

# Oregon Business Lawyer

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## Avoiding Litigation: Tips for Transactional Lawyers

By David B. Markowitz and Stanton R. Gallegos, Attorneys at Markowitz Herbold PC

Litigation can be extremely costly for businesses, both in terms of legal fees and lost productivity. While some lawsuits are unavoidable, the fact that most business litigation involves relationships and transactions negotiated and documented by lawyers means that those lawyers have an opportunity to lay the groundwork to prevent, or at least limit, future litigation for their clients.

Below are a few tips for transactional lawyers that can, in our experience, reduce the likelihood and cost of future litigation.

### Clarity is Key

One important way to limit the likelihood of future litigation is to make written contracts as straightforward and easy to understand as possible. Businesses generally try to comply with their agreements to avoid potential liability and litigation expense, but misunderstandings and misinterpretations can arise if the contract is not clear. Many of the contracts we see in litigation are densely written and full of legalese, long sentences, and unnecessary terms. They provide ample opportunity for misunderstandings and for the parties' lawyers to argue for different (more advantageous) positions. A contract written in plain English without extraneous terms and unnecessary legalese not only makes it

easier for business people executing the deal to understand their responsibilities, but it also lessens the likelihood that a party will try to use ambiguities to change their interpretation after the fact.

### Be Consistent

Another key to avoiding litigation is to maintain consistency across transaction documents. Many transactions are negotiated in stages—for example, the principal terms are set out in a term sheet before a contract is drafted—or involve several related agreements, like an asset purchase agreement coupled with a royalty or employment agreement. Inconsistencies between a term sheet and a contract, or between two related contracts, can often result in litigation. For example, in a sale leaseback arrangement, if the description of the property differs from the term sheet to the sale agreement to the lease, the ambiguity increases the risk of litigation. Reviewing the final agreements for consistency with any prior agreements and each other will help limit this risk.

### Create Disincentives to Litigation in the Contract

Another way to decrease the likelihood of future litigation is inclusion of terms in the contract that limit the amount of money that can be recovered, which makes litigation less attractive. Examples of this include:

- **Limiting the damages that can be recovered if a claim is successful.** For example, the parties can limit damages to the amount paid, waive consequential and/or punitive damages, and waive any equitable remedies.
- **Waiving and/or releasing all claims existing at the time of the contract,** including claims related to the negotiations that led up to the contract
- **Allocating the responsibility for any foreseeable risks.** For example, if products are being shipped, the parties can specify that all risk of shipping loss will be borne by one party.
- **Relieving the parties from liability** for claims related to any conduct that is not intentionally harmful or grossly negligent

## In this Issue

### Articles

Avoiding Litigation .....	1
R&W Insurance .....	3
Accounting Principles .....	5
Opportunity Zones .....	8

### Business Law Section News

Year-end report from the Chair .....	10
Subcommittee reports .....	10

Upcoming Events .....	11
-----------------------	----

Job Postings .....	11
--------------------	----

Continued on page 2



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Stanton Gallegos represents businesses and nonprofits in complex litigation, including cases involving securities, shareholder disputes, breach of contract, products liability, class actions, employment discrimination claims, and other torts. He has extensive experience in matters involving securities and financial investments, where he has represented financial institutions and individual investors.

In addition to limiting the upside of litigation, contract terms can discourage the parties from bringing weaker claims, or encourage them to resolve meritorious claims early, by allowing the prevailing party in any dispute to recover attorneys' fees and costs.

It is important to recognize, however, that these types of contract provisions are generally written to apply equally to both parties to ensure they are enforceable, so it is essential to consider whether the decreased likelihood of litigation is outweighed by other interests that may be more important to your client.

### Take Control of the Procedural Aspects of Potential Litigation

A third tip for avoiding or lessening the cost of litigation is to take control of the dispute-resolution process by defining it in the contract. Doing this gives you a chance to make litigation less attractive, or at least less costly if disputes are unavoidable. The prototypical example is an arbitration clause stating that all disputes related to the contract will be resolved through arbitration, but the options vary widely and can be modified based on the circumstances. Examples include:

**Arbitration Clauses:** At a minimum, these require arbitration of some or all disputes, but they can also do much more than that.

