



## BUSINESS AND EMPLOYMENT NEWSLETTER

SECOND QUARTER, 2008

### SO YOU WANT TO RAISE MONEY— A WARNING ABOUT SECURITIES LAWS

By Kirsten Barron

Many of the articles in this Newsletter are initiated by questions from you, or in this case, from many of you. For a number of reasons, it has been more difficult to obtain conventional financing for businesses. A fair number of our clients have called over the past few months asking about raising money to support the growth of their business, to get their business off the ground, or to provide assistance during a difficult time. Many business owners think – well, I will just sell a portion of my business to raise the funding for \_\_\_\_\_ (whatever that may be). The next sentence is in bold because it is a warning

and should really be on the “label” of every business.

**Warning: The sale of securities is a highly-regulated activity. Beware. It is a trap for the unwary and can result in significant liability, including in egregious cases, criminal liability. Securities are broadly defined and include, for example, shares of companies, units of limited liability companies, options, warrants, bonds, debentures and sometimes promissory notes.**

The information we provide in this article is not meant to tell you how to do

anything other than to *know when to consult legal counsel*. I note that while Barron Smith Daugert does some of this type of work, we often refer clients to lawyers outside of the firm when the issues exceed our knowledge and experience. We want to make sure that our clients (1) know when to contact counsel and (2) do not unwittingly run afoul of these laws in a desire to raise capital for their businesses.

When small businesses raise capital, they usually do so through a private placement rather than a public offering. The term "private placement" refers to the offer and

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## **LEASE SERIES— LOOKING TO THE FUTURE: WHAT KIND OF INITIAL TERM AND RENEWAL OPTIONS MAKE SENSE?**

By Sallye Quinn

A key provision in any lease is the length of the initial term and the number of renewal options. The term sets the length of time the parties will be bound to the leasing relationship. The renewal options allow the tenant to increase the term once the initial or a prior renewal term expires. The particular circumstances surrounding each lease will drive whether the parties want a short-, mid- or long-term lease.

For a landlord, a longer term will give assurances as to rental income for a greater period of time and allow the landlord to avoid having to incur expenses related to finding a new tenant, such as lost rent during periods of vacancy, leasing commissions and the cost of landlord-financed tenant improvements. On the other hand, a shorter term allows the landlord to take advantage of market shifts and potentially increase rent on future leases. It also allows the landlord to more easily end a relationship with a “bad” tenant, i.e. a tenant who is always late in making payment but manages to pay in time to avoid an unlawful detainer action or one who has a significant number of other defaults that it manages to cure within the cure period.

For a tenant, a longer term is usu-

ally only advantageous when the tenant has an established business and knows that it will be able to complete the term, when the tenant has invested significant amounts of money into tenant improvements, or when the tenant believes it will gain significant goodwill based on the location and does not want to move from the space for an extended period. In most instances, a tenant prefers a shorter term lease in order to have the flexibility of not being bound to rent payments and the option to move to a better location if one becomes available or to accommodate growth or downsizing.

A properly-drafted renewal term is one way to “split the baby,” so to speak, because it gives the tenant the option to increase its term without having to make the commitment when it first enters into the lease. Although the option belongs to the tenant, the landlord still benefits as long as the manner in which rent for the option periods is determined tracks market increases. An option is usually required to be exercised within a certain period before the expiration of the lease. This gives the landlord time to plan in the event of a vacancy.

Once the landlord and tenant decide that renewal terms are impor-

tant in the specific leasing situation, the focus should be on drafting a renewal term that addresses certain key issues: 1) the number and length of renewal options; 2) how rent during the option period is determined; 3) how and when the tenant must provide notice of the exercise of its option(s); and 4) conditions that must be met before the tenant is allowed to exercise its option(s).

### **Number and length of lease options**

The relevant factors in determining the number and length of options are very similar to those used to determine what the initial term of the lease should be and are discussed above.

### **How rent during the option period is determined**

A good way to set rent during an option period is to craft a provision that provides for the agreement of the parties as to the rental amount, but includes a method to resolve a disagreement as to the rental amount in the event the parties are unable to agree. For example, the parties should first have the opportunity and an established time to reach an agreement as to the rent on their own. A landlord and tenant with a good working relationship are often able to reach a decision on their

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[www.barronsmithlaw.com](http://www.barronsmithlaw.com) (click on Links and Resources).

