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IT'S YOUR BUSINESS

PREVENTING OR RESPONDING TO DATA SECURITY BREACHES: IS YOUR INFORMATION SAFE?

by Devin J. Chwastyk

An overriding concern today for any business that collects customers' personal information should be the security of that information. For the modern business, a data breach will mean bad publicity, loss of customers, and, perhaps, overwhelming costs.

A 2010 study found the average cost to a company of a data security breach is $7.2 million, or, an average of $214 per compromised customer record. How many customer records are secured on your systems? And how confident are you in that security?

More troublingly, those estimates include only the direct costs of a response to a data security breach, e.g., repairs and upgrades to your IT infrastructure, and hiring of outside vendors and lawyers to assist in the investigation and response. But these direct costs pale in comparison to potential damage to the reputation of your business, in terms of customer trust and brand loyalty. An identity theft victim spends an average of nearly 100 hours to resolve problems caused by a breach. How likely is that customer to return to your business knowing you failed to safeguard their information?

Criminals have plenty of incentive to steal your customers' information: on the internet black market, credit card or bank account numbers can be sold for $30 each, or more if accompanied by expiration dates, zip codes, and other authenticating information. Social security numbers can fetch $25 or more. Even e-mail addresses, alone, can be sold in bulk for significant sums. Hackers may be motivated by more than just money: in 2010, hackers accessed the personal information of 170,000 employees of Royal Dutch Shell and, for political reasons, shared the information with Greenpeace and other environmental activist groups.

Unauthorized access to your systems can have a huge impact on your bottom line. In 2007, hackers stole the records of 45 million customers of the TJX Companies (owners of the T.J. Maxx retail chain). The company's subsequent SEC filings disclosed more than $200 million in costs as a result of the breach; some industry analysts have estimated the company's total losses (including harm to its brand) at more than $1 billion.

How can you prepare for or avoid the theft of customer information from your business? This article outlines a few basic tips:

- Devise and implement a data security policy. If you accept customers' credit card information, you are required to have such a policy by the Payment Card Industry Data Security Standards. That policy should govern how your network is built and maintained, and require periodic testing for vulnerabilities. Even if you do not take credit card transactions, you should have an equal level of security for customers' private information, such as mailing addresses, social security numbers, and email addresses.

- Separately, prepare a policy for response to a data security breach. Pennsylvania's Data Breach Notification Law requires disclosures of breaches to affected customers, and imposes liability on companies that fail to make such disclosures. Federal laws imposing greater penalties may be forthcoming. Your IT department and your legal team should work together to develop a plan to ensure an effective response to a breach, large or small, that will limit the scope of the breach and otherwise protect you from liability.

- Get rid of outdated (paper and electronic) records. If you are retaining more than the current records your business needs to operate or legally is required to retain, you are greatly increasing the risk of a sizeable breach. McNees can help you develop a records storage plan that will minimize such risk while ensuring compliance with Gramm-Leach-Bliley, HIPAA, and other relevant laws.

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SUCCESSOR LIABILITY – NOT YOUR PROBLEM, OR IS IT? *by Timothy R. Deckert*

When negotiating the sale of a business, tax considerations typically drive the structure of the sale. After taxes, however, liability issues are one of the most significant factors in how a deal is structured. From a liability perspective, a buyer prefers to acquire assets, which allows it to assume only certain negotiated liabilities, while the seller would rather sell the company as a whole (i.e., stock or LLC membership interests), which would saddle the buyer with all liabilities that are associated with the selling entity. While the buyer can protect itself in a stock purchase through indemnification provisions, escrowed funds and other techniques, there are limits (particularly time limits) to those types of defenses, which is why an asset sale is generally preferable for a buyer.

The Pennsylvania Supreme Court recently addressed the issue of successor liability in the case of *Fizzano Bros. Concrete Products, Inc. v. XLN, Inc.*, 42 A.3d 951 (Pa. 2012). In this case, the Court noted the following five exceptions to the general rule that a purchaser of assets is not responsible for liabilities of a seller: 1) the liabilities are expressly or implicitly assumed, 2) the transaction constitutes a de facto merger (i.e., a transaction that is not legally structured as a merger, but the end result is the same), 3) the purchaser is merely a continuation of the selling entity, 4) the transaction is a fraudulent attempt to escape liability, and 5) there is inadequate consideration and no provisions are made for the creditors of the selling entity.