The parties can agree on a variety of procedural limitations on the arbitration proceeding itself, including:

- *Selecting the arbitration service.* Arbitration Services of Portland are known for providing faster resolutions, while other services are more like litigation in the courts.
- *Pre-selecting arbitrators.* Identifying the arbitrator(s) at the time the contract is signed will save your client significant time and money that would be spent arguing over the appointment of an arbitrator later.
- *Limiting the number of arbitrators.* Limiting the arbitration to a single arbitrator, rather than a panel of three, can speed up the process and limit the expense.
- *Selecting the forum.* For example, a contract that requires that arbitration occur in Multnomah County, Oregon, may make litigation less attractive to a party based on the east coast.
- *Prohibiting the counterparty from serving as a class representative.*
- *Shortening the statute of limitations for certain claims.* For example, stating that any claim based on a breach of the contract must be brought within one year of the breach.
- *Limiting the scope of discovery.* Discovery is often one of the costliest parts of litigation. A contract can reduce that cost by, for example, limiting the number of depositions, the time for the depositions, and other aspects of discovery.

- *Limiting the presentation of evidence.* Specifying that the arbitrator will decide the dispute based on written submissions without a full hearing, or setting specific time limits on a hearing (e.g., three hours per side), can limit the cost of arbitration.

Even if the parties do not agree to arbitration, several of these options—along with a waiver of the right to a jury trial—can be used to limit traditional litigation as well.

**Mediation Requirement:** Another common procedural mechanism is to require mediation before a lawsuit or arbitration is filed. This can be particularly helpful in avoiding litigation where the parties have good reasons to continue their professional relationship, to make negotiations more promising.

### Consult a Litigator

Consulting a litigator when drafting contracts or setting business policy can also help to limit the possibility of litigation.<sup>1</sup> Often litigators are not consulted until long after the contract is signed and a dispute is in sight. But involving litigators in the planning and contract drafting process can add significant value because they approach issues with different perspectives and can spot risks and ambiguities. For example, a litigator with relevant experience will be able to assess the likelihood that a covenant not to compete or a release of liability will be subject to a later challenge in court. It is particularly important to have a litigator draft or review contract provisions that limit the parties' claims and the procedural aspects of litigation as discussed above.

### Comply with Community Expectations

Last but not least, ask yourself whether your client's goals, the terms of the contract, and the desired conduct are consistent with the standards of the relevant community and industry. The law that judges and juries will ultimately apply is an expression of current community expectations for conduct. To the extent a transaction or contract could be considered unfair under those standards, it is far more likely to result in litigation.

### In Conclusion

Whether negotiating a merger or drafting a basic sales agreement, there are many ways to reduce the risk of future litigation. Because client interests vary, there is no one-size-fits-all approach to minimizing litigation risk, but in our experience these are among the most effective tools available. ♦

### Footnote.

1. We also recommend consulting a competent insurance broker when entering into new business arrangements or transactions. In many cases, insurance may be available to pay defense costs or liability in the event litigation is unavoidable.

# Representations and Warranties Insurance: Go On, Take the Money and Run

By Adam Adkin and Jeff Woodcox, Attorneys at Tonkon Torp LLP



Adam is an associate in Tonkon Torp's Business Department. He works closely with business owners and their key employees in the purchase and sale of businesses. Adam has assisted clients at every stage of their business life cycle, including corporate formation, corporate governance compliance, raising capital through private placements of debt and equity securities, and structuring ownership transitions.



Jeff is a partner in Tonkon Torp's Business Department. He focuses his practice on mergers and acquisitions, corporate finance, securities regulation, and corporate governance. He is experienced in advising clients on the acquisition and disposition of businesses and assets, securities compliance, and raising capital through private placements of equity and debt.

