JMBM | Jeffer Mangels Butler & Marmaro LLP
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# CORPORATE LAW NEWSLETTER

## Cloud Computing, Part II

*by Robert E. Braun*

In our winter edition of the JMBM Corporate Law Newsletter, we discussed some of the benefits of cloud computing. While there are a number of advantages which make cloud computing attractive, there are also a number of business and strategic challenges of cloud computing which need to be considered. While these challenges are not unique to cloud computing, the qualities of accessing software and data through the Internet does raise concerns that need to be addressed by users. This article briefly reviews some of those challenges, and will conclude in the next edition of the JMBM Corporate Law Newsletter with legal considerations and resolutions to these challenges.

### What is Cloud Computing?

"Cloud computing" commonly refers to delivering computing services – software, storage capacity or other products and services – over the Internet. We use these products and services regularly, including off-site data storage (such as Internet-based automatic file backup), online banking, Gmail, online search engines and online photo albums. Most of us use the cloud every day, by accessing search engines, social networks and email.

Cloud computing, however, is different. While most of these functions are for convenience, businesses using cloud computing may transfer essential functions from in-house operations to Internet-based services.

### Challenges of Cloud Computing

In our last edition, we discussed some of the advantages of cloud computing, including cost savings, staffing benefits, scalability, mobility, information security and regulatory compliance. However, cloud computing also raises some concerns for business:

*Is Cloud Computing Cheaper in the Long Run?* Because cloud computing negates the need to purchase hardware and operating software, the initial costs are almost always less than setting up a proprietary equivalent from scratch, and lower cost is one of the key drivers to cloud computing, particularly for companies with limited resources. Over time, however, companies may find that their costs may be less or more than an in-house system, particularly since the customer of a cloud provider has little, if any, leverage on fees. That lack of leverage is magnified since, as described below, transferring from a cloud provider may be so difficult or expensive that it is possible to be handcuffed to a particular vendor.

*Flexibility and Termination*. Probably the last thing a potential cloud computing convert thinks of when considering a new provider is what will happen when it's time to end the relationship. Most software users know that it is difficult and expensive to change systems, often requiring operating multiple systems for testing, retraining personnel, and dealing with inevitable problems. However, cloud computing adds an additional complication, since the software and data is in a third party's hands, and remote – often very remote – from the user. The very things that make cloud computing attractive and solution-oriented are the factors that will create complications on termination. This is the case especially if the cloud provider is unable to meet its commitments generally. Consequently, users of cloud computing systems may be handcuffed to their programs.

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## Credit Card Accountability Responsibility and Disclosure Act of 2009 ("Credit Card Act"): New Gift Card Legislation

*by Martin H. Orlick*

More than half (55%) of people asked in a survey requested a gift card as their gift of choice last holiday season. Shoppers, on average, spent $139.91 on gift cards this year and 77.2% of people bought at least one

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# Credit Card Act *continued from page 1*

gift card during the holidays, according to a survey by the National Retail Federation and BIGresearch.

According to the Code of Federal Regulations, "A gift card is a prepaid card that is designed to be purchased by one consumer and given to another consumer as a present or expression of appreciation or recognition. When provided in the form of a plastic card, a user of a gift card is able to access and spend the value associated with the device by swiping the card at a point-of-sale terminal, much as a person would use a debit card. Among the benefits of a gift card are the ease of purchase for the gift-giver and the recipient's ability to choose the item or items ultimately purchased using the card."

> JMBM has been defending retailers in complex gift certificate and gift card consumer class actions for more than a decade.

While gift cards have been successful for retailers in attracting new customers and keeping old ones, implementing them requires retailers to follow state and federal laws which are often complex and conflicting. California and an increasing number of states have already enacted gift certificate and gift card laws restricting transaction, maintenance and dormancy fees and prohibiting expiration. By now, few, if any, retailers sell gift certificates or gift cards that will expire. Some leading retailers have even eliminated dormancy and maintenance fees altogether.