## WASHINGTON LEGISLATURE AMENDS DEED OF TRUST STATUTE

By Sallye Quinn

For the first time in nearly 10 years, the State Legislature made significant amendments to the deed of trust statute, RCW 61.24. These changes were enacted through Substitute Senate Bill 5378 (SSB 5378) and Substitute House Bill 2770 (SHB 2770).<sup>1</sup> The changes took effect June 12, 2008.

SSB 5378 focused on refining the duties and role of the trustee. The summary of the bill as set out in the House Bill Report categorizes the changes as 1) Trustee Rights and Obligations; 2) Washington Presence; 3) Notice Requirements; and 4) Restraining Orders and Injunctions.

The amendments made by SHB 2770 are the result of recommendations to the legislature from a task force created by Governor Gregoire “to evaluate instability in the national subprime mortgage market and to make recommendations to minimize the impact of this national trend in Washington.”<sup>2</sup> SHB 2770 enacts the recommendations of the governor’s task force, but only those that affect the deed of trust statute, RCW 61.24, are addressed in this article.

Specifically, SHB 2770 amends RCW 61.24 by adding a requirement that the initial notice

to the borrower in a non-judicial foreclosure, the Notice of Default, include a statement with specific information for homeowners. This new statement must only be included in foreclosures of owner-occupied residential property.<sup>3</sup>

So, what do these specific changes really mean?

### 1. Trustees have clear(er) rights and obligations

**A. Duty of Impartiality.** Ever since the Washington Supreme Court’s ruling in *Cox v. Helenius*, 103 Wn.2d 383 (1985) ambiguities have existed as to the trustee’s duty – was it a fiduciary duty or merely a duty of impar-

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<sup>1</sup> For a succinct summary of what a deed of trust is, the role of the trustee and the non-judicial foreclosure, see both the House Bill Report and the Senate Bill Report for SSB 5378 at <http://apps.leg.wa.gov/billinfo/summary.aspx?bill=5378&year=2007>.

<sup>2</sup> Senate Bill Report, SHB 2770.

<sup>3</sup> The required statement provides as follows:

*You should take care to protect your interest in your home. This notice of default (your failure to pay) is the first step in a process that could result in you losing your home. You should carefully review your options. For example:*

*Can you pay and stop the foreclosure process?*

*Do you dispute the failure to pay?*

*Can you sell your property to preserve your equity?*

*Are you able to refinance this loan with a new loan from another lender with payments, terms, and fees that are more affordable?*

*Do you qualify for any government or private homeowner assistance programs?*

*Do you know if filing for bankruptcy is an option? What are the pros and cons of doing so?*

*Do not ignore this notice; because if you do nothing, you could lose your home at a foreclosure sale. (No foreclosure sale can be held any sooner than ninety days after a notice of sale is issued and a notice of sale cannot be issued until thirty days after this notice.)*

*Also, if you do nothing to pay what you owe, be careful of people who claim they can help you. There are many individuals and businesses that watch for the notices of sale in order to unfairly profit as a result of borrowers' distress.*

*You may feel you need help understanding what to do. There are a number of professional resources available, including home loan counselors and attorneys, who may assist you. Many legal services are lower-cost or even free, depending on your ability to pay. If you desire legal help in understanding your options or handling this default, you may obtain a referral (at no charge) by contacting the county bar association in the county where your home is located. These legal referral services also provide information about lower-cost or free legal services for those who qualify.*

## WASHINGTON LEGISLATURE—CONTINUED

ality?<sup>4</sup> In *Cox*, the Washington Supreme Court held that the trustee was a fiduciary for both the debtor and the lender and that the “fiduciary duty imposed upon the trustee is exceedingly high.” *Id.* at 390. The Court went on to hold that the trustee must act “impartially” between the debtor and the lender and that the trustee is “bound by his office to present the sale under every possible advantage to the debtor as well as the creditor.” *Id.* (quoting *Swindell v. Overton*, 314 S.E.2d 512 (1984)). As a result of SSB 5328, it is now perfectly clear that the “trustee or successor trustee shall have no fiduciary duty or fiduciary obligation to the grantor or other persons having an interest in the property subject to the deed of trust.” The trustee must, however, act impartially between the borrower, grantor, and beneficiary. RCW 61.24.020(3) and (4). The duty of impartiality is the common standard around the country. See *House Bill Report*, SSB 5378.