No seller in a mergers and acquisitions (M&A) transaction wants to wait for the release of its money from escrow while the buyer takes the business for a spin. And no buyer wants to discover post-closing issues. These competing objectives regarding post-closing risk allocation often create tension in the M&A process. Even with the risk-allocating tools available to lawyers to balance these competing objectives—including materiality and knowledge qualifiers, escrow holdbacks, survival periods, baskets, and caps, to name a few—sellers and buyers can still find themselves unable to reach agreement. For the right deal, representations and warranties insurance (R&W insurance) can bridge the gap.

## What is R&W Insurance?

R&W insurance insures a buyer (or, more rarely, a seller) against losses resulting from a seller's breach of its representations or warranties in the purchase agreement. Instead of making claims against the seller and pursuing losses against an escrow holdback or the seller directly, the buyer seeks compensation by filing a claim with the insurer.

R&W insurance is becoming increasingly common as a tool used by both strategic and private equity buyers to distinguish their bids in an M&A auction. Additionally, sellers are weaving R&W insurance policies into the fabric of a deal early on to set expectations for how indemnification claims will be handled. Although insurance brokers can assist parties who are interested in obtaining an R&W insurance policy, the best starting place for parties who are considering R&W insurance is likely their current insurers.

## Benefits of R&W Insurance

R&W insurance provides a number of benefits in M&A transactions.

### **R&W insurance can save time and alleviate frustration.**

Although an insurer will expect the seller and the buyer to thoroughly negotiate the representations and warranties in the purchase agreement, the R&W insurance can go a long way in resolving many of the more challenging concerns each party may have regarding the scope of the representations and warranties.

A seller may also be more amenable to providing certain representations and warranties if the R&W insurance policy will provide the sole or even primary source of recovery for breaches of those representations and warranties.

### **R&W insurance can put more of the purchase price in the seller's pocket at closing.**

Because R&W insurance provides the buyer with an alternative source for recovering losses it suffers from the seller's breach of its representations and warranties, the seller can negotiate for shorter survival periods and smaller holdbacks and caps. As a result, the seller gets more funds at closing and has greater certainty it will get to keep those funds after closing.

### **R&W insurance can minimize the concerns of how liability is allocated among multiple sellers.**

Buyers often require sellers to be jointly and severally liable for losses that arise from breaches of the sellers' representations and warranties. This requirement can be contentious for sellers who do not want to bear the responsibility for their fellow sellers' share of liabilities. R&W insurance can reduce that tension by diverting claims to the R&W insurance policy. Additionally, because passive investors typically have little or no knowledge about the accuracy of the representations and warranties in the purchase agreement, they may resist sharing in any losses arising from breaches of those representations and warranties. Passive investors are, however, more likely to accept sharing the cost of R&W Insurance as a cost of the transaction.

### **R&W insurance offers greater certainty to the buyer of collecting losses.**

Buyers often don't have great appetite for tracking down a seller to make claims for breaches of representations and warranties, which is why buyers press hard for a robust holdback escrow. An R&W insurance policy may provide greater coverage for claims than a seller would be willing to commit to an escrow holdback, and may provide coverage for longer than a seller would be willing to escrow a portion of the purchase price.

*Continued on page 4*



**For the right deal, R&W insurance can facilitate negotiations and resolve roadblocks that otherwise may have prevented the parties from reaching an**

R&W insurance can also prove useful in transactions with a distressed seller, such as a seller that is in bankruptcy or otherwise unable or unwilling to agree to indemnify the buyer.

In those cases, an R&W insurance policy can provide the buyer with a source of recovery that otherwise would be unavailable.

**R&W insurance can help preserve post-closing relationships.**

If the buyer and the seller will have an ongoing relationship following the sale, such as when a selling party rolls over part of its ownership into the buyer or the buyer retains one or more sellers as employees following the sale, the independent source of recovery offered by R&W insurance can reduce the likelihood that post-closing claims will sour the continuing relationship.

**Drawbacks and Limitations of R&W Insurance**

While offering many benefits, R&W insurance is not right for all transactions and won't solve all post-closing risk allocation issues.

