



## message from partner in charge

We started this newsletter with the idea of giving our clients and friends insights into a wide variety of legal issues that confront businesses today. This latest issue certainly fits that bill.

An old song says, “The best things in life are free.” But as our lead article explains, when it comes to open source software, “free” software usually comes with hidden costs, and raises issues that can complicate or even derail corporate mergers, acquisitions and similar transactions. Astute dealmakers need to understand these issues – and how to spot them and resolve them.

Switching gears to litigation, Eric Goldberg and Michael Meeks review a California Supreme Court case involving the divorce of Bruce Springsteen’s keyboardist and his wife – but more importantly, dealing with the enforceability of mandatory fee arbitration agreements. Such agreements are becoming increasingly common for many professional service providers, and the outcome of this case likely will influence how such agreements are drafted in the future.

As always, we welcome your feedback on our newsletter and your suggestions for future articles. Thanks for reading!

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## Open-Source Software Issues in M&A Transactions

Open-source software has become a key issue in M&A transactions, especially those involving midmarket software businesses. Many dealmakers know that the presence of open-source code can derail a merger or acquisition. The danger exists when a programmer has embedded source code with a particular kind of opensource license, accidentally creating “free ware” instead of a commercial product. The end result can be costly, negating potential revenue to the bottom line of the newly acquired software company.

But that doesn’t mean that transactions involving open-source software should be avoided. Instead, sellers of software companies must understand and manage the use of their code to prevent the erosion of value to their technology product. Meanwhile, buyers must conduct audits to understand the liability they may acquire in any M&A transaction involving technology.

The open-source movement dates back to the early 1980s. It was founded on the belief that increased rights to access, share and modify source code will foster greater innovation. Source code (human-readable code as opposed to machine-readable object code) allows programmers to customize and build software products.

The Open Source Initiative ([www.opensource.org](http://www.opensource.org)) outlines the principles that a code must meet to qualify as an open-source code license, including free distribution, availability of source code and permission to make derivative works.

Open-source code licenses exist for dozens of well-known products, including Apache, Apple, GNU, IBM, MIT, Nokia and Sun. Open source also is routinely found in the programmable microprocessors that operate navigational devices, Web servers, CRM applications and cell phones.

Open source has clearly been a boon to technology development, but it doesn’t come without some hidden costs. **Sun Microsystems Inc.** CEO Scott McNealy once quipped, “Open source is free like a puppy is free.”

It comes with a binding license, the terms of which can wreak havoc during a transaction. From a programming perspective, the most common — and the most dangerous — open-source license is the GNU General Public License, or GPL. This license preserves “openness” by requiring modified software to be redistributed on the same terms at no charge.

Theoretically, if a programmer embeds even a small amount of open source into a proprietary software product, then distributes it commercially, the entire product may become subject to a GPL, meaning further copying and distribution of the whole product must be free.

This contamination of a software product’s proprietary code by open source is the key reason for scrutiny in merger and acquisition transactions. Whether the code is embedded, distributed with or is separate from the proprietary product becomes key as to whether the viral nature of the GPL or other open-source license applies. Fortunately, due diligence is becoming easier and more prevalent, thanks to technology. Software such as Black Duck Software can analyze whether the product has open source embedded in it or distributed with it and can identify which license the software is subject to.

Once code review is complete, the issue becomes remediation. If open source is used for noncritical aspects, the

transaction generally proceeds without any issues. However, if removing code from a product results in a loss of functionality, that may affect valuation or significantly delay closing. Remediation also may require compliance with strict license requirements. Another approach is to eliminate the noncomplying code or rearchitect the product to allow the open-source component to be independent.

Much of the remediation effort will depend on whether the software being acquired is the reason for the acquisition or just a tagalong. But in transactions where the acquired software product will be merged into the acquiring company’s software, the danger of contamination goes up — and the need for an open-source audit becomes critical.

It is not simply the discovery of open source that can quash a deal, but what executives selling the software business have to say about it. How a company has managed the use of open source speaks volumes about whether proper business controls were in place: That, in turn, can affect confidence in the management team.

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## **Peppercast: LEED Certifications For New and Existing Developments**

**Vicki Harding**, a resident of the Detroit office of Pepper Hamilton and a real estate lawyer who is currently working on qualifying as a “Leadership in Energy and Environmental Design” (LEED) Accredited Professional, and **Sean Delaney**, an associate in the Harrisburg office of Pepper who also is working on becoming a LEED Accredited Professional, discuss green building initiatives, particularly LEED certifications for new and existing developments.

In addition to reviewing the components involved in a project being LEED certified, this podcast also discusses energy-efficiency credits and the relevance of LEED to organizations.

If you’re interested in learning more about the latest developments in Real Estate Law, e-mail [podcasts@pepperlaw.com](mailto:podcasts@pepperlaw.com) to subscribe to Pepper Hamilton’s Real Estate Update.

Listen to this podcast today by visiting the Real Estate section of [www.pepperpodcasts.com](http://www.pepperpodcasts.com).