**B. Collusive or Defective Bidding or Void Sale.** A trustee may now decline to complete a sale or deliver the trustee’s deed and refund the purchase price if it appears that the bidding has been

collusive or defective, or that the sale might have been void.<sup>5</sup>

### 2. Trustees must have a Washington presence

The trustee must now maintain a Washington street address where personal service of process may be made and must also maintain a physical presence in Washington and have telephone service at the Washington street address prior to the date of the trustee’s sale and continuing through the date of the sale. This change, along with the change discussed below, which requires trustees to respond to written request for current payoff or reinstatement amounts within ten (10) days, seem particularly focused on issues created by the current housing crisis because the changes are intended to improve communication with the lender. As foreclosures rise on homes financed with subprime mortgages and those mortgages that have been bought and sold, it will be more and more difficult to make contact with lenders and servicing agents, much less determine who that lender is. This change will increase a debtor’s ability to make contact with lenders by increasing access to the trustee.

### 3. Additional notice requirements

**A. Notice of Continuance.** Currently, when a trustee continues a sale date, the trustee is only required to make a public proclamation of the continuance. As a result of SSB 5378, in order to continue a sale date, the trustee must make a public proclamation of the sale and give notice of the new time and place of the sale to the borrower, grantor and junior lien holders by both first class and either certified or registered mail, return receipt requested. If the sale is continued for up to seven days, the notice must be mailed at least four days before the new date fixed for the sale. If the sale is continued for more than seven days, the notice must be mailed at least three days after the date of continuance by oral proclamation. As a practical matter, it would seem that most trustees will make the public proclamation on the Friday of the day set for sale and mail notice that same day.

**B. Notice of Payoff and Reinstatement Amounts.** Although trustees are required to disclose the amount required to reinstate the promissory note and deed of trust as of the 11<sup>th</sup> day prior to the sale, trustees currently have

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<sup>4</sup>Fiduciary duties are duties of loyalty and duty of care and are generally the highest standard of care owed.

<sup>5</sup>In the recent case of *Udell v. T.D. Escrow Services, Inc.*, 129 Wn.2d 903, 913 (2007), the Washington Supreme Court noted some procedural irregularities that would void a non-judicial foreclosure sale, such as the borrower’s bankruptcy filing and a pending action on the obligation secured by the deed of trust. Unfortunately for the trustee in the *Udell* case, mistakenly opening the bid \$100,000 less than what the beneficiary had instructed did not constitute a procedural irregularity that voided the sale and the trustee was required to deliver the trustee’s deed.

## WHAT KIND OF INITIAL TERM AND RENEWAL OPTIONS MAKE SENSE?—CONTINUED

own with little negotiation. Second, if the parties cannot reach agreement as to the rental amount, many leases provide for a process to determine fair market value. For example, each party appoints its own appraiser and those two appraisers appoint a third appraiser who determines what fair market rent for the renewal period is. The decision of the third appraiser can either be binding, or the parties can have the right to submit the issue to arbitration. Alternatively, the parties can each submit their own determinations of fair market rent to an arbitrator they mutually agree upon, and that arbitrator decides rental value. If the parties cannot decide on an arbitrator, they can each choose an arbitrator and those two arbitrators choose a final deciding arbitrator. The arbitrator's decision is typically binding.

From a landlord's perspective, including a provision stating that "in no event shall the rent in any renewal term be less than the rent for the previous term" gives the landlord assurances that even if the market declines, the landlord will not receive less rent than it has in the past. If that provision is included and the tenant feels that it is paying above-market rent, the tenant can always choose to not exercise the option in the first place.

Rarely is the rent for an option period set, unless the initial term and the option period terms are short. However, in most instances where the initial term is at least five years and any renewal term is for another five years, the parties will want to have a fresh start at determining an appropriate rent amount.

### **How and when the tenant must provide notice of the exercise of its option**

Renewal options are typically exercised by the tenant providing notice of its election to exercise the option. The tenant should always be required to give notice of an exercise of a renewal option in writing.

The bigger issue is when the notice should be given. As a practical matter, landlords want as much advance notice as possible in order to have sufficient time to find a new tenant if the tenant does not exercise the option. Tenants want less time so that they aren't forced to make a decision about a new term before they are ready. As a practical matter, requiring the tenant to make a decision between three and six months before the expiration of the term is standard. If the space is unique and it will require a fair amount of time to find a new tenant, the landlord is likely to want a full six months or even a full year of notice.

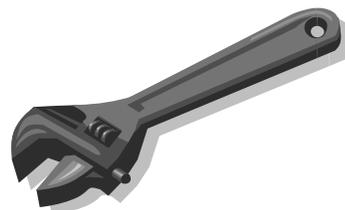
Tenants must be certain to calendar dates for when notice must be given. Unless significant equitable arguments exist (such as construc-

tive notice of the exercise of option or when the tenant has invested significant sums towards improvements in anticipation of exercising the option), a tenant who fails to comply promptly with the notice requirements will not be able to exercise the option once the notice period has passed, unless the landlord agrees.