**Like all insurance, R&W insurance exchanges uncertainty for a fixed cost.**

Generally, the premium for an R&W insurance policy ranges from 2% to 4% of the policy's limit. Although the seller rarely bears the cost of obtaining the R&W insurance directly,<sup>1</sup> the premium for R&W insurance is ultimately a transaction cost. Accordingly, a seller who perceives little risk of post-closing claims is unlikely to see the value in reducing the purchase price that the buyer otherwise would be willing to pay by the cost of the R&W insurance premium. The cost of obtaining an R&W insurance policy may make it a poor fit for transactions with a value of less than \$20 million, and many insurers are not willing to provide R&W insurance for transactions with a value of less than \$50 million.

**R&W insurance policies generally provide for a retention of between 1% and 3% of the value of the transaction.**

Similar to a deductible, the retention is the amount of losses that the insured must incur before the insurer will pay claims under the policy. Depending on the size of the retention and who pays for the R&W insurance policy, the buyer and the seller may struggle to agree on whether the seller should share responsibility for any portion of the retention.

**Acquiring R&W insurance brings a third-party into the deal that has the potential to disrupt deal flow.**

The insurer will make its own assessment of the risks and impose requirements on the parties and the purchase agreement that, depending on the posture of the negotiations, could derail the negotiations or delay closing.

**R&W insurance won't cover all claims.**

Generally, R&W insurance does not provide coverage for breaches of representations or warranties that are known when the transaction closes. Additionally, R&W insurance generally does not provide coverage for breaches of covenants or other indemnification obligations that may be negotiated in the purchase agreement. Accordingly, the buyer may require a holdback escrow or reserve the right to pursue claims against the seller regardless of an R&W insurance policy.

**Conclusion**

For the right deal, R&W insurance can facilitate negotiations and resolve roadblocks that otherwise might have prevented the parties from reaching an agreement. Nonetheless, it is not a silver bullet for all negotiation hang-ups. The sooner the concept of R&W insurance is introduced in a deal, the more likely it will serve the parties in reaching a successful agreement. ♦

**Footnote**

1. M&A Market Trends Subcommittee, Mergers & Acquisitions Committee of the American Bar Association's Business Law Section, *Private Target M&A Deal Points Study* 106 (December 22, 2017).

# Bridging the GAAP: Understanding References to Generally Accepted Accounting Principles in Business Transaction Documents

By Jay Richardson, Attorney at Cosgrave Vergeer Kester LLP



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Financial statements<sup>1</sup> are integral to a business transaction and are referred to frequently in transaction documents. Many of those agreements also refer to generally accepted accounting principles (GAAP).<sup>2</sup> GAAP is not fully understood even by accountants. Indeed, one prominent local CPA told the author that asking what the meaning of life is might be an easier question to answer than what is GAAP. Thus, it is not surprising that the author has seen a wide variety of references to GAAP in transaction documents. Though many transaction lawyers refer to GAAP in their documents, they may not fully understand its meaning, scope, and implications. In short, there may be a GAAP “gap” in transaction documents. This article provides guidance to attorneys whose transaction documentation involves references to financial statements and financial statement standards such as GAAP.

## A brief overview of GAAP

Financial reporting standards is the language that communicates key financial information. If financial statements are prepared following GAAP, then the user can compare an issuer’s financial performance (i) year-over-year and (ii) with another issuer’s financial statements. GAAP financial statements provide a level of credibility to an issuer’s financial statements. GAAP must be followed when an issuer distributes its financial statements outside of the issuer. (In this article, “user” refers to any outside entity or person that receives financial statements, such as government, a buyer, lender, or landlord; and “issuer” refers to the entity that issues the financial statements such as a seller, borrower, or tenant.)

The Financial Accounting Standards Board (FASB)—along with the Securities Exchange Commission (SEC) for public companies—determines GAAP. GAAP is not static. Standards evolve as the FASB and SEC explore new ways to improve the understandability of financial statements for users.

A key GAAP principle is “consistency,” which means that once an issuer adopts an accounting principle or method, the issuer must continue to follow it. The issuer can change an accounting method if the new method improves the understandability of the financial statements.

If a privately held entity communicates only with its owners and management, financial reporting that employs GAAP standards is not required. Indeed, most issuers do not follow every GAAP standard. However, GAAP may be required by a user as discussed below.