Now in conjunction with these state laws, the recent federal Credit Card Act tightens the restrictions on dormancy, inactivity, and service fees with a particular emphasis on disclosure.

## The Credit Card Act

The Credit Card Act applies to both closed-looped cards, cards that are honored by a single merchant or group of merchants (such as a chain of bookstores), and open-looped cards, cards issued by financial institutions (such as Visa or American Express) and can be redeemed at a variety of merchants who accept the brand. These parameters do not include loyalty reward or promotional program devices that are reloadable and not marketed as a gift card or gift certificate.

Under the Credit Card Act, dormancy, inactivity or service fees for a gift card cannot be imposed unless: 1) there is no activity on the card within the one-year period prior to the imposition of the fee; 2) only one such fee is given out every month; and 3) vendors clearly and conspicuously state the terms and details of the fee. Such conspicuous disclosure of fees imposed must be provided on the card and disclosed prior to purchase with a toll-free number and, if applicable, a Web site which a consumer can use to obtain fee information or replacement cards.

Furthermore, gift certificates, store gift cards, and general-use prepaid cards can no longer expire for at least 5 years from the date of purchase. If there is an expiration date, it must "include a disclosure alerting consumers to the difference between the [gift] certificate or card expiration date and the funds expiration date, if any, and [call out a notice] that the consumer may contact the issuer for a replacement card," according to the Code of Federal Regulations.

These changes will go into effect by federal mandate on August 22, 2010, just in time for the 2010 holiday season. The Credit Card Act will change the way retailers issue and administer gift cards. State laws differ, make sure you are in compliance with current or new gift cards programs.

JMBM has been defending retailers in complex gift certificate and gift card consumer class actions for more than a decade and we have watched the cases and legislation evolve over that time. We invite you to discuss how the Credit Card Act might affect your gift card program with us. ■

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EVENTS

### THE JMBM CORPORATE COUNSEL ROUNDTABLE - YOU ARE INVITED

Once a month, the Corporate Department at Jeffer Mangels Butler & Marmaro LLP hosts an informative breakfast roundtable addressing current issues affecting the corporate world. There is no charge for in-house counsel to attend the MCLE approved Corporate Counsel Roundtable. Complimentary parking and breakfast is provided.

***June 16, 2010 Roundtable: Practical Steps In-House Counsel Can Take To Protect Themselves From E-Discovery***

***This program will feature a roundtable discussion on the practical steps in-house counsel can take to prepare for, be ready to respond to, and minimize the impact of e-discovery demands. The discussion will be led by Bill Capps, Chair of JMBM's Corporate Department, Dan Sedor, Co-Chair of JMBM's Discovery Technology Group, and special guest Michael Pontrelli, Director of Applied Discovery, Inc.*** **If you would like to attend this roundtable, please contact Jessica Hekmatjah at 310.201.3567 or jh7@jmbm.com.**

# The Business Divorce *by Michael A. Gold*

***A longer version of this article was published in the California State Bar Business Law News Issue 1 2010. Reprinted with permission.***

One of the most painful events any business owner can experience is a "business divorce," when partners split up, a key partner dies or leaves on less than cordial terms, or even when a partner leaves and takes the company's confidential and proprietary information. Most people who have been through one of these experiences will agree that it is just like a matrimonial divorce, only without the china and silverware.

As with a matrimonial divorce, a business divorce can be rife with acrimony, egos, emotions, accusations, and expensive and protracted litigation. Often at the conclusion of the business divorce, when the collective balance sheet is tallied up, the divided parts equal far less than the pre-divorce whole.

No matter how well documented the partners' business relationship is, a business divorce can still be nasty and expensive. Partners look for loopholes in the buy-sell agreement, they assert that key provisions are ambiguous, claim financial irregularities, and the richer partner tries to overbear the financially weaker partner. Sometimes partners attempt to destabilize or divert relationships with important third parties in order to ramp up the pressure on the other side. And these actions are frequently undertaken with no strategic plan in mind.