### **Conditions for tenant to meet prior to being allowed to renew**

A tenant who is currently in default is typically not able to exercise an option. In addition, landlords should consider whether the ability to exercise an option should be conditioned on the tenant not having had numerous defaults during the prior term. That way, a landlord is not forced to continue a leasing relationship with a tenant who continually fails to comply with the terms of the lease. For example, some leases state that the tenant cannot exercise an option if the tenant has been late on its rent payment more than three times in the prior twelve-month period.

*Be sure to check out next quarter's article in our continuing lease series: **Leaking Roofs and Broken Glass: What Does A Maintenance Provision***



## WASHINGTON LEGISLATURE—CONTINUED

no obligation to disclose the amount necessary to satisfy the full amount of the note. With the new amendments, the content of the Notice of Foreclosure must now include disclosure of the amount necessary to satisfy the obligation in full. In addition, trustees must now respond to written request for current payoff or reinstatement amounts within ten days of the trustee's receipt of the request.

In situations where a loan has been bought and sold a number of times and the trustee has no direct contact with a lender and minimal contact with a servicing agent, these new provisions should significantly increase communication. For example, I had a recent pro bono case where I represented debtors whose home was being foreclosed. As the sale date neared, the trustee was not able to provide me a reinstatement amount for at least 10 to 14 days. Because of the delay, the loan would have been accelerated, creating a situation the debtor could not likely correct. The trustee noted that it was only in contact with the servicing agent's call center, which was located in India and that 10 to 14 days was the soonest it could provide an up-to-date reinstatement number. The globalization of the mortgage market has clearly made communication with lenders and servicing agents more complicated. These new requirements are likely to improve communication by, if nothing else, requiring trustees

to force lenders to make sure they are accessible for contact so that the trustee can comply with the new statutory requirements.

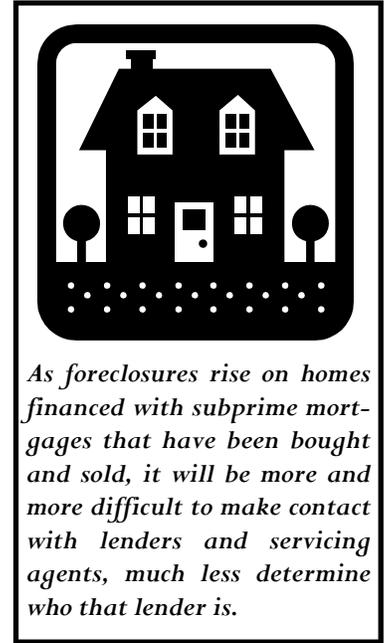
#### 4. Use of restraining orders of injunctions

The changes now clarify that a trustee's sale may be restrained on any proper *legal or equitable* ground (as opposed to any proper ground). In addition, the issuance of a restraining order or injunction does not prohibit the trustee from continuing the trustee's sale per RCW 61.24.040(6).

#### 5. New language for owner-occupied notice

The contents of the owner-occupied notice (the "Owner-Occupied Notice") make it clear that the new notice is intended to provide specific information regarding foreclosure to homeowners and advise them of options they may have regarding the foreclosure. Providing additional information to homeowners, especially given the current housing crisis, is certainly a good thing. However, I question whether the notice and the requirements for the notice were worded in the best manner possible.

Unlike the provisions of RCW 61.24, which set out the contents of the Notice of Trustee's Sale and Notice of Foreclosure and state that those notices should be "substantially in the following form," the Owner-Occupied Notice requirement provides that the statement "shall



*As foreclosures rise on homes financed with subprime mortgages that have been bought and sold, it will be more and more difficult to make contact with lenders and servicing agents, much less determine who that lender is.*

state," which indicates that the form should not be modified to take into account more specific circumstances, such as defaults that do not involve a failure to pay. The Owner-Occupied Notice itself defines the default as a failure to pay by providing "[t]his notice of default (your failure to pay)." Although most defaults are the result of a failure to pay, other defaults can be the cause of the Notice of Default, such as a failure to pay property taxes, a failure to properly insure or an unauthorized transfer of the property.