## GAAP and CPAs

An issuer can prepare GAAP-based financial statements in Oregon without the assistance of an independent CPA. A CPA can be hired to compile GAAP-compliant financial statements or “attest” to the issuer’s financial statements. Attested financial statements will be either audited or reviewed.

Audited financial statements provide the best assurance that the issuer’s financial statements are materially accurate. An audit also considers the issuer’s internal accounting controls and may identify material weaknesses or significant deficiencies in those controls. An audit opinion letter will read something like this:

*“The financial statements present fairly, in all material respects, the financial position of issuer as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with GAAP...”*

Reviews provide limited assurance on the issuer’s financial statements. Reviews rely upon the CPA’s inquiry of company management, and the performance of analytical procedures applied to financial data. These procedures are significantly less in scope than the substantive testing that is performed in an audit. As such, in a review, a CPA is less likely than in an audit to identify missing or inaccurate amounts in the financial statements. If financial statements are reviewed, the CPA’s letter will say:

*“Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with GAAP.”*

Compiled financial statements (write-ups) provide no assurance on the issuer’s financial statements. The CPA is obligated to investigate any obvious GAAP departures. There is very little CPA attestation of compiled financial statements.

In an audit or a review, the CPA’s opinion is limited by a materiality standard. In an audit, the CPA is opining that the financial

*Continued on page 6*

statements “fairly present” the issuer’s financial condition; but does not promise accuracy. Audited, reviewed, and compiled financial statements are not a guaranty that an issuer’s financial statements are free from fraud, errors or omissions. Users are always encouraged to read the CPA’s “opinion letter” carefully.

**GAAP in transaction documents**

Because GAAP has meaning to the accounting profession, the parties should avoid any language that departs from that meaning. The author recommends the parties consider this simple GAAP representation:

*“Issuer represents that their financial statements were prepared in accordance with GAAP.”*

If the transaction has international components, and the parties want United States GAAP (as opposed to, for example, Japanese GAAP), the parties can add “United States” before GAAP. Often, however, lawyers are tempted to expand a GAAP reference. Some believe that such a simple sentence will not adequately protect the user. The author suggests that “more” is not necessarily “better,” as can be seen from the following real-world examples:

**Example 1:**

*“The financial statements have been prepared in accordance with GAAP in effect from time to time and consistent with the past financial practices of the company, and accurately state in all material respects the financial condition of the company consistently applied as of the dates thereof, and the cash flows and results of operations of issuer, for the periods related thereto.”*

Two parts of this representation are redundant (“from time to time” and “consistently”). The most glaring issue is that the representation asks the issuer to warrant that their financial statements are “accurate in all material respects.” GAAP only requires that the financial statements “fairly present” the issuer’s financial condition; “fairly present” does not mean “accurate.” Combining “GAAP” and “accurately” in this example may lead to disputes.

The preceding example was a major restatement of the recommended GAAP representation. Sometimes the parties attempt minor modifications to a GAAP representation. Even minor modifications to “GAAP” can obscure GAAP’s meaning:

**Example 2:**

*“The financial statements shall be prepared on an accrual basis, and shall be in accordance with GAAP.”*

Accrual accounting is already part of GAAP.<sup>3</sup> Does this sentence imply that accrual accounting is the only part of GAAP with which the issuer must comply?

**Example 3:**

*“GAAP means United States generally accepted accounting principles as of the date of this Agreement.”*

By adding the phrase “as of the date of this Agreement,” the parties have opened up the possibility that GAAP as it existed in prior periods is no longer valid for existing financial statements. Did the parties intend that prior financial statements be restated to comply with GAAP “as of the date of this Agreement”?

**Example 4:**

*“GAAP means generally accepted accounting principles and practices set forth in the opinions and pronouncements of the Accounting Principles Board and the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board.”*

The FASB replaced the APB in 1973. While a few opinions of the APB still exist, most have been replaced, restated, or amended by the FASB. The AICPA does not issue GAAP.

