

Reduce Your Dispute-Related Legal Costs

Want to save some serious time and money? Place mediation and arbitration clauses in your business contracts and agreements.

Let's face it — disputes and litigation happen. Our court system is extremely slow, inflexible, impersonal, adversarial, expensive, and unpredictable.

Maybe you've heard bad things about mediation and arbitration, but take a look at the facts:

- For more than half a century there has been steadily growing acceptance of alternative dispute resolution (ADR) — primarily mediation and arbitration.¹
- Virtually all companies that use ADR report saving time and money, and enjoy more control over their disputes.¹
- Growing acceptance of ADR is driven by growing sensitivity to the importance of preserving valuable business relationships (an advantage of ADR) and increasing determination to steer clear of costly litigation when dealing with business disputes.¹
- A stream of evidence suggests there is real business value in the rapid, comparatively inexpensive and easily accessible alternative to the judicial system that is ADR — primarily mediation and arbitration.^{1,2}
- “Dispute wise” companies overwhelmingly prefer ADR over litigation.^{1,2}



If you have a bias against alternative dispute resolution, including mediation and arbitration, we encourage you to take a closer look. Read this issue of *The Business Owner*. Using ADR is easy: just include an ADR clause in your business agreements and/or attempt to get parties you are in dispute with to agree to use ADR instead of the court system. This issue of *The Business Owner* will help you learn how to do both.

¹ *Dispute-Wise Business Management: Improving Economic and Non-Economic Outcomes in Managing Business Conflicts*. An American Arbitration Association-Sponsored Research Study.

² *The Appropriate Resolution of Corporate Disputes: A Report on the Growing Use of ADR by U.S. Corporations*. David B. Lopsky and Ronald L. Seeber. □

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From the Editor

Odds are you've been in a legal dispute of some kind. I'm sure you found it to be a real waste of time, energy and money. I sure did.

But I've had two personal experiences with mediation/arbitration as well. My first was a dispute that arose from a business deal I entered into about eight years ago. The opposing party wanted the ADR clause in our agreement, so we included it. I didn't pay much attention to it until the dispute arose. I dove deep into the clause and its meaning. It required us to address my grievances by AAA mediation and then, if necessary, arbitration.

My opponent had far more financial resources than I did, so I was thankful for ADR. I found ADR expenses reasonable. The dispute also was getting in the way of my business, so I needed to resolve the matter quickly. To my great satisfaction, the entire process took about three months. We worked things out to our mutual satisfaction in the mediation phase. From that point on, I began placing ADR clauses in my agreements.

My second personal experience with ADR is taking place now. It's with a former employee. I put an ADR clause in his employment agreement. It's paying dividends. ADR just seems to be a much more sensible way to settle disputes.

If you are not already using ADR clauses in your agreements, I hope you will read the articles herein and consider the benefits.



David L. Perkins, Jr.

Sincerely,

David L. Perkins, Jr.
Publisher and Editor

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What You Need to Know About Alternative Dispute Resolution (ADR)

Our country's founders knew that a fair, accessible system for resolving disputes was critical to the dream of freedom, equality and prosperity for all. They devised our federal court system and then our state governments did the same to adjudicate claims arising within an individual state. As a result, people and organizations that believe they have been wronged may bring their case before a court of law. The facts are presented and reviewed, arguments are made by each party and a decision is rendered.

To be sure, our court systems have served us well, but they're far from perfect. Court rules and procedures, designed to be fair, result in long delays, substantial cost, unexpected rulings and lack of finality (i.e., nearly endless rights of appeal). In addition, our court system is public, adversarial and requires representation (i.e., hiring a lawyer, which is expensive). Given this long list of undesirables, many people are:

- > Taking proactive steps to avoid, minimize and/or settle disputes before they result in litigation.
- > Choosing arbitration as an alternative (to the court system) way to adjudicate disputes that cannot be settled cooperatively by the disputing parties.

A recent study conducted by the American Arbitration Association (AAA) interviewed the chief in-house counsel of 254 large public and private U.S. companies. Based on the way that each company handles disputes, AAA sorted them into three groups: "Dispute-Wise," "Moderate Dispute-Wise" and "Least Dispute-Wise"². It then analyzed the profitability and value of each business and found that the "Dispute-Wise" companies were much more profitable and valuable than the others — 28% more than the "Moderate Dispute-Wise" companies and 64% more than the "Least Dispute-Wise."

Dispute Avoidance: Studies show that company culture has a substantial impact on dispute frequency and cost. Cultures that are competitive, aggressive, vindictive and prideful tend to have the most disputes and highest cost per dispute. Recognize this, and then develop a culture that strives to avoid disputes and, when grievances arise, minimize the expense. Also, by tracking how and where disputes arise, root causes may be identified. Are disputes arising regularly with a particular product or service? A particular contract? Employee? Division? When a pattern is discovered, action may be taken to eradicate the problem at its roots.

Early Dispute Detection and Resolution: A key to reducing dispute- and litigation-related expense is to develop and maintain a company-wide culture in which all employees seek to identify "hot spots" and deal with them before they're ablaze. The first step is for everyone to understand that early detection is important. Next, develop a culture that supports and rewards the voicing of problems at an early stage and, when disputes arise, promotes open expression and dialogue. Conflicts can best be resolved by demonstrating a genuine interest in

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understanding and addressing the issue while resolving the problem in a manner that maintains healthy relationships and minimizes relationship damage.

Alternatives to the Court System:

Disputes — even hardened disputes in which the parties are unable to reach a resolution — don't have to be settled in court. There is an alternative, generally referred to as alternative dispute resolution (ADR). Here is a definition:

The use of any form of mediation or arbitration as a substitute for the public judicial or administrative process available to resolve a dispute (i.e., the judicial system).

Mediation: Mediation, also called facilitated dispute resolution, is a dispute resolution strategy or mechanism in which a neutral person attempts to assist the disputants in reaching a resolution. There are virtually no rules, so the parties and the mediator are free to conduct the mediation wherever and however they see fit, and include whatever information they decide is merited, fair, necessary or appropriate. The disputing parties are not required to have legal representation, and most do not. Whether an agreement results or not, and the terms of the agreement, if any, are solely determined by the parties themselves. In other words, settlement is completely voluntary. The mediator cannot force a settlement on the parties. The mediator simply assists the parties in their attempt to settle their dispute.

The disputing parties may be individuals, businesses or virtually any type of entity or organization.

Use of mediation is widespread:

An extensive survey of 1,000 large companies in the United States¹ found that 87% had used mediation in the past three years. Even more compelling is that more than 80% said that they were likely to use mediation now and in the future. Obviously, they wouldn't do so if they did not see the benefit.