## Ex-Wife of Springsteen Bandmate Challenges Mandatory Fee Arbitration Agreement

What do Bruce Springsteen, a mandatory fee arbitration provision and the California Supreme Court have in common? It's *Federici v. Gursej Schneider & Co., LLP*, No. B183945, 2006 WL 2775212 (Cal. Ct. App. Sept. 28, 2006), a matter arising out of the divorce proceedings between Bruce Springsteen's keyboardist, Danny Federici, and his wife, Kathlynn Federici. *Federici* raises the issue of the enforceability of a mandatory fee arbitration agreement between Kathlynn Federici and the accounting firm she retained during the divorce.

In 2002, after 15 years of marriage, Kathlynn Federici filed for divorce. Before and during their marriage, Danny had enjoyed a financially rewarding career as a member of Bruce Springsteen's E Street Band, earning money primarily from concerts, record royalties and merchandising royalties. Kathlynn retained the accounting firm of Gursej Schneider & Co., LLP (Gursej) to provide accounting services in connection with the divorce.

Gursej's retainer agreement contained an arbitration provision that provided for mandatory arbitration of "[a]ny controversy, claim, or dispute relating to . . . unpaid fees for professional services." Further, the arbitration clause provided that:

- if Kathlynn should have any claims of professional malpractice against Gursej, she must raise such claims as a defense to Gursej's arbitration action for unpaid fees
- the only way that Kathlynn can bring an action in court against Gursej for accounting malpractice is if she (i) prevails in the arbitration (*i.e.*, the arbitrator determines that Kathlynn does not owe Gursej any money), and (ii) the arbitrator does not limit Kathlynn's relief to the amount of Gursej's contended fees
- if, however, the arbitrator determines that Kathlynn does not owe Gursej any money for its services, but that her malpractice claim does not exceed Gursej's contended fees, Kathlynn "will be prevented from bringing the same contention in any separate civil action."

*Gursej's retainer agreement contained an arbitration provision that provided for mandatory arbitration of "[a]ny controversy, claim, or dispute relating to . . . unpaid fees for professional services."*

In 2002, Kathlynn's attorney negotiated a marital settlement agreement in which she gave up the rights to certain cash and virtually all of Danny's E Street Band royalties. Kathlynn later believed that the settlement was extremely unfavorable and that Gursej was partly to blame. She refused to pay Gursej for its services.

In June 2003, Gursej initiated an arbitration proceeding against Kathlynn for unpaid fees. Kathlynn did not oppose the arbitration or raise a counter-claim for accounting malpractice. In July 2003, the arbitrator awarded Gursej over \$29,000.

On February 10, 2005, Kathlynn filed a professional negligence complaint in California state court against Gursej alleging that due to Gursej's malpractice, Kathlynn failed to receive any portion of significant assets in the marital settlement. Gursej filed a demurrer – California's equivalent of a motion to dismiss – asserting that Kathlynn's malpractice claim was barred by the doctrines of waiver and *res judicata*. Among other things, Gursej argued that the arbitration clause obligated Kathlynn to raise the malpractice claim during the arbitration, and her failure to do so effectively waived her malpractice claim. The trial court sustained the demurrer.

On appeal, Kathlynn argued that even if the arbitration provision required her to assert her malpractice claim in connection with the arbitration, such a requirement is unconscionable. The appellate court rejected this argument for two reasons. First, Kathlynn waived the right to argue

“unconscionability” because she failed to do so during the arbitration. Second, even assuming that the arbitration provision was *procedurally* unconscionable (*i.e.*, a contract of adhesion), Kathlynn also failed to show that the provision is *substantively* unconscionable (*i.e.*, overly harsh or one-sided). Under California law, both types of unconscionability must be established to invalidate a contract.

The appellate court did not believe that Gursey’s arbitration clause was substantively unconscionable, because the arbitration agreement only required Kathlynn to arbitrate Gursey’s claim for unpaid fees. If such arbitration took place, Kathlynn was further obligated to assert any related malpractice claims as a defense/offset to Gursey’s claim for unpaid fees. The court believed that these requirements, by themselves, are not unconscionable. In reaching this conclusion, the court stated: “It is important to note, however, that the arbitration provision did not attempt to impose a monetary ceiling on a potential malpractice recovery; plaintiff did not contract away her right to receive a malpractice award exceeding her accountancy fees.”

The arbitration clause authorized Kathlynn to file a civil action for the amount in damages that exceeded Gursey’s fee. Although this aspect of the arbitration provision essentially meant that Kathlynn potentially would have to litigate her malpractice claims in two forums – arbitration and civil court – the appellate court did not find this to be “onerous.”

In January 2007, the California Supreme Court agreed to review the decision of the Court of Appeal. The case will be watched closely as it will certainly provide guidance concerning how fee arbitration provisions will be drafted in the future.

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## Upcoming Events

Pepper partners **Julia D. Corelli**, **Steven D. Bortnick** and **Leonard Schneidman** will be presenting on various topics of interest to the private equity community at IIR’s West Coast program for “Venture Capital Private Equity Tax Practices,” on October 22-24, 2007 in Palo Alto, California.

Contact Paul Rocco at [procco@iirusa.com](mailto:procco@iirusa.com) for more information.

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