As a practical matter, Notices of Default are usually sent by attorneys in their capacity as counsel for the beneficiary, since the trustee need only be involved once the trustee's sale is initiated. I believe attorneys will modify the form in cases where the default is does not involve a failure to pay or in-

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## WASHINGTON LEGISLATURE—CONTINUED

volves more than a failure to pay, in order to make the Owner-Occupied Notice as clear as possible. In addition, I believe most cautious attorneys will send the Owner-Occupied Notice whenever the foreclosure involves residential property, regardless of whether the property is owner-occupied or not, short of instances where the attorney has specific information from the client that the home is not owner-occupied. Like the Notice to Occupants or Tenants included as paragraph X in the

Notice of Trustee's Sale and the Notice to Guarantor, my opinion is that the Owner-Occupied Notice will become standard content in Notice of Default as opposed to content used on a case-by-case basis.

As always, if you have any questions regarding the new law or foreclosures, I'd be happy to discuss them with you. Please feel free to give me a call, or send me an email at [squinn@barronsmithlaw.com](mailto:squinn@barronsmithlaw.com).

**THINK GREEN!**

**If you would  
prefer to receive  
this  
Newsletter  
by email, please  
call us at  
360-733-0212.**

### **\*\* EMPLOYER ALERT\*\***

## **LEAVE FOR VICTIMS OF DOMESTIC VIOLENCE**

By Amy Robinson

Employers need to take note of a new and innovative law that went into effect on April 1, 2008. In response to the prevalence of domestic violence and its negative impact on the safety and economic security of innocent victims and their families, Washington has now enacted a law that requires employers to permit victims of domestic violence, stalking, and sexual assault and parents of abused children to take as much leave as necessary to deal with court appearances, counseling appointments, and other personal matters related to domestic violence, stalking and abuse. There is no "cap" on the amount of leave that may be used, but

the basis for the leave must fall within the list of covered activities listed in the statute. They are listed as:

1) *Seek[ing] legal or law enforcement assistance or remedies to ensure the health and safety of the employee or employee's family members including, but not limited to, preparing for, or participating in, any civil or criminal legal proceeding related to or derived from domestic violence, sexual assault, or stalking;*

2) *Seek[ing] treatment by a health care provider for physical or mental injuries caused by domestic violence, sexual assault, or stalking, or attend[ing] to health care treatment for a victim who is the employee's*

*family member;*

3) *Obtain[ing], or assist[ing] a family member in obtaining, services from a domestic violence shelter, rape crisis center, or other social services program for relief from domestic violence, sexual assault, or stalking;*

4) *Obtain[ing], or assist[ing] a family member in obtaining, mental health counseling related to an incident of domestic violence, sexual assault, or stalking, in which the employee or the employee's family member was a victim of domestic violence, sexual assault, or stalking;*  
or

5) *Participat[ing] in safety planning, temporarily or permanently*

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## EMPLOYMENT ALERT—CONTINUED

*relocate[ing], or take[ing] other actions to increase the safety of the employee or employee's family members from future domestic violence, sexual assault, or stalking.*

See SHB 2602.

The employee is required to provide advance notice of the need for leave in accordance with the company's regular policies, absent an emergency situation, and in any event no later than the end of the first day of such leave.

When the employee asks for this leave, employers are permitted to ask for verification that the leave applies and/or that the employee or their family member qualifies as a victim of domestic violence. Acceptable forms of such verification include police reports, court documents, documentation from an attorney, clergy member, or medical provider, or a written state-

ment from the employee. Please be aware that these documents and the employee's statements about the need for leave must be kept strictly confidential and may not be shared with anyone without the em-

### **ACTION ITEM**

*Washington has enacted a law that requires employers to permit victims of domestic violence, stalking, and sexual assault and parents of abused children to take as much leave as necessary to deal with court appearances, counseling appointments, and other personal matters.*

ployee's consent.

The new law operates in many ways like FMLA leave. For example, just like FMLA leave, employers are prohibited from terminating or penalizing employees for such absences and must reinstate the employee to the same position or an equivalent position (with equivalent

pay and benefits) upon their return. Also, employees need not be paid for such leave, but may be permitted to use sick leave and other paid time off.

Unlike the FMLA, however, this law applies to all Washington employers, regardless of size, and has a more expanded definition of "family member" that includes children, spouses, parents, parents-in-law, grandparents or other persons with whom the employee has a "dating relationship".

Employers will want to use this opportunity to update their company leave policies and/or employee handbooks to address this new leave. As always, please feel free to contact us if we can assist you with that effort, if you have any additional questions, or if you receive a request for leave and would like compliance assistance.

## SECURITIES LAWS—CONTINUED

sale of any security not involving a public offering. To offer a security to the public, the security must be registered with the United States Security and Exchange Commission ("SEC"). The cost of an initial public offering can be as much as \$750,000 – not within the range of most of our clients. The private placement has the

advantage of reducing transactional and ongoing costs because of its exemption from many of the extensive federal and state registration and reporting.