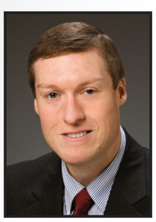
The *Fizzano* case focused on the application of the de facto merger test. A software company, System Development Group, Inc. ("SDG"), sold its stock to XLN, Inc. ("XLN"), with the bulk of the consideration consisting of two promissory notes. The two majority shareholders of SDG (the "Shareholders"), who together were entitled to approximately eighty-five percent of the promissory note payments, were employed by XLN and retained the ownership of the software (which was licensed to XLN) until the promissory notes were paid in full by XLN. Subsequently, XLN sold substantially all of its assets, including the right to license the software owned by the Shareholders, to XLNT, Inc. ("XLNT"), which also employed the Shareholders and maintained the same business location. The dispute in *Fizzano* stemmed from a lawsuit filed against XLN for breach of contract by SDG (XLN was responsible for this breach of contract claim due to the stock acquisition). While XLNT only acquired the assets of XLN, the plaintiff asserted that XLNT was liable under the de facto merger exception.

The trial court examined each of the following factors of the de facto merger exception, before ultimately determining that XLNT was in fact liable: 1) continuity of the enterprise (i.e., management, personnel, physical location, assets and general business operations); 2) continuity of ownership; 3) cessation of selling corporation's business as soon as practically possible; and 4) purchaser's assumption of the obligations ordinarily necessary for the uninterrupted continuation of the normal business operations of the seller. The trial court determined that three of the four factors were present, and held XLNT liable even though the continuity of ownership element was not met. On review, the Superior Court reversed the trial court ruling, holding in part that continuity of ownership was "indispensable" in order to establish a de facto merger.

In reviewing the de facto merger exception, the Pennsylvania Supreme Court considered a number of different issues. First, the Court noted that other jurisdictions were split on the question. The Court acknowledged that the cases where the continuity of ownership requirement had been relaxed typically involved criminal or tort law, or some other "overarching matter of public policy", as opposed to the contractual/corporate law dispute that arose in *Fizzano* (the thought process being that in more "serious" cases, it is appropriate to lower the threshold for finding a purchaser liable). The Court was swayed in particular by the statutory merger language contained in Pennsylvania's Business Corporation Law of 1988. Specifically, the Court noted that in several places, the statutes referred to an exchange of shares/ securities or obligations. Focusing on the "or obligations" language, the Court concluded that since a statutory merger does not always require an exchange of shares, it did not make sense to create a broad rule that a de facto merger always have a continuity of ownership interest.

Ultimately, the Supreme Court reversed the Superior Court ruling, but declined to adopt a broad ruling. Instead, the Court limited its holding to cases involving breach of contract and express warranty. The Court did hold that the de facto merger exception requires "'some sort of' proof of continuity of ownership or stockholder interest." While the Shareholders received promissory notes from XLNT (which were renegotiated from the promissory notes issued by XLN as part of the initial stock acquisition of SDG), the Court did not make a determination as to whether these notes constituted a sufficient continuity of ownership; instead, the case was remanded for further proceedings to make that determination.

While the threat of successor liability may not be present in many legitimate business transactions, the Supreme Court's holding in *Fizzano* does underscore the importance of heightened awareness in structuring transactions. With some careful planning, the risk can be further reduced or outright eliminated. ■



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JOBS ACT OPENS UP NEW CAPITAL RAISING ALTERNATIVES FOR PRIVATE COMPANIES *by Michael L. Hund*

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act, also known as the "Jobs Act." The Jobs Act will effect dramatic changes in the law as it applies to companies seeking capital by way of private placement stock offerings, overturning certain restrictions that have been in place for decades. The Jobs Act also added a brand new concept, "crowdfunding", to the array of choices for private placement offerings.

The overall intent of the Jobs Act, which was passed with broad bipartisan support, was to ease regulatory burdens on capital raising by smaller companies with the hope that such easing would lead to job creation and growth in the U.S. economy. In addition to opening up new capital-raising opportunities for small, privately held companies, the Jobs Act also added some fairly significant relief for companies that have recently gone public or that intend to go public in the future. There is a new category of companies identified under the Jobs Act known as "emerging growth companies," a classification that most observers have deemed a misnomer since it includes companies with up to $1 billion in annual revenues, a size that includes a lot of older, established companies not normally thought of as being in the emerging growth phase. These emerging growth companies will now get a break on the path to public status through a process that is slightly more streamlined than the process encountered in the past. Additionally, once public, these companies will enjoy a five-year holiday from some of the more onerous disclosure and compliance provisions of the Dodd-Frank Act and the Sarbanes-Oxley Act, including a pass from the controversial auditor attestations on the internal controls of a company.

While the provisions relating to newly public companies are interesting and will surely be helpful to those companies, the provisions in the Jobs Act relating to private placement stock offerings are the more compelling and newsworthy parts of the new law. These new provisions will be especially important for companies planning to engage in a search for outside capital through the sale of shares of stock to investors. The two parts of the Jobs Act that give rise to this are the relaxation of the prohibition on general solicitations under Rule 506 of Regulation D, adopted under the Securities Act of 1933, and the implementation of the crowdfunding concept.