## The Challenge

Sometimes even the most well-drafted agreement is not enough to prevent strife. Without an effective agreement and barring the rare occurrence of a cordial business split-up, the partners can expect the worst in a business divorce.

A bad agreement can be a disaster in a business divorce. Poorly drafted provisions can inject uncertainty into negotiations and in any ensuing litigation. An ambiguous buyout provision, for example, can be the root cause of a fatal division among the partners and lead to litigation, because conflicting interpretations may leave one side with no practical alternative to accepting what he perceives to be an unfair result. How can this worst-case scenario be eliminated or ameliorated before the fact? With a thoughtful, well drafted agreement that clearly addresses all of the inflection points of the partners' business relationship and accounts for all of the predictable "life events" in a company's existence.

## The Key Provisions

Does all of this mean that the agreement must be a work of art in order to be an effective tool in a business divorce and a deterrent to mischief? No, it does not. But, there are certain "inflection points" that should be addressed in the agreement and drafted with clarity and precision.

*Control Features:* The partners should be clear about governance of the company. Especially in companies with an even number of partners, an agreement with no mechanism for surmounting a deadlock is a recipe for expensive disputes. A deadlock breaking mechanism can also be critical if one partner dies or becomes disabled and the other partner now has a new "partner"—a conservator, trustee, executor, or administrator.

*Estate Planning Provisions:* Many agreements contain a provision that permits the company or the other partners to buy a deceased partner's interest in the company. These same agreements also permit a partner to transfer his or her interest to an estate planning vehicle, such as a living trust, where the trustee then effectively becomes the partner. What happens when the partner who transferred his interest to a trust dies? There is often no compulsory sale of "his" shares because the trustee who became the new partner has not "died." The company is then left with a shareholder or partner who is a mere stakeholder and prays no productive role in the company. Hence, care must be taken to connect all of the dots in an agreement's estate planning provisions.

*Buy-Out Triggers:* Death and disability are the obvious triggers and routinely appear in agreements. But these may not be enough. What about a partner's divorce or bankruptcy? What if the partner is charged with or convicted of a moral turpitude felony? What happens if the partner is also an employee and is not performing? The latter trigger—poor performance—is frequently omitted from agreements, in part because it is an unpleasant subject and can be very difficult to craft with enough precision to give the provision the requisite bite. The company can fire the partner/employee but is stuck with him as a stakeholder, where the other partners continue to owe him fiduciary duties and must respond to inspection rights if they are asserted.

*Valuation and Payment Mechanisms:* There are any number of valuation methodologies, including adjusted book value, a fixed price, a formula, and fair market valuation with a discount for lack

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of control or illiquidity. Why is it then that valuation causes so many problems? Sometimes, it is because the mechanism adopted provides a patently unfair or unworkable result. In other cases, the valuation provision is ambiguous or vague. Sometimes the parties do not foresee that the company may not have enough cash to effect the buyout in one lump sum or is prohibited from doing so by Code § 500 (limiting distributions to stockholders), and the parties did not include a provision for a cash down payment and a promissory note or some other mechanism for adjusting payment terms based on the financial condition of the company. Partners also need to address funding mechanisms other than the company's cash flow, such as life insurance, which if purchased early enough in the company's life when the partners are young(er), can be a cost effective way to provide for the purchase of a deceased partner's interest. Attention should be paid to who will foot the expense of the valuation process, which can be costly.