To qualify as a private placement under federal law, an offering by an issuer must meet either the requirement of Sections 3(b) or 4(2) of the 1933

Act (as interpreted by the SEC and courts) or must follow the conditions set out under Regulation D of the 1933 Act. Anyone claiming an exemption carries the burden of proving that its activities came within that exemption.

Here is what entities who want

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## INTRODUCTION TO EMPLOYEE INCENTIVE AND OWNERSHIP ISSUES: KEY EMPLOYEES AND “PHANTOM EQUITY”

By Amy Robinson



For a variety of very good reasons, business owners today are becoming increasingly open to the idea of employee ownership and profit sharing through incentive programs. Such programs help attract and keep talent in today's competitive market. They are also useful for succession planning, by allowing a mechanism for successor employees to buy-in or earn-in to ownership over time. In addition, they have proven to be a very dynamic tool for improving employee productivity and thereby increasing the overall profitability, sustainability and value of the business.

Given the benefits these programs can have on the long-term performance of your business, we want to provide you with a general discussion of some options available to you in

this regard. Since this is a topic that can become quite detailed and extensive, we will consider this the introductory article in what we hope will be a three-part series throughout the year. Also, since most of our clients tend to be closely-held, non-publicly traded companies, our discussion and comments are limited to that context unless otherwise noted.

As you begin to consider whether to open up ownership and profit-sharing to your employees, here are some key questions that will help to determine what plans might work best for you:

### **1. Is your goal to allow for genuine ownership by employees or do you want them to only share in the profits?**

Assuming that you aren't yet ready to share ownership, there are several ways in which you can allow employee to share in the "up-side" of your business. You could do this in the form of periodic bonuses based on profits or performance, either at your discretion or pursuant to a guaranteed payout plan. You can structure such bonuses in a variety of ways that allow you to share the financial returns

and the overall success of the operation, while giving some predictability in participation to the employees to promote retention and performance.

Another popular option is to provide for equity- or profit-based compensation pursuant to a formal program known as a Phantom Stock Plan or Stock Appreciation Rights (SAR) Plan that provides employees with a payout, usually in cash, based on the increase in the company's stock value.<sup>1</sup> These types of programs are popularly referred to as "Phantom Equity." In particular, they allow key employees to recognize the increased value in the company, as measured by the company's stock value, and participate much like an owner would, but do not give them any actual ownership rights or responsibilities. Although actual shares of stock are not transferred, the employee is compensated if the stock's value increases (Stock Appreciation Rights Plans), or receives the benefit of the value of a certain percentage of the business at a particular time (Phantom Stock Plans). Typically, these increases are measured by either book value or a formula price based on earnings and cash flow, and this is a con-

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<sup>1</sup> While these plans are discussed in the context of a corporation and therefore "stock" ownership, they are equally available in the limited liability company context. In that case it would simply be referenced as Phantom Units and based upon a membership interest percentage or unit allocation rather than stocks.

## EMPLOYEE INCENTIVE AND OWNERSHIP ISSUES—CONTINUED

sideration that will need to be made as you prepare any plan.

While these two types of plans are very similar, under a typical Phantom Stock Plan, the employee is given a phantom account which is credited with a stated number of shares (or units in the LLC context) equal to a certain number of shares as of certain date that are equal in value to a share of the employer's stock. Most closely-held businesses use current book value to measure stock value. However, another formula may be chosen, such as an annual agreed value based on that year's performance, or valuation by the company's regular accountant as determined at the time of issuance. A Phantom Stock award is outstanding for a period specified in the plan, for example, five years, or until a particular event occurs (known as a "triggering event"). At the end of the measurement period, the key employee receives compensation equal to the stock's appreciation measured by the difference in the value of the shares at the end of the period and their value on the date of the agreement. A Phantom Stock Plan does not usually allow the employee to exercise any rights under

the agreement before the end of the specified award period or event. For example, you may decide that the employee will only receive the value of his/her Phantom Equity in the event that he or she is still employed at the time of a sale of the business (the "triggering event"), or you can allow them to receive the value after a certain term, for example, after five years of employment.

Conversely, Stock Appreciation Rights are typically valued based upon a specified measurement period between the value of the shares on the date that they are granted to an employee and the date that the rights are actually exercised by the employee allowing the employee to recognize the growth value over the time that they have been directly contributing to the bottom line. Typically, they are tied to certain events like retirement, death, termination (other than for cause) or a specified period of time. Just like Phantom Stock, the payout can be either in a lump sum or in an installment plan.