Selecting a Mediator: Essential to any mediation is for the disputing parties to view the mediator as both qualified and impartial. For this reason, the parties must agree on selection of the mediator. There are a variety of accepted means for

doing so. To avoid a dispute about the manner in which a mediator is selected, it makes sense to stipulate such in any mediation clause used in a document (or, as an alternative, stipulate that a mediator will be selected in accordance with the American Arbitration Association).

Finding a Qualified Mediator:

The disputing parties have the freedom to choose the mediator, so long as they agree on the selection. The mediator can be literally anybody, and does not have to have training in mediation. It could be a respected person in your industry, for example. Most, however, choose a person trained and experienced in mediation. Often, the person is also an attorney. Thousands of people from all sorts of disciplines — attorneys, accountants, engineers, architects, construction professionals and union leaders — are trained in mediation and actively conduct mediations in the United States. A recent study¹ found that 95% of corporations that have used mediation found their mediator to be “qualified.” Only 1% said that they felt their mediator was “not qualified.”

Mediation is highly effective:

Studies and surveys regularly peg the success rate at more than 70%, with some as high as 90%. That is, disputing parties have at least a 70% chance of settling if they try mediation. These same surveys report extremely high rates of satisfaction.

If mediation is attempted but fails, either party can pursue justice in the state or federal legal system (unless the parties have waived their right to do so, such as by agreeing to arbitration as the means for settling disputes).

Arbitration: Arbitration is a settlement means that is more like a traditional court with a “judge” (in this case called an arbitrator) who reviews the facts, hears the arguments and then renders a judgment, but this alternative to the court system:

- is private (i.e., what is said, submitted and decided is not filed publicly as with the court system).
- is not bound by complex rules of evidence (which cause expense and delays in the court system), so the arbitrator has great freedom over

what information to consider and how it may be submitted.

- does not require that the disputants be represented by legal counsel (lowers costs considerably).
- allows for the disputing parties to have a say in who is the “judge” (i.e., arbitrator), which virtually ensures that the judge will be able to understand the subject matter and be qualified to decide the case.
- tends to move much more swiftly (the court system is overloaded, but there are plenty of trained, experienced and qualified arbitrators).
- guarantees that the matter will be settled with finality in a matter of months (there are very limited conditions under which the losing party may appeal).

Again, arbitration — often referred to as binding arbitration — is truly a substitute for the court system. It offers many of the same benefits of mediation (listed above), but the parties DO cede control of the settlement to the arbitrator. Why cede control of the settlement terms? Because if the dispute goes to court, the parties will lose control of the settlement terms as well as suffer all of the other undesirables of the court system.

For an arbitration ruling to be binding, the parties must have agreed in advance to put resolution in the hands of an arbitrator. When this occurs, the arbitrator's ruling is final. If either party tries to go to court with the same case, the opposition can produce the arbitrator's ruling and the court will in most cases consider it the final resolution of the case. Also, if a party fails to adhere to the terms of the arbitrator's ruling, the other may present this failure in a court of law and obtain judicial enforcement.

To be clear, either party to an arbitration may appeal the arbitrator's decision in a court of law, but the court will rarely review the arbitrator's findings of fact, rather simply review whether the arbitrator was guilty of malfeasance, exceeded the limits of his or her authority, or whether the award conflicts with prevailing law.

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In conclusion, our court system is one of the best and fairest in the world, but it has many undesirables. Given that disputes are simply a part of business and can be very expensive and disruptive, smart business people and business owners are taking proactive measures to protect themselves. The first step is education. What you will find is that the state of the art of alternative dispute resolution (ADR) has developed considerably over the past 50 years. It is now well vetted, well organized, well established, and most who are using it give it rave reviews and

plan to continue using it. All indications are that ADR is here to stay and will continue to gain acceptance in the business and legal community. We think you, the owner of a small private company, should adopt ADR for yourself and your organization. It's not hard to do. For disputes not already governed by a mediation and/or arbitration clause, try getting your opponent to agree to try mediation and then, if a settlement cannot be reached, binding arbitration. For all future legal agreements that you execute or ask

others to execute, place a clause that binds the parties to mediation and/or arbitration as an alternative to the courts. Get the language that's right for you at www.adr.org and/or from your attorney.

¹ *The Appropriate Resolution of Corporate Disputes: A Report on the Growing Use of ADR by U.S. Corporations.* David B. Lopsky and Ronald L. Seeber

² *Dispute-Wise Business Management: Improving Economic and Non-Economic Outcomes in Managing Business Conflicts.* An American Arbitration Association-Sponsored Research Study. □

Save Time and Money: Place ADR Clauses in Your Agreements

Almost anyone who has been involved in litigation will urge you to avoid it at all costs. One surefire way to do so is to include alternative dispute resolution (ADR) clauses in the legal agreements you enter into. Doing so is simple. Just locate the language that suits you and have it placed in the agreement.

How can you go about deciding what language is right for you? Reading this article is a good first step. Then read the other ADR articles in this issue. Of course, consult your lawyer as well.

Mediation and arbitration clauses have become popular in legal agreements. For example, parties entering into an agreement — whether to lease property, contract for services or enter into a partnership — agree (in writing) that if a dispute arises, a certain resolution protocol will be followed. The clause may be “soft,” such as stipulating that the parties will attempt to resolve the dispute by mediation (out of court), or the clause may be “hard,” stipulating that the parties will use mediation and then, if a settlement is not reached, binding arbitration. Typically, the language will stipulate how a particular mediator or arbitrator will be selected, how costs will be shared, and which “tribunal” will be used.

ADR Administrators (Tribunals)

Many ADR “tribunals” promulgate rules for mediation and arbitration and provide administrative support for the same. A few of the more prominent are the International Centre for Settlement of Investment Disputes (ICSID), the International Chamber of Commerce (ICC), the American Arbitration Association (AAA) and the London Court of International Arbitration (LCIA).

Making Your ADR Clause Clear and Binding

If you go to the trouble of crafting an arbitration clause and incorporating it into your agreements, you want it to be binding and enforceable on the parties. It needs to be able to withstand legal challenge. This can be achieved only when the clause is written and used correctly. Here are guidelines your ADR

clauses should conform to or risk being thrown out by the courts:

- **Knowledge and Agreement:** Make sure that any party you wish to be bound reads, understands and has the option to accept or decline your offers, goods or services that require agreement to the arbitration clause.
- **Giving Value:** At the time of agreement, provide the party something of value for accepting your terms, such as goods, services or promises.
- **Neutrality:** Make sure that the clause is fair to both parties in time, cost and win-lose prospects.
- **Equally Binding:** Don't try to require the opposing party to use ADR while you retain the right to sue.