The Jobs Act mandates that the Securities and Exchange Commission ("SEC") remove the long-standing ban on general solicitations for private placement offerings completed under Rule 506 of Regulation D. General solicitations include all attempts to sell shares except for offers made to a small, discrete group of persons who have some prior connection to the company making the offering. The removal of the ban on general solicitations is important because, both in terms of dollars raised and number of individual transactions, Rule 506 of Regulation D forms the basis for almost all private placements conducted by companies in the United States. Historically, offerings conducted under this rule were required to be structured to avoid making any widespread offering, i.e., a general solicitation. Now, under the Jobs Act, so long as all purchasers under such offerings qualify as "accredited investors", there is no longer a prohibition on offers extended more widely, including those in which a general solicitation is made. Accredited status for individual investors is fairly easy to achieve and consists of any person with a net worth of at least $1 million (excluding personal residence) or $200,000 in annual income ($300,000 joint income with spouse), including a reasonable expectation that such income will continue into the current year. This new relaxation on general solicitations is significant because it allows companies to avoid the excruciating process of conducting private placement offerings that are indeed truly private in the sense of how they are conducted. Companies will still need to ensure that the actual purchasers are accredited investors, but a relaxation on the prohibition on general solicitations is likely to be deemed a significant benefit to companies conducting such an offering.

The second major capital formation change affecting private companies included in the Jobs Act is the introduction of the concept known as crowdfunding to the capital formation process. Used previously to harness the power of a crowd to solve a problem, the Jobs Act will allow private companies to raise small amounts of capital by selling shares of its stock by the use of this process. Crowdfunding offerings are limited as to size and must be done by way of numerous and significant requirements. For instance, a company is able to use this process to raise no more than $1 million in any 12-month period. The aggregate amount sold to any one single investor is based on the investor's income. The investment limit is $2,000 or 5% of the investor's income, whichever is greater, for investors with annual net income of up to $100,000. For investors with higher incomes, an investment of up to 10% of annual net income is permissible, with a cap of $100,000 per investment. Further, requirements will be put into effect by the SEC to require that crowdfunding offerings be conducted by a third-party intermediary rather than by the company raising capital. There will be specific disclosure requirements (including audited financial statements for most offerings) and subsequent financial and other reporting to be done by the company after completing the offering by the use of crowdfunding. The companies raising capital will generally be prohibited from advertising such offerings. Third-party intermediaries will need to be registered either as broker-dealers or as funding portals and will be required to engage in specific steps to make information available to investors, perform background checks on the principals of the company issuing securities, and collect and control the distribution of offering proceeds in the offering.

The SEC has up to 270 days from the April 5th effective date of the law to issue rules before the various new provisions concerning general solicitation relaxation and crowdfunding offerings will be allowed. Until then, the old rules and requirements remain in effect. Most observers believe that the SEC will be late in releasing the new rules because of the significance of the change in the landscape of private placements brought about by the Jobs Act. Once the rules

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- Carefully dispose of old electronic equipment, and govern your employees' use of portable devices and storage media. A growing number of breach cases stem not from hacking, but from a company's loss or haphazard disposal of outdated, but un-scrubbed, hard drives, flash drives, laptops, and other devices.

- Do you use third party vendors? Do those vendors have access to your systems, or do you otherwise entrust them with your customers' personal information? If so, you should include risk transfer and indemnification provisions in your contracts with those vendors. This will provide you with an additional layer of protection should that vendor fail to safeguard your information (or if their unscrupulous employee misuses or sells your data).

- Consider data breach insurance. Electing for security and privacy liability endorsements on your policy could protect you from liability to customers and other third parties, as well as pay attorney's fees and other internal and external costs in case of a breach. McNees can review your policies and evaluate your coverage for these potential costs.

With careful forethought, the risks of a data breach can be minimized or avoided. We invite you to consult with us regarding your plan to prevent or respond to this continuously evolving threat to your business and customers. ■

Devin is a Member of the McNees litigation group, and has handled litigation involving companies with large-scale data security breaches. He defends companies in litigation and investigations arising from the loss or theft of personal information, and counsels them on how to avoid and respond to such events.

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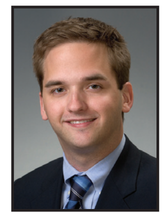

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are promulgated and these new paths for private placement offerings become available to issuers, it is anticipated that the relaxation on general solicitations for 506 offerings will likely prove to be helpful to many. It is hard to see how the crowdfunding alternative will be deemed particularly useful, however, given the extensive conditions for its use and considering that there are existing private placement offering alternatives already available for small offerings without nearly as many hurdles and impediments. On balance, it appears as though the new crowdfunding alternative is appealing because of its trendiness and creativity, but it probably has more political appeal than substantive merit. Some critics also fear that it will create new opportunities for fraud and deceit. ■

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