As you can see, Phantom Stock Plans and Stock Appreciation Rights Plans are very similar and both are governed by the terms of a written agreement

which creates the plan. Both are good options available to the closely-held or family-owned business to incentivize key employees, but care needs to be taken in adopting any one approach.

Of course, if you are ready to provide for genuine ownership acquisition, rather than profit-sharing only, you will want to consider implementing an Employee Stock Option Plan or an Employee Stock Purchase Plan, which will allow your key employees to either buy or earn their way into genuine ownership. This can be a great succession planning tool. Tune in next quarter for a discussion of those types of plans and their relevance to your business.

### **2. Who will be allowed to participate?**

In a closely-held or family-owned non-publicly traded company, formal incentive programs, such as equity incentive plans (like Phantom Stock or Stock Appreciation Rights Plans) and stock options plans (to be discussed in the next edition), should typically be made available only to a specific class of employees that are considered "key" to the business.<sup>2</sup> Often they are your upper level

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<sup>2</sup>If you do not limit such a plan to key employees, and instead set it up so that it acts like a retirement plan by covering most or all employees and deferring some or all payment until termination, it may be subject to ERISA (the Employee Retirement Income Security Act of 1974), which can have unintended and unwanted consequences.

## EMPLOYEE INCENTIVE AND OWNERSHIP ISSUES—CONTINUED

managers or successors with a direct effect on the bottom line and the future of the business.

It is important that you have some objectively measurable, clearly articulated standard for how you identify these “key” employees. For example, make sure they are in the same echelon of management, even if they have seemingly different departmental responsibilities. It is important to be sure that all employees who arguably meet that standard are included, because it can have unintended legal exposure if you don’t. For example, if you select only two of three managers with direct reporting responsibilities

to the president who happen to both be white males, and the one manager who is not offered the opportunity to participate happens to be the only female, or a non-white male, you could face a discrimination claim, even if the decision was based on legitimate reasons. This can be easily avoided if you take the time to articulate your basis for selecting these employees well in advance.

Of course, even if you implement a more formal equity-based plan for key employees, you can still allow the rest of your employees to share in your company’s success and profitability through discretionary

bonuses. That allows you to retain control over when, whether, and how much to distribute based upon your determination of what is appropriate to your business model and the particular level of performance.

As always, we hope you find this information helpful and we encourage you to speak to your counsel to determine which, if any, of the plans we mentioned might work best for your particular business.

*Tune in next quarter for a discussion on Employee Stock Option Plans, Employee Stock Purchase Plans and their relevance to your business.*

## SECURITIES LAWS—CONTINUED

to raise capital should know:

⇒ You may not send out a general solicitation for the sale of securities – no cold calls, no public meetings, no advertising.

⇒ Sales to people other than “accredited investors” (certain executives, officers, those worth more than \$1 million or who earn in excess of \$200,000 per year and expect to continue doing so), family and friends and sometimes employees may be a violation of the securities laws.

Whether you can pay a commission to someone who as-

sisted you in raising the capital is also a question that needs to be answered based on the exemption you use.

⇒ Federal and state laws limit the number of people to whom you may sell securities.

⇒ Federal and state laws limit the amount of equity you may raise in one year.

⇒ Purchasers must be buying the security for investment purposes and not to re-sell.

⇒ Even though there is an exemption from registration for private placements, fraud and misrepresentation laws apply

and companies should be careful to fully inform investors, accurately answer all questions posed by the potential investor and be very careful not to make oral representations.

### Federal Law

To qualify for a private placement, a company must structure the transaction within the various categories of exemptions available, such as Section 4(2), the broad “private offering” exemption; Section 3(b), the intrastate exemption; or the most common, Regulation D, which specifies three distinct

**Continued on Page 12**

## SECURITIES LAWS—CONTINUED

exemptions from the registration provisions.

Section 4(2) allows an exemption from registration for "transaction(s) by an issuer not involving a public offering." This language has been a source of much controversy and confusion in the legal and financial communities. Over the years, court cases have established that targeted investors in a 4(2) offering must have access to the same kind of information that would be available if the issuer were required to register its securities under Section 5 of the Securities Act.

Section 3(b) allows an exemption from registration for "any security which is part of an issue offered and sold only to people resident within a single state by an issuer that is a resident and doing business within such state." It is not quite as controversial as Section 4(2). The key issue here is ensuring that the offering is truly an intrastate offering. The SEC has adopted Rule 147 to assist in determining whether the requirements have been met. We note that state laws will apply in this case.