State and federal courts have consistently upheld arbitration agreements that are fair, not discriminatory and agreed to by adults of sound mind. For example, the Supreme Court ruled in *Circuit City Inc. v. Adams*, May 2001, that employers may bind employees to an ADR agreement as long as it is fair and equitable.

Consumer Goods and Services, Opt-Out Provisions

With the proliferation of Internet sales, companies struggle with consumer demand for speed and the company's desire to stipulate the terms a sale is made under — such as with an agreement that disputes will be resolved by ADR. To address this issue, companies try to enforce such agreements through “I accept the terms” buttons on their websites, and “opt out” clauses inserted into the terms of agreements included in packaging. The former requires consumers, before purchase, to confirm that they have read and accepted the terms of sale (which might include an ADR agreement). The latter allows customers time to “opt out” of the ADR clause (or return the product for a refund) if they do not wish to accept the goods with the ADR clause. Visit with your attorney before implementing one of these strategies, but it appears that courts uphold the validity of such agreements when they are fairly and properly written. □

Drafting Your ADR Clause: The Basic Six

There are a lot of different provisions one could include in an ADR clause, but here are the basic ones. If you are like most ADR users, your clause will simply contain some combination of these six.

Basic Clause 1: Should the parties be obligated to attempt to work out their differences before they submit the dispute to mediation, arbitration or the court?

We suggest you put language to this effect in your ADR clauses. Believe it or not, it can help resolve some disputes before you spend more money and time. Include something like this:

If any dispute, claim, question, or disagreement arises from or relating to this agreement or the breach thereof, the parties hereto shall use their best efforts to settle the dispute, claim, question, or disagreement. To this effect, they shall consult and negotiate with each other in good faith and, recognizing their mutual interests, attempt to reach a just and equitable solution that is satisfactory to both parties.

Basic Clause 2: Do you want to require the parties to attempt mediation as a way of resolving the dispute?

We suggest that you do. So after Basic Clause 1 language, add something like the following:

If the parties are unable to reach a resolution within 60 days, the parties agree to try in good faith to settle the dispute by mediation.

Basic Clause 3: Do you want the parties to agree to use arbitration rather than the court system to settle disputes that cannot be resolved?

We suggest that you do. So after Basic Clause 1 and 2, add something like the following:

Basic clause 1: Parties must first attempt to “work things out” on their own.

Basic clause 2: Parties must attempt to settle through mediation.

Basic clause 3: Parties agree to arbitrate (and waive the right to litigate).

Basic clause 4: Stipulate the locale of any mediation or arbitration (i.e., venue).

Basic clause 5: Stipulate the rule of law to be used.

Basic clause 6: Stipulate the organization that will administer your mediation and/or arbitration.

If the parties are unable to reach a resolution within 60 days, the parties agree to try in good faith to settle the dispute by mediation.

Basic Clause 4: Would you like the parties to agree on where a mediation or arbitration hearing can be held?

We suggest that you do. It simply eliminates one potential issue of conflict. It could also save you a lot of travel time and expense. So add to your ADR clause something like this:

The parties agree that any mediation or arbitration will take place in (desired location).

Basic Clause 5: Would you like the parties to agree on the law that will govern the contract?

We suggest that you do. For example:

This agreement shall be governed by and interpreted in accordance with the laws of (specify state).

Basic Clause 6: Would you like to stipulate that a specific ADR administrator be used for any mediation or arbitration that becomes necessary?

Again, we suggest that you do. This will be one less thing that the parties could

argue about. The administrator is an organization that will act as a neutral party in helping the disputants adhere to the ADR clause agreed to, interpret and rule on issues that may not have been clearly described in the ADR language, and assist in selecting a mediator or arbitrator, scheduling, etc. Example:

The parties agree to use the American Arbitration Administration (AAA) as the sole and exclusive administrator of any disputes that arise from this agreement.

Again, there is a myriad of other issues that can be addressed in an ADR clause. As valuable as ADR can be in controlling and limiting legal costs, we suggest that you not delay in putting ADR to use. In the worst case, if you get the language wrong and it ends up being thrown out or ignored, you'll never be worse off than you would be if you had not attempted to bind the parties to ADR. That is, you'll end up in the court system. But all you have to do to get it right is to send this article to your attorney, tell him or her what you would like your ADR clause to stipulate and ask him or her to provide you with language to use in your agreements. □

Richard E. Coulson generously shared his expertise for the articles herein on ADR. Mr. Coulson is a recognized expert on mediation, arbitration and alternative dispute resolution (ADR). He is a Professor of Law Emeritus, active as a commercial arbitrator, and an independent legal scholar. You can reach him at rcoulson@okcu.edu.

“Fraud and falsehood dread examination. Truth and honesty invite it.”

Sample Comprehensive ADR Clause

If a dispute, claim, question, or disagreement arises from or relating to this agreement or a breach thereof, the parties hereto shall use their best efforts to settle the dispute, claim, question or disagreement. To this effect, they shall consult and negotiate with each other in good faith and, recognizing their mutual interests, attempt to reach a just and equitable resolution that is satisfactory to both parties. If the parties are unable to reach a resolution within 60 days, the parties agree to try in good faith to settle the dispute by mediation. If the mediation does not result in a settlement, the parties agree to settle the dispute by binding arbitration. The parties agree that any mediation and/or arbitration will take place in (desired location). This agreement shall be governed by and interpreted in accordance with the laws of (specify state). The parties agree to use the American Arbitration Administration (AAA) as the sole and exclusive administrator of any and all disputes that arise from this agreement including any mediation or arbitration that becomes necessary. The parties agree that each will bear its own expenses related to any dispute but will equally share the costs of any mediator and/or arbitrator. The parties agree that there will be just one arbitrator unless one of the parties wishes to pay the full cost of two additional arbitrators (so that there will be three). Any resolution agreed to by the parties by mediation and any decision or ruling made by an arbitrator or arbitrators will be final and binding and may be entered into a court of law for enforcement under the law.

Caution: Do not use this clause without first checking with your own attorney and into the applicable laws of your particular state. □

Drafting Your Arbitration Clause: A Checklist

The only way to keep your disputes out of the court system is to set up something with the parties you do business with. The most reliable method is to place ADR language in all your business contracts and agreements. There are no rules about what language can and cannot be used other than it must be fair to both parties. Similarly, there is no perfect ADR clause.

Simplicity is nice, but clarity is better. For example, if an arbitration clause simply says the parties agree to submit any disputes to final and binding arbitration, too many issues are left open. Which arbitration organization (i.e. tribunal, such as AAA)? How are arbitrators selected? How many arbitrators? What system of laws does the arbitrator use? Where will it be located? How are expenses shared?