*Protection from Former Owners:* Partners often overlook the need to protect the company from a partner once he or she is expelled from the company. It surprises business owners to discover that when a partner is bought out or pushed out and he is paid a pre-negotiated (fair) value for his interest, he can compete with the company in the absence of an effective non-competition provision. The absence of a post-buyout competition restriction can be ruinous for the company when the expelled partner is a skilled operative and may have the ability to quickly start a competing business or contribute his expertise to an existing competitor. While Business & Professions Code § 16600 et seq. generally prohibits any agreement that restricts a person from engaging in a lawful trade or business, it does not prohibit a noncompetition provision in an agreement when attached to the buyout of all of a partner's interest in an entity.

*Remedies:* Many agreements have no dispute resolution provisions, and those that do either have a short "standard" arbitration provision or a provision that requires all disputes to be resolved in superior court. This shortsighted drafting can often have the effect of pushing the partners into litigation when they should be talking. Worse, many partners do not fully understand the consequence of an arbitration provision and the finality of that dispute resolution mechanism. It often comes as a shock that mandatory arbitration of claims with uncertain but potentially high value and unpredictable outcomes will not be subject to appeal. Hence, more thought should be given to longer form alternative dispute resolution provisions that are crafted with the specific issues of a business divorce in mind, including even judicial references, which permit a private trial with retired judge and still afford the parties the right to appeal.

> Poorly drafted provisions can inject uncertainty into negotiations and in any ensuing litigation.

*Spousal Consents:* Despite the impact of community property laws, agreements often have no spousal consents. Such agreements produce interesting consequences in marital dissolution cases when the partner's spouse claims that the agreement is unfair or is a breach of the partner's fiduciary duty to his or her spouse. The absence of a spousal consent can destabilize an agreement, and the partners' relationship and can be an invitation to the family court to scrutinize the agreement and order actions the partners never agreed to. In today's world, where almost 50% of all marriages end in divorce, the partners cannot ignore the importance of getting written spousal concurrence to the terms of the agreement.

## When the Business Divorce is Imminent

Whether or not there is an agreement, what should a partner do if a 'business divorce" is imminent? Several steps are advised:

Consult an experienced attorney. Partners can do a lot of damage on their own without suitable guidance from a lawyer who understands business disputes. In the world of business divorces, not all lawyers are created equal. Very much like in a family law divorce, the business divorce lawyer must command or have access to a variety of skills—knowledge of contract law, familiarity with the Code, access to sound tax advice, knowledge of competition law and, as important as all the rest, the ability to endure the emotional roller coaster that a business divorce often becomes.

Become re-acquainted with the agreement, if there is one, and provide a copy to the lawyer. Too often, the partner will persist in demanding certain things that are either barred by or not provided for in the agreement. A realistic grasp of the agreement is essential for the partner-lawyer team to be effective in a business divorce. Some lawyers periodically remind their clients to review the agreement for changes. It may be assumed, for instance, that an agreement entered into in 1976 when the partners were in their 30s may benefit from some adjustments in 2009 when the partners are in their 60s and 70s.

Know where key business documents are and get copies of them. So often, when asked for an essential company agreement a partner will say, "I don't have it." The lawyer then spends an inordinate amount of time trying to assemble documents that the partner should already have or have access to. Sometimes, the partner will tell his lawyer that documents exist but, for whatever reason, they are not important. Worse yet, without the key documents, the lawyer risks taking positions that are undermined by the missing documents and is hobbled from responding appropriately to the other side.

If there is an agreement, determine whether you, your partner, or both of you are in compliance or in breach. In a business divorce, three kinds of arguments are usually made - legal, equitable, and emotional. However strong the emotional overlay may be, attention must be paid to whether your client is in breach of the agreement. Not knowing if you are in compliance with the agreement is a sure way to lose leverage in a business divorce.