Regulation D includes three basic exemptions:

*Rule 504* applies to transactions in which no more than \$1,000,000 of securities is sold

in any consecutive 12-month period. *Rule 504* imposes no ceiling on the number of investors, permits the payment of commissions, and imposes no restrictions on the manner of offering or resale of securities. Further, *Rule 504* does not prescribe specific disclosure requirements, although most securities lawyers we know advise the issuer to have a formal disclosure statement. Even though this issuance is "exempt" from registration, there are still a number of procedures to follow and forms to file.

*Rule 505* applies to transactions in which not more than \$5,000,000 of securities is sold in any consecutive 12-month period. Sales to 35-five "non-accredited" investors and to an unlimited number of accredited investors are permitted.

*Rule 506* has no dollar limitation of the offering. *Rule 506* is available to all issuers for offerings sold to not more than 35-five non-accredited purchasers and an unlimited number of accredited investors. *Rule 506*, however, unlike 504 and 505, requires an issuer to make a subjective determination that at the time of acquisition of the investment, each non-accredited purchaser meets a certain sophistication standard, either individually or

in conjunction with a "Purchaser Representative."

### State Law

Washington state securities laws provide for the Small Company Offering Registration ("SCOR"), which offers an optional method of registration that utilizes a question and answer disclosure document and enables corporations and limited liability companies (LLCs) to raise up to \$1 million during a period of up to 12 months. SCOR registration is designed by the state legislature to be exempt from federal registration with the SEC pursuant to Rule 504 or Section 3(b) of the Securities Act of 1933 and Rule 147. The Washington Secretary of State has a great website on the SCOR exemption and how that works.

We care very much about our clients and do not want to see your successes compromised by inadvertent violations of complicated state and federal laws. There is one message in this article - if you are considering raising funds from equity investment(s), please contact legal counsel. Depending on the size and complexity of the transaction, Barron Smith Daugert may be able to assist you, but we are also able to identify the lawyer with the necessary knowledge and experience to assist you.

**BEFORE YOU RAISE CAPITAL—**

**TALK TO A LAWYER!**



**A PERSONAL NOTE FROM THE DEPARTMENT:**

By Kirsten Barron

This newsletter finds its way to you all a bit late this quarter. We apologize. Despite all of the gloom and doom we have been hearing and some of the realities of recession, our clients continue to move forward with business agreements and transactions. I look at production reports from the summer months of prior years. It has been a long time since I have personally been this busy in the summer. It is always interesting to look at what is happening, what was happening and think about what may happen, given the context of production data. Despite my lack of expertise, I especially love thinking about “why” a particular cycle is happening.

I think the increased activity may have something to do with people working harder to stay ahead of the downhill slide (however steep that is or becomes), rather than spending leisurely and wonderful time enjoying various sizes of boats, lengths of hikes and other summer recreation in what has to be the most beautiful place on the planet – or certainly in the running. I hope that you all do get some time to enjoy this summer, and in the meantime, we are here to help you work through deals, contracts, disputes, transitions and whatever else may come your way.

Sometimes in business your plans and expectations actually meet with reality. We have had the opportunity to enjoy that this summer. We have a new addition to help us with all of this work. Christina Cusolito, a WWU graduate has returned to Bellingham and has joined the law firm as a legal assistant. She was an English major at Western and has worked as an editor and copywriting intern. She is working primarily in the business department, where we are making very good use of those skills. She is new to the legal field but brings some wonderful experience from her prior work in Seattle, where she was most recently with Pyramid Communications, a marketing firm. She is smart, easy going, a quick learner and team-oriented. It has been a great fit and a smooth transition. I hope that each of you gets the opportunity to work with her. We are delighted to have her with us.

I hope you enjoy this issue of the newsletter —even in the rush of preparation —this is a fun one. We are always looking for topics that interest you, so if you want us to address something, just let us know. We continue to appreciate your feedback on our newsletters.



*Kirsten Barron*

**CONTRIBUTORS AND EDITORS TO THIS PUBLICATION**



**Sallye Quinn** is a senior associate in the firm’s business department and focuses her practice on business and real estate transactions and creditor’s rights.

**Amy Robinson** brings employment and human resource experience to the firm and is invaluable to our department and the Litigation team in solving a myriad of complex legal issues. Her practice is focused on employment and civil litigation.



**Debbie Nelson** is a paralegal in the firm’s business department and has extensive experience in corporate legal services.

**Christina Cusolito** is a legal assistant in the firm’s business department and is responsible for the administrative and organizational flow of the department.