Ideally, your clause will settle these issues. Here are some clauses to consider:

□ **Mediation, Arbitration or Both?**

Want to avoid the court system altogether? If so, you need a binding clause. You also may want a two-step resolution. First, stipulate that if the parties can work out their differences on their own in good faith, they must attempt to mediate. Mediation can be swift and less expensive than arbitration, and both parties maintain control of

the resolution. But if resolution is not achieved by mediation, you may want your clause to stipulate that the parties will then submit to binding arbitration. The arbitrator's decision is final.

□ **Expenses.** A well-drafted arbitration clause stipulates how expenses are divided. Though most parties choose to divide expenses equally, some expense items may not be divided. For example, if one party decides to have a court reporter transcribe the proceedings, should both parties pay? Also, if the plaintiff loses, should that party pay more of the expenses? Many choose to stipulate that each party bears its own expenses and splits the cost of any mediator and/or arbitrator.

□ **Selection of Mediator, Arbitrator.**

For mediation, a single mediator is typical. But given the higher risk inherent in binding arbitration, you may want more carefully crafted terms for selecting an arbitrator. For example, to select a single mediator or arbitrator, each party could select one. The sole purpose of the two arbitrators is to select who will mediate the case. Sometimes, to reduce the risk and impact of a maverick

arbitrator, a three-person panel is desirable (but it comes at additional financial cost). The "third one chosen by the first two" method works well here, too. When multiple arbitrators are desired, an odd number makes more sense.

□ **Qualifications of Professionals.**

Qualifications should be tailored for the type of dispute. If the agreement is contained in a purchase and sale agreement for a business, you may want an arbitrator to be an attorney, business broker or mergers-and-acquisitions professional with a minimum of (fill in the number of years here) years of experience in transactions involving purchase and sale of businesses. You also may want a mediator or arbitrator trained and certified by one of the main certifying organizations, such as the American Arbitration Association. Trained mediators and arbitrators are often lawyers but also may be accountants, architects, engineers, scientists, et al.

□ **Discovery.** How much discovery will be allowed? In what form: depositions, interrogatories, requests to produce documents, requests to admit, requests for inspection or physical examination? If discovery is allowed, for what period of

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time? Most tribunals such as AAA have limited rules on discovery. If you want discovery rules, you may want to develop your own or just include language that federal or state statutes will be used.

Scheduling. You may wish to stipulate when arbitration will occur, how swiftly the mediator or arbitrator will be selected, and any limit on the number of days that arbitration hearings will continue. This necessarily implies limits on the amount of time each party can have to present direct testimony as well as on the amount of time for cross-examination.

Privacy. You may want to include a confidentiality provision, keeping confidential any disputes, testimony, documents and outcomes involving the arbitrator. Consider as well the issue of remedy if this provision is violated. Many find this issue very complicated and remedy difficult to draft and enforce.

Role of Arbitrators. You may want to consider whether arbitrators also can serve as mediators (i.e., trying to settle the dispute through settlement negotiations), or whether the arbitrator's role is strictly limited to deciding the disputes.

Rules of Evidence. In most arbitrations, there are no rules of evidence. The arbitrator has discretion to consider whatever evidence he or she wants. If you want something different, stipulate such in your arbitration agreement. For example, the attorney-client privilege is a right granted by federal and state courts, but such does not exist in most ADR tribunals. So, if you want to enjoy attorney-client privilege in your ADR, add such language to your ADR clauses.

Briefs. If you want to file pre-hearing or post-hearing briefs, provide for them in the arbitration agreement. You may want to require that each party prepare an opening letter brief, no more than three pages long, setting forth the parties' positions at the outset of arbitration. You also may want to allow each party to submit briefs to the arbitrator(s) within (fill in the number of days here) a certain number of days after the close of arbitration hearings. Consider varying the number of briefs allowed depending on the dollar amount in controversy.

Decision format. Do you want a decision announced orally at the close of the arbitration hearing? Written with explanation of reasoning or written without explanation? Make sure it's spelled out in your agreement.

Appeal-Enforcement. Arbitration awards generally are considered final and binding. If this is what you want, state it in your arbitration clause. But be aware that the courts still may get involved. For example, if one of the parties claims that the subject matter is outside the scope of the arbitration agreement (called substantive arbitrability) or if a party claims procedural arbitrability, meaning that appropriate arbitration procedures were not followed. Also, some courts have said that for disputing parties to use the court system to enforce an award agreed to in mediation or awarded in arbitration, ADR

language must specifically say so. A well-drafted arbitration agreement sets forth the precise agreement of the parties on both substantive and procedural arbitrability.

Limit of Arbitrator's Authority. Most statutes allow a court to set aside an award if the arbitrator exceeds his or her powers. A well-drafted arbitration clause defines the powers of the arbitrator. For example: the arbitrator shall have the authority to award compensatory damages. An award of punitive damages by an arbitrator, or an attempt by an arbitrator to issue an injunction, undoubtedly would exceed his or her authority under such a clause.

Choice of Law. Some parties want their ADR clause to specify that the law of a particular legal jurisdiction will be followed. Unless the arbitration agreement clearly indicates that the arbitrator's judgment on the law of the jurisdiction shall be final and binding, such a clause invites a losing party to go to court to set aside the award because the arbitrator has misapplied the law. A well-drafted clause identifies the jurisdiction of law that applies to the contract and indicates whether the arbitrator's judgment on questions of law shall be final and binding or subject to review in court.

Be Aware of Local Laws: For example, the Vermont Arbitration Act contains a significant trapdoor that parties can fall through if they are not careful. It provides that an agreement to arbitrate is not enforceable unless the parties sign a separate acknowledgment of Arbitration drafted in a certain manner. Always check local laws.

Provisional Remedies. Unless your clause allows a party to seek immediate yet temporary and preliminary relief from the courts, such as attachment, garnishment, or injunctive relief, you may find that your arbitration clause gives the arbitrator exclusive remedy. So consider whether you want your clause to allow provisional remedies from the courts while arbitration is pending.

Scope: The scope of issues that you want covered by the ADR clause should be stipulated. For example, does the ADR clause pertain only to specific disputes, such as those that directly arise from the subject contract, or all disputes relating to the contract, such as tort or statutory issues?

Remedy: Most arbitrators follow the general law and award compensatory damages, but as you craft your ADR clauses you should consider whether you want to allow the arbitrator to consider any just remedy or whether you want to limit the arbitrator in some way, such as providing limited damages only.