Be aware of tax issues. Particularly in alternative business entities such as limited

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## Cloud Computing *continued from page 1*

*Is Cloud Computing More Secure?* Cloud vendors argue that their systems are more secure than in-house systems, since their entire focus is on providing software or data storage services to customers, while a customer's system is not a core competency. Cloud vendors often have full-time security analysts and can spread the cost of state-of-the-art security measures over a variety of clients. However, cloud providers are also more attractive targets than their individual clients, since they have so much more information. To put it another way, a data thief may prefer the challenge of stealing the information equivalent of the Hope Diamond instead of a handful of ½ carat gems because the payoff is so much greater. Moreover, since the cloud vendor is operating a 'utility,' there is always the concern that over time the vendor's commitment to security may decrease, and customers have no way of knowing that standards have dropped.

*Technological Edge.* Clients look to a cloud vendor because they seek access to higher quality technical resources than would otherwise be the case – cloud vendors help level the playing field, particularly for smaller clients. Maintaining the edge is difficult and expensive, and there is no guarantee that cloud providers will continue to upgrade and advance the product and provide the same degree of advantage. Similarly, one of the benefits of cloud computing, to the user, is its scalability; however, if a cloud provider loses its commitment to responsiveness and capacity, the cloud user may not be able to take advantage of this key benefit.

*Disaster Recovery.* One added benefit of cloud computing is enhanced disaster recovery. An effective disaster recovery program is an important part of virtually any business (and for financial institutions and certain other firms, an obligation); creating and maintaining a disaster recovery program is complicated and expensive. Since data retention is a core function of cloud computing companies, cloud vendors can focus on this portion of their services. However, it is also difficult to verify the existence and effectiveness of a system that may exist thousands of miles from the client. Even cloud providers may not create a meaningful system: in one case, a cloud provided substantial protections for its mainframe computers but, when audited, the racks of individual personal computers used by many customers were not similarly protected, despite representations to the contrary.

### Conclusion

Accessing software, storage capacity and other products and services over the Internet bears the promise of achieving benefits key to many companies. At the same time, cloud computing customers need to understand what can stand in the way of those benefits. In our next issue, we'll discuss how some of these challenges can be addressed. ■

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## The Business Divorce *continued from page 4*

liability companies and partnerships, significant tax issues can arise. A partner's threat to withdraw from the company is all well and good as a strategic threat. But, for example, if he has a significant negative capital account, he will have a recapture tax liability he may not have anticipated. Threatening to dissolve the company might be a good strategy in some cases. But the parties need to know that dissolution could generate significant capital gains liability if there are valuable assets that will be sold or distributed to the partners.

Be aware of the impact on third parties. A business divorce can be an event of default if a loan agreement contains a covenant relating to or prohibiting material changes in ownership of the company. Likewise, vendors and customers may grow concerned about the stability of the company and its ability to fulfill its obligations if its resources and those of the partners are focused on their internal dispute. Partners need to think very carefully about how an escalation of hostilities will impact the actions and views of key outside business relationships.

Carefully consider the consequences of litigation. Like matrimonial divorces litigating a business divorce can be very costly. The usual standards for estimating litigation expense seem to fall apart in the face of a business divorce lawsuit, which can encompass complex legal and factual issues and emotional pressures that lead the parties to take extreme and hard-ball positions. Too often, partners find themselves hurtling toward a full-blown lawsuit when something short of that might be sufficient. Every action or omission of a partner can be subject to the scrutiny of the court or arbitrator. Control of the business can be lost or reduced as a result of the litigation. A courtroom is not the recommended venue for partners to be accusing each other of tax and other legal irregularities. Most courts will have little tolerance with partners bickering over minor matters.

### Conclusion

There is no question that a well-crafted agreement can take much of the pain out of a business divorce. To achieve a suitable agreement, nothing works better than a structured approach to dealing with all of the company's key "life events" and running various scenarios through the draft agreement to make sure the document works and satisfies the partners' expectations. And when a business divorce is imminent, taking a few rudimentary steps can lay the groundwork for a smoother and less costly dispute resolution process. ■

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# CORPORATE LAW

## What's Inside?

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This newsletter is also available in electronic format. For more information or to provide feedback, contact Bob Braun at RBraun@JMBM.com.

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