**Example 5:**

*“Issuer’s financial statements shall comply with GAAP or with such other financial reporting standards as may be approved by a significant segment of the accounting profession that are applicable to the circumstances as of the date hereof.”*

Outside the US, International Financial Reporting Standards (IFRS) is the recognized financial reporting standard. Does this sentence allow the issuer to choose elements of GAAP and IFRS most beneficial to it? The parties should choose just one reporting standard; as of today, GAAP is the standard in the US.

**Example 6:**

*“Each accounting term not otherwise defined in this Agreement has the meaning assigned it in accordance with GAAP.”*

Some transaction documents use terms such as “adjusted net worth” that are not defined in GAAP. If the document uses a phrase that is not a GAAP term, then the agreement should define the term or only use GAAP terms.

**Recommendations for issuers**

**General.** Issuers usually do not follow GAAP because their non-GAAP financial statements are adequate for their internal decision-making needs. Many users make a GAAP representation without understanding its ramifications. For issuers being asked to comply with GAAP, the author urges caution on making such representations if their financial statements do not comply with GAAP. If a user expecting GAAP financial statements finds undisclosed non-GAAP issues, a dispute may arise. Some of the more common areas of dispute involve environmental remediation costs, undisclosed contractual obligations, and overstated accounts receivable and inventory.

**Alternate language.** Rather than making the GAAP representation recommended above, an issuer instead may offer one of the following representations, depending on which one fits the transaction:

*“The financial statements have been based upon and are consistent with the information contained in issuer’s records and, to the best of issuer’s knowledge, are materially accurate.”*

*“To the best of issuer’s knowledge, the financial records of the issuer used to prepare the financial statements: (i) have been maintained in accordance with sound business practices, (ii) are stated in reasonable detail and reflect actual bona fide transactions of issuer in all material respects, (iii) constitute the basis for the financial statements and (iv) have been consistently applied unless the new method in some way improves reported financial results and position of issuer.”*

Continued on page 7

Many users resist a complete disclaimer but it never hurts to add:

*"The financial statements were not prepared in a manner that complies with any published guidelines of any regulatory or professional body or with GAAP."*

Issuers should never represent that their financial statements are complete, accurate, or correct.

**EBITDA.** Users often rely upon earnings before interest, taxes, depreciation, and amortization (EBITDA) in making business valuation determinations. An issuer needs to pay close attention to the quality of EBITDA components given to a user. For example, inventory is a material asset for some issuers. If the issuer does not perform regular inventory observations and make adjustments using GAAP, the issuer should perform an inventory observation before providing financial information to the user. Write-offs of missing or unusable inventory by the user after the sale might be significant.

**Purchase price adjustments.** Financial statements are usually required in transactions where the purchase price is based on data from the issuer's post-closing financial performance. If the documentation states that the user will prepare the financial statements under GAAP, and the internal statements are not GAAP compliant, the issuer should consider adjusting its internal records to GAAP as soon as possible before closing. Otherwise, any differences between the user's internal financial statements and the GAAP statements prepared by the user could cause negative adjustments to the purchase price.

**Knowledge qualifier.** If the user insists on referring to GAAP and the issuer believes in good faith that its financial statements comply with GAAP, the issuer may try to add a knowledge qualifier ("To the best of issuer's knowledge,") as shown above.

**When a GAAP demand is not negotiable.** If the user insists upon a GAAP representation, the issuer will have to bring its financial statements into compliance with GAAP. In that case, the parties should agree on a CPA to make a GAAP study. A mutually agreed-upon CPA can prevent the issuer from paying for a study by the issuer's CPA only to find that the user wants to hire its own CPA to do the same analysis.

**Post-closing financial statements.** Most financial statements are issued as of the end of the issuer's fiscal year. If a transaction closes after year-end, users often demand the short-period financial statements be compliant with GAAP. If the issuer cannot represent that

its short-period financial statements comply with GAAP, the issuer may want to use the following language:

*"Issuer represents that (i) its year-end financial statements were prepared in accordance with GAAP, and (ii) there has not been a material adverse change in its financial condition following issuer's fiscal year."*

### **Recommendations for users**

**Understand what you are asking for and why.** In any transaction involving financial data, the user should decide if GAAP produces a number that is more meaningful than a non-GAAP number. An issuer may have valid business reasons to depart from GAAP; non-GAAP financial statements may provide more meaningful financial information. For example, GAAP might not yield the best value of inventory or property because these items are recorded at cost. For issuers who follow GAAP, the issuer's management may have made many significant estimates about financial items such as inventory, accounts-receivable reserve, and incurred but not reported medical claims. A user insisting on GAAP should understand what those estimates are and how they were derived.