When drafting your own ADR clause, share this list with your lawyer. Consider as well the requirements of any applicable laws and consult other appropriate authorities. Always seek the advice of legal counsel.

Richard E. Coulson generously shared his expertise for the articles herein on ADR. Mr. Coulson is a recognized expert on mediation, arbitration and alternative dispute resolution (ADR). He is a Professor of Law Emeritus, active as a commercial arbitrator, and an independent legal scholar. You can reach him at rcoulson@okcu.edu.

Shelter Life Insurance Proceeds from Estate Tax

Life insurance policies are taken out — in most cases — to provide financial benefits (i.e., money) to the heir(s) of the insured. For most people, the heir is the spouse, then children, then grandchildren.

Of course, life insurance policy benefits are not paid out until the death of the insured. That's why it's called a death benefit. But with death comes the inevitable estate tax, commonly referred to by opponents of the tax as the "death tax". Sure, the wealth of a deceased passes to his or her spouse tax-free, but this results in a mere delay of estate taxes because Uncle Sam will get his full cut when the surviving spouse dies. That means less for your children and grandchildren if the value of the estate exceeds certain thresholds.

The logical question, then, is why have a life insurance death benefit paid into an estate that is soon to be taxed? It's a good question.

The good news is there are ways to "shelter" life insurance proceeds from death taxes.

The common strategy is to hold the policy inside an irrevocable life insurance trust (ILIT) that has an independent trustee. When the insured dies and the policy pays the death benefit, such funds go into the trust and are invested as directed by the trustee (and the trustee invests the monies as stipulated by the trust document). Funds are then periodically distributed to the surviving spouse, once again as directed by the trust document. Then, upon the spouse's death, the money that remains in the trust is distributed to his or her heirs.

Again, the purpose of an ILIT is to remove life insurance proceeds from the insured's estate for federal estate tax purposes.

Ideally, the life insurance policy is taken out (i.e., purchased originally) by the trust itself. If the policy was purchased/originated before the trust is set up, it can be transferred into the trust, but there is a three-year rule, which stipulates that if the

insured dies within three years of such a transfer, the death benefit will be taxed as if the trust did not exist. In addition, some life insurance policies — namely whole life policies — include a cash buildup feature. Transferring such a policy into an ILIT trust could trigger gift taxes. You don't want this to happen, so consult your tax professional. He or she might suggest a remedy that entails the insured selling the policy to the ILIT in exchange for a promissory note. The terms of the note would call for the ILIT to repay the note with cash from future gifts by the insured to the ILIT or upon the death of the insured.

Tax and estate planning is complex. Always secure the aid of a skilled, experienced specialist.

Source: Hall Estill Tax and Estate Planning Newsletter (www.hallestill.com)

Matthew Henderson of Henderson Financial Group (www.GoHenderson.com) also contributed his expertise to this article. □

MONEY

Life Insurance Cautions

Do not cancel any life insurance without first determining the annual net cost, i.e., the annual premium less the annual buildup in cash value plus any annual dividends. Reason: You may find that the policy does not cost as much as you think. To determine the net cost, request what is called an "in-force illustration" from your agent.

Do not risk having your life insurance unintentionally lapse for nonpayment. Notify the insurers on all policies that the cash value of the policies (or any earned dividends) is to be automatically used to pay for any missed premiums.

Do not arbitrarily cancel or cash in an annuity or life insurance policy; the move can result in substantial taxable income and, possibly, tax penalties. Get a letter from your agent and insurance company on the tax consequences before taking such an action.

Do not arbitrarily designate irrevocable beneficiaries or co-owners. If you do, you will need their approval to borrow from the policy, apply dividends to premium payments, change ownership, or effect other important policy amendments.

Do not buy insurance or annuities from questionable insurance companies. Check out their rating, investment performance and financial health before doing business with them. □

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Business Etiquette: A Soft Issue That Moves Hard Dollars

There are a few basic rules to winning. The most basic is to get in the game. You can't win if you're not in the game.

The second rule is not to beat yourself — by doing things like not trying or making silly errors. Business etiquette falls into this category.

More business is won and lost due to poor business etiquette, social skills and first impressions than to lack of experience, competence, character, work ethic, and quality of products and services.

More business is won and lost due to poor business etiquette, social skills and first impressions than to lack of experience, competence, character, work ethic, and quality of products and services. Think about it. Before people hire you or buy your product, they don't know the actual quality — they simply buy on impression. Business etiquette plays a very important role in the impression you make. So if you want to succeed, conduct yourself in a way that opens doors and wins business.

The good news is that rules of etiquette are no mystery. They're easy to learn and not hard to adhere to. You have total control in the etiquette game. In addition, most people are pretty forgiving about etiquette issues. They just want to see you display basic good manners and make a good-faith effort to conduct yourself with professionalism and treat people with respect. A few slip-ups should not cost you a relationship or sale, but better etiquette — which conveys maturity, education and sincerity — may make the difference between you and your competitor.

First Impressions. When people first meet you in a business setting, they'll immediately decide whether they're willing to do business with you. They size you up visually. Are you well dressed? Well groomed. Professional? Healthy? Successful? Experienced? Friendly?

Fail the first-impression test and nothing you say or do will matter. Take care of your appearance and smile, make eye contact, stand up straight and offer a firm handshake. Call this silly, but if you are serious about building your business, this is a game you have to play well.

Once people accept you based on first impression, they'll give you a few minutes to begin building rapport. How do you do this?

Synchronize and Mirror. This means, generally, "do what they do." If they shake hands firmly, speak loudly in a rapid cadence and remain standing, you do the same. If they speak softly, pause for long moments of silence and sit in a relaxed manner, you do the same. The bottom line is that people like and are comfortable with people like themselves.

Listen and Engage. This means that you show a genuine interest in them. Ask them questions, listen to the answers and get to know them. This does not mean talking all about yourself. It's like a game of tennis. Keep hitting the conversation ball back in their court and get them engaged.

Connect. Find common ground. This could be anything. Perhaps you share a love of fishing, you grew up in the same area or you work in the same industry. Finding common ground will increase the opportunity to build a relationship.

Basic Tips

Your hands and arms should not be crossed or in your pockets. People like to see your hands. It facilitates the building of trust and openness.

Handshakes should be firm but not too tight or forceful. Two good shakes and then let go. Do the same for men and women — no limp handshakes for either gender.

Introduce higher-ranking persons to lower-ranking ones. For example, introduce the president of a company to the vice president of a company (not the other way around). Also, add a conversational information point to each person you introduce, such as:

"Tobey, this is John Paxon. John has been with XYZ Company for 25 years and is head of U.S. Operations. John, this is Tobey Johnston. Tobey joined ABC's Houston office about a year ago. He was previously with PDQ Services in Denver."

