covered by the federal Family and Medical Leave Act (FMLA). The FMLA requires covered employers to provide eligible employees with 12 weeks of unpaid leave in a 12-month period for the birth or placement of a child; to care for a spouse, child or parent with a serious health condition; or to care for the employee's own serious health condition. The FMLA also requires employers to provide eligible employees with 26 weeks of unpaid leave for a qualifying military exigency.

Although there are similarities, coverage under the PFLL is not coextensive with coverage under the FMLA. Generally, the FMLA only applies to individuals or entities who employ at least 50 employees. With few exceptions, the PFLL applies to individuals or entities who employ at least one employee.

Typically, only an employee who has worked for a covered employer at a qualifying worksite for at least one year, and who worked at least 1,250 hours in the 12 months preceding leave, is eligible to take FMLA leave. An employee may gain eligibility for Paid Family Leave after working for a covered employer for less than six months, regardless of how many hours he or she worked during that time. More specifically, under the PFLL individuals who regularly work more than 20 hours per week gain eligibility to take Paid Family Leave after 26 weeks of employment with a covered employer, and those who regularly work less than 20 hours per week become eligible after 175 working days of employment with a covered employer.

Further, the reasons an employee may take leave under the FMLA are slightly different than the qualifying events under the PFLL. Notably, under the PFLL an employee generally may not take Paid Family Leave to care for his or her own serious health condition or for the birth of his or her own child. The PFLL also employs a broader definition of family

member than the FMLA. Under the PFLL an eligible employee may take Paid Family Leave to care for a grandparent, parent-in-law or domestic partner in addition to those individuals covered by the FMLA.

What Are Employers' Obligations?

Although family leave insurance is paid for by employee payroll deductions and employees are responsible for submitting claims, employers still need to prepare. The PFLL requires covered employers to provide employees with notice of their rights under the law. As such, employers are required to update their handbooks and post an appropriate notice of employee rights in a conspicuous place. The PFLL requires employers without written handbooks to provide employees with written notice of their rights.

Covered employers are required to maintain Paid Family Leave insurance funded by employee payroll deductions. An employer should work with its disability insurance carrier to ensure that it has appropriate coverage. In addition, as of July 1, 2017, employers are permitted to take appropriate payroll deductions to fund family leave insurance premiums, and they should work with their payroll processors to ensure that they are prepared to make and track appropriate deductions. Improper deductions include those that exceed the maximum amount allowed by law or that exceed the amount required to fund family leave insurance. An employer also is required to furnish premiums to the family leave insurance carrier. Employers may be liable under the PFLL for failure to maintain appropriate insurance or for making improper deductions.

Employers should ensure their administrators and human resources professionals are familiar with the PFLL. While an employee is required to provide his or her employer with sufficient notice of a qualifying event, at least initially, he or she is not required to expressly invoke the PFLL. In light of this, human resources personnel must be able to identify situations that qualify for leave, charge that leave to the applicable leave entitlement(s) and provide the employee with appropriate notice. Employers are also required to complete certain paperwork when they receive requests for leave under the PFLL and should develop systems to track leave that account for the various reasons why employees may use leave under state and federal law.

To ensure compliance with the PFLL's mandates, employers operating in New York should carefully review their policies, contact their insurance carriers, work with their payroll administrators and train their personnel to implement appropriate procedures and systems.

Please contact Jason Carruthers with any questions.

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