The one exception to the above is: Always introduce your customer or client first. This signifies that, in your world, your customer ranks above all else.

Example: "Mr. Customer, this is Ms. Jones, the CEO of our company Gift & Gadgets. Ms. Jones, Mr. Customer has been a valued customer for many years.

Always stand when being introduced, and always shake hands. When shaking hands, move to a position where you are not shaking over a table, chair, person, car, etc.

The painful thing about etiquette failures is that they are nobody's fault but your own. You can't blame the referee because you should have known the rules. A professional golfer who does not know and adhere to the rules will not make it on the tour. Similarly, a professional business person who does not know the rules will not make it big in the business world. For this reason, *The Business Owner* will begin including articles on basic etiquette.

Jana Christian provided expertise for this article. She is president of The Etiquette School of Oklahoma. You can reach her at www.oketiquette.com. □

The Future of Management

By Gary Hamel

Reviewed by David L. Perkins

Everyone's looking to make a buck. Yes, money may not make you happy, but it sure greases the skids.

In the *Future of Management*, Gary Hamel argues that your greatest hope for growing your organization and leading it to breakthrough success (and making a LOT of money) is to get out of the way. You're not going to lead your company to greatness. At least not enduringly. Your personal wisdom and creativity are just no match for the collective wisdom and creativity of a team of people charged with figuring out how to make your organization adapt, grow and succeed.

So quit trying to be the leader, savior and hero, and focus on developing a management model that:

- Attracts and retains a diverse pool of smart, talented people
- Gives its people the freedom to devise and test breakthrough ideas, innovations, strategies and methodologies
- Lets both employees (team members) and the marketplace determine which innovations get additional resources and which do not
- Allocates the spoils disproportionately to the individuals and teams that create the value

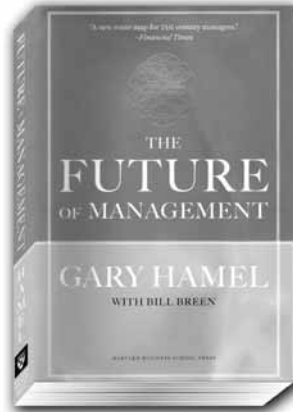
Hamel writes that the way businesses manage their employees (i.e., management models) has not evolved much in the past 100 years. Operating and business models have — such as the move to standardization of component parts and tasks, use of economies of scale (i.e., efficiencies garnered from volume), and control over costs through detailed cost accounting, have changed. But the way groups of people come together and are organized has not evolved much. The result is organizations that lack durability, adaptability and longevity.

The current management model, used by almost every business today — centered on control and efficiency — no longer suffices in a world where adaptability and creativity drive business success.

To be sure, some companies are trying to find new and better management models. They're testing radical new ways to organize themselves and, in some cases, finding breakthrough success. Here's what we can learn from them:

- Hire bright, creative, motivated people from all disciplines
- Organize employees into near-autonomous teams that self-select who is on the team and what they work on

- Allow employees to spend up to 20% of their day on any project or idea they choose (so long as they disclose what it is and what progress is being made)



- Let employees and marketplace determine which ideas get initial and additional funding
- Share profits earned on new product with teams that create them

Radical, no doubt. Google's founders want a company that has "more swings of the bat per unit of time than anyone else in the world." More swings should translate into more singles, doubles, triples and home runs.

Hamel writes that businesses are organisms. They should be able to survive, adapt and thrive on their own, perpetually, so long as they are organized and "managed" in a way that allows this. But few businesses are so highly evolved.

Business owners should seek to build organizations like the most adaptive organisms in the universe, namely, human beings and human civilizations/communities. Their defining characteristics are diversity, decentralized decision-making, experimentation, natural selection and survival of the fittest. Not command and control from the top. □

FAMILY

IRS Targets College Savings (529) Plan Abuses

The law governing so-called 529 plans allows an individual to make generous gifts to a college savings plan (529 plan) for the benefit of another individual without any gift or estate tax consequences. A couple can make gifts up to \$120,000 in one year for the benefit of another individual.

IRS has discovered that some taxpayers abuse the rules by making \$120,000 gifts to several different individuals, then quickly change the beneficiary on all the accounts to one person. The donors thus circumvent the gift tax limits on gifts to an individual that would otherwise apply. The IRS has promised a crackdown.

Source: *Hall Estill Tax and Estate Planning Newsletter* (www.hallestill.com) □

Protect Yourself from Compensation Claims of Former Employees

If you're like most business owners, you prefer to minimize what you pay to departing employees, whether the departure is your doing or theirs. Of course, if an employee is salaried or paid by the hour, you have to pay at least for the time he or she actually worked. State law stipulates how quickly you must pay. Some say the next day. Many stipulate the next normal payroll date for your company.

When employee compensation includes bonuses, commissions or other contingent amounts, post-employment compensation gets a little more complicated. To minimize the risk that an employee could win a claim for post-departure contingent compensation, be sure all your employment- and compensation-

related agreements and policies clearly stipulate that no bonus, commission or other contingent-type compensation will be paid to any employee following his or her departure. Place similar language in your employee manual or handbook.

State law could construe certain types of bonus or commission payments as wages, requiring that they be paid. Your best bet is to consult an employment law attorney in your state about types of compensation agreements you make with your employees as well as optimal avenues for both complying with the law and limiting compensation you have to pay to departing employees. □

CREDIT AND COLLECTION

Cheap and Easy Collection of Amounts Under \$10,000

Small claims court can be a low-cost, effective way to collect on claims under \$10,000. This entails filing a "notice of small claim" form with the district courthouse of the county where the debtor resides, where the contract was signed, or where the real property is. Call the appropriate courthouse, ask for the court clerk, and request the form (by fax or from the court website). Be sure to ask about the maximum amount you can file for because it varies by state. Some states have limits as low as \$2,000. The court clerk also can help with questions about what to do, where to go, local laws and limits, what to file, when to show up, etc.

Filing fees are minimal, usually around \$30, and the information required is also minimal. Upon receipt of your application, the small claims court clerk assigns a case number and trial date, usually within three to four weeks. You must provide a copy to the defendant at least 10 days before the trial, but you are not permitted to deliver these papers yourself. You must use certified mail, county sheriff, process server (listed in the Yellow Pages under "Process Servers"), or anyone over 18 who is not involved in the case. Certified mail is cheap and easy.

You must then file proof that the defendant was served with the notice. If the sheriff or professional process server delivers the notice, he or she completes a certificate of service and sends the original to the court on your behalf. If another person serves the notice, you must have that person sign an affidavit of service in front of a notary public. If the defendant is served by certified mail, file the return receipt as proof of service with the court clerk.

When you (or your representative) arrive at the courtroom, check in with the court clerk. When the case is called, you are sworn in along with the defendant and any witnesses. Explain your case and provide any relevant facts and witnesses. The defendant does the same. When both sides have been heard, the judge renders a judgment that is binding and has the full force of law as it allows for garnishment of wages or a lien on the defendant's assets.

Steve Soule of Hall Estill provided his expertise for this article. □



"Paper covers rock — sustained."
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About the Publisher



David L. Perkins, Jr. owns, writes, edits and publishes *The Business Owner*, the

newsletter of choice for more than 40,000 business owners who are serious about building wealth through successful private business ownership.

Perkins draws editorial ideas and inspiration from his own life as a business owner and investor, and his daily work as a mergers & acquisitions consultant, where he has advised on more than 100 purchase/sale transactions involving both private and public companies. His M&A consulting firm is Acquisition Advisors, which he founded in 1997 and which specializes in transactions valued between \$5 million and \$75 million. Visit AcquisitionAdvisors.com to learn more.

Perkins holds a bachelor of arts degree in psychology from the University of Oklahoma and an MBA from the University of Notre Dame, and has completed the executive education course titled "Mergers and Acquisitions" at The Wharton School, University of Pennsylvania. He also pulls editorially from prior experience in commercial real estate leasing and brokerage, commercial bank lending and private company financial management.

Perkins is the author of *A Concise Overview of Business Valuation* and co-author of *The Business Sale, An Owner's Most Perilous Expedition*. You can buy the former at www.TheBusinessOwner.com.

Contact him at 800-634-0605 or DPerkins@DLPerkins.com.

IRS Cracking Down on Employers That Overuse Independent Contractor Status

IRS has begun cracking down on companies that classify some or all of their workers as independent contractors. In many cases, the IRS believes, these workers should be treated as employees. Employers must pay FICA and FUTA taxes on their employees' wages and also must let them participate in various company pension and welfare benefit plans.

Using one of several avenues of pursuit available, the IRS has begun cooperating with states in identifying leads. The IRS so far has signed up 33 states to share data from payroll tax exams. Information from the states likely will mean thousands of new audit leads. In addition, federal and state agents will train together and even conduct joint exams in some cases. The IRS uses an electronic matching system to spot businesses issuing 1099 forms with payments of \$25,000 or more to at least five workers with no other income sources.

Leads from a company's own workers could also spell trouble. The IRS invited 2007 income tax return filers who are independent contractors to tell the IRS (on form 8919) whether they think their employers have incorrectly classified them as contractors. The incentive for workers is that they could avoid paying self-employment tax and participate in company pension and benefit plans if their classification were changed to employee. Employers still can rely on a 1978 law that limits the ability of IRS to reclassify workers. Companies must be able to show that they filed Form 1099 showing payments to their workers and treat their other, similarly situated workers as contractors. And the firms must have a reasonable basis for classifying them that way. Valid reasons include reliance on precedent, e.g., a court case or an IRS ruling, prior industry practice or even a previous IRS employment tax examination. Reduced IRS penalties apply when misclassification is not intentional.

A bill now before Congress would limit this statutory relief. The bill would allow the IRS to require reclassification of contractors as employees prospectively and end industry practice as a way for firms to avoid reclassification.

This article was adapted from information found in the Hall Estill Tax and Estate Planning Newsletter (www.hallestill.com) □

HOME

Tax Relief Enacted for Forgiven Mortgage Debt

A recent tax law change has been enacted that addresses issues brought about by the subprime lending crisis. This change provides relief to homeowners whose mortgage debt is forgiven. Prior to enactment of this law, a homeowner could be taxed on the amount of forgiven mortgage debt. For example, before this law, an individual with a \$200,000 mortgage whose lender foreclosed on the home and sold it for \$180,000 would have had to report \$20,000 of income from the forgiven debt. The result would have been the same if the lender restructured the loan and reduced the principal amount to \$180,000. Under the new law, a taxpayer does not have to pay federal income tax on up to \$2 million of debt forgiven for a qualifying loan secured by a qualified principal residence. The change applies to debts discharged from January 1, 2007 to December 31, 2009.

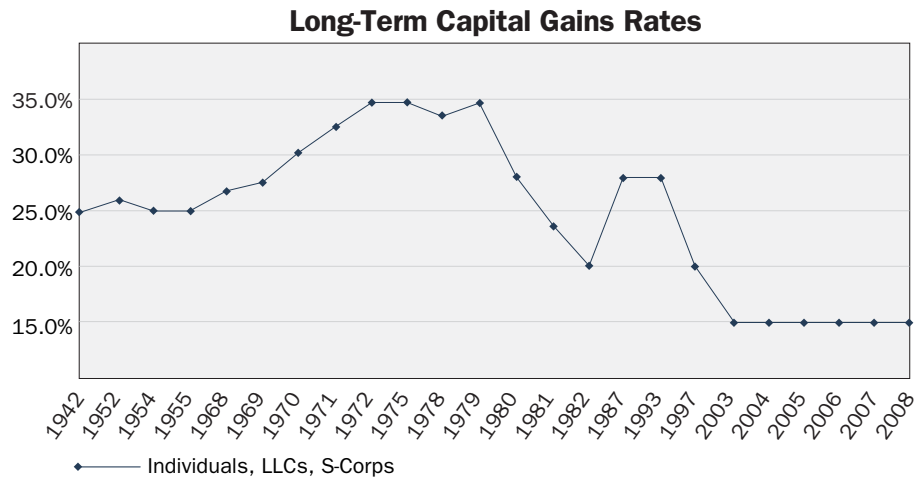
Source: Hall Estill Tax and Estate Planning Newsletter (www.hallestill.com) □

How to Protect Yourself from the Coming Capital Gains Rate Hike

Capital gains rates have been at historic lows since 2003. The result has been slim tax bills enjoyed by investors who have sold and taken gains, and record U.S. federal budget deficits.

The deficit, running at about \$1.4 billion per day, is not entirely the result of lower capital gains rates, but it will have to be reduced somehow — and soon. President Bush will not raise taxes before he departs next January, so the task will be left to the next administration/Congress. Looking at the adjacent chart of historical long-term capital gains rates, it seems too easy for Congress to try to reduce the deficit in part by raising capital gains rates to a level more in line with historical rates.

If I were a betting man, I'd wager that it's coming. Rates will rise by 2010 unless Congress enacts new legislation,



probably 100% (given the deficit).

What can you do about it? Pretty simple. Take your gains now. That is, if you plan to sell an asset that has appreciated in value, do it before the tax law changes.

If you sell a business and take a \$1 million gain, the current 15% long-term rate means your tax bill will be \$150,000. If the rate rises to 25%, your bill will be \$250,000. That's a lot of money. □

Protect Your Customer Lists, Other Confidential Information

Customer lists that your company has developed, along with marketing and business plans, are considered your company's "intellectual property" under trade secret laws and, as such, are entitled to protection under that law. Sales and marketing personnel who go into business for themselves or who go to work for a competitor may be tempted to remove and use a former employer's customer lists to get off to a fast start in a new job.

Be aware: Lists of prospects compiled from directories or similar public sources may not be protected. But a company's "confidential" lists are protected, including names of customers that an employee could have learned about only through his or her employment, and names of potential customers obtained on the basis of the company's past selling experience.

The problem is that a salesperson can easily claim that his "customer/prospect list" has been obtained from sources other than his previous employer's lists (e.g., his memory), or that he had known about them prior to his employment. In that

case, your only protection is a written agreement with those employees that they will not compete with your company for a specific period of time after they leave the company, and within a certain geographical area.

What to do: Send a memo to all employees to make them aware of the company's rules on customer lists, patents, processes, etc., and get a written agreement for select employees. Even without a written agreement, an employee is generally bound to the proper use of his employer's secrets and prohibited from divulging them to others.

But the best approach is to use a written agreement and/or include the guidelines in your company's employee manual. Both of these approaches are much stronger deterrents with employees. But be careful. Enforcement of the agreement depends on the reasonableness of the restrictions you impose. So get expert advice on the wording of these agreements from a lawyer who specializes in employment contracts and trade secret laws in your state. □

Avoid Wasting Time & Money on Prospective Business Deals

Big transactions take an immense amount of time and money. Ditto for starting new businesses. They're well worth it when a profitable deal closes or a new venture takes flight. Unfortunately, for every one that takes off, a hundred never make it out of the hangar. That's why savvy business people are skilled at managing the process to minimize wasted time and money. Here are some of their tips.

Be Clear About Your Objective. To measure and assess, you need a yardstick. What is yours? That is, how will you evaluate your project? Number of souls touched? Amount of waste cleaned up? Percentage that say "yes"? Amount of money earned? Set guideposts and they'll keep you focused.

Not So Fast on the Well-Paid Specialists. Maybe the largest money pit opens up when experts are hired and the deal fails to close. The key is to hold off on the high-paid experts until as late in the process as possible. Also, once they're hired, don't be afraid to manage them actively. Have them update you constantly on the time they've spent and the tab they've rung up. Better yet, give them a budget and insist they stick to it.

Qualify the Other Parties. People waste time. We have to be cautious about who we are willing to work with on projects that require a lot of time and money. Here are some tips for qualifying the other parties:

- Are they the decision-maker(s)? Who else has to approve the project before it's a "go"? Insist that you develop a direct dialogue with all decision-makers. Fail to do so and you leave yourself exposed.
- Do they have the money required? If not, where will they get it? Have you talked to the capital provider and received answers that give you confidence?
- Have these people succeeded in the past? Have they shown willingness and ability to deal? Make decisions? Get things done? Take risks? Invest money?
- Are they willing to cut to the chase and deal with the big issues early on, or do they shy away from potential deal killers?

Qualify Yourself. While you assess the other parties to determine whether you can trust them not to waste your time, assess yourself. Is this a deal you will do? Do you have the money required? If you do, are you willing to risk it on this venture? If you are selling, are you serious about letting go and doing something different? Will your spouse go for it? Are you sure you're not wasting the other parties' time? If the answer to any of these is no, try to turn them into a yes before you waste anyone's time — including your own.

You Can't Please People. Unfortunately, business is not about pleasing people. This does not mean that business is cruel or unkind or uncaring; it's just efficient and economical. A common way to waste time and money is trying to please other people. An example is agreeing to work exclusively with someone who is not the sole decision-maker because the party you are dealing with resists your insistence on talking to all decision-makers before you commit more time and money. Another example is failing to tell the party that you don't want to proceed because it will disappoint him or her.

The Process or the Accomplishment? Many people are happy simply enjoying the sport of talking about and working on deals, but they rarely get any done. So the first question to ask is: Are you serious about doing a deal and making some money?

Get It 80% Right, Then Pull the Trigger. If you wait until it's 100% right, you'll never get going. Instead, get it 80% right, then pull the trigger. Figure out the other 20% as you go.

If the Ship Is Going to Sink, Sink It Now. A lot of people want to delay the inevitable. Savvy business people say, "Why wait?" If the ship is sinking, wouldn't you rather get it over with? Sink it now so you can swim ashore, dry off and get on with your life. Similarly, remember when you were young and you were due a spanking? Didn't you prefer to get it over with rather than wait until after dinner? Same principle. If the writing is on the wall and your new venture is not making it, call a meeting and tell your partners what the tea leaves say. If they agree, you're 90% of the way to your next, more profitable venture.

Time is your most precious commodity. If you had all the time in the world, you could develop additional products and services, sell to endless numbers of prospects, and add to your knowledge base in ways that help you make more money. You could argue that money is more precious, though you can always borrow money, but you can't borrow time.

Prospective business deals can soak up time like no other, and most business ventures never take flight. Guard yourself. The above tips will help you. □

"A family business combines the most rational human institution — a business — with the most irrational human institution — the family."

Anonymous

What Every Business Seller Should Know (Part III of VI)

SELLING A COMPANY

BUYING A COMPANY

BUSINESS VALUATION

Financially, you'd probably be better off keeping your business.

Let's face it. If you have a healthy, profitable and growing business that you believe will keep growing, you'd make more money keeping your business. That's because buyers typically pay just three, four, maybe five times your annual, adjusted, pre-interest profit. Heck, you'll earn that anyway by owning it!

Similarly, let's say you earn \$1 million per year right now from your business. You sell for \$5 million, pay your taxes and fees and net \$3.25 million cash. Invest the proceeds at 8% per year and you now earn \$260,000 per year. Why sell?

The reality is, many do. That's because they sell for **non-financial** reasons. That's right. They sell when they decide that they value their freedom more than the money. To be sure, they work smart and hard to sell for the maximum value. And when this time comes for you, you'll do the same. And that's where Acquisition Advisors comes in. We help make that happen. Help owners of great companies sell in an orderly and confidential manner for the highest price and lowest risk.

Before you sell, get comfortable with the sobering fact that you'll be taking a pay cut. Yes, but you'll have your freedom.



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