**No guaranty.** Not every company that uses non-GAAP practices has legitimate reasons. Some issuers avoid GAAP to hide problems with their financials or to otherwise mislead users. That said, complying with GAAP is not a guaranty that an issuer's financial statements are free from fraud, errors, or omissions. Even if an issuer does not follow GAAP, it does not necessarily mean that its financial reports are "wrong."

**Targeted GAAP.** If a user has interest in a particular financial component of the issuer, rather than requiring the issuer to represent that their financial statements comply with GAAP, the user may consider requiring GAAP only for specific items:

**Accounts receivable and cash.** *"Issuer's accounts receivable are current and collectible net of the reserves therefore shown on the financial statements (which reserves are calculated in accordance with GAAP). Cash-on-hand shall include all cash and cash equivalents, determined in accordance with GAAP."*

**Valuation of stock:** *"Corporate securities owned by issuer for which there is no established trading market shall be valued in accordance with GAAP."*

**Labor costs.** *"The cost of all labor, employment benefits and taxes related thereto shall be charged as gross operating expenses and shall be accrued in accordance with GAAP."*

**EBITDA.** *"EBITDA means earnings before interest, taxes, depreciation, and amortization determined in accordance with GAAP."*

### **Summary**

Transaction documents often contain references to GAAP without both sides understanding what GAAP means to the financial statements of the issuer. An inappropriate or misunderstood use of GAAP can lead to ambiguities, hard feelings, and even litigation. Understanding a client's current accounting practices and their impact on the transaction are paramount before including any reference to GAAP in a transaction document. ♦

### **Footnotes**

1. The four main financial statements are: statement of financial position (balance sheet), profit and loss statement (income statement or results of operations), statement of cash flows, and statement of retained earnings.
2. Many countries use IFRS because they believe that IFRS offers greater understandability of financial statements than GAAP. Eventually, IFRS may converge with GAAP.
3. The accrual method of accounting recognizes revenue before cash is collected. Most small businesses do not want to recognize income before cash is collected.

# Investing in Qualified Opportunity Funds

By Thomas B. Eriksen, Attorney at Jordan Ramis PC



*Thomas B. ("Brad") Eriksen represents business and corporate clients in all aspects of business operations, from choice of entity and capitalization decisions to operational issues and growth, exit, and transition strategies. Brad's focus is on acting as general counsel to a variety of closely-held businesses in the design and construction industries. Business transactions, including acquisition and sale of businesses, capitalization and organizational structuring, and succession planning for business owners and senior management, are a substantial part of Brad's practice.*

The 2017 Tax Cuts and Jobs Act includes new tax incentives designed to spur economic development in areas of the country determined to be disadvantaged. Internal Revenue Code (IRC) Subchapter Z—Opportunity Funds provides three distinct tax incentives intended to encourage investors to invest capital into low-income areas of each state. All 50 governors had until March 21, 2018, to designate certain disadvantaged geographic areas within their state as "opportunity zones." Interactive maps of national<sup>1</sup> and Oregon<sup>2</sup> opportunity zones are available.

Once designated, the opportunity zones may not be modified during the 10-year run of the opportunity fund tax provisions. It is interesting to note that some states relied on old (up to 10 years old) data to determine the location of their opportunity zones, raising questions as to the validity of some designations of disadvantaged areas. For example, the recently revived Vancouver, Washington, waterfront is located in an opportunity zone. However, tens of millions of investment capital was already flowing into this area before the new tax incentives.

## Deferral of Capital Gains

The first tax benefit is the deferral of capital gains upon the sale or exchange of a capital asset on or after January 1, 2018. The sale of any capital asset qualifies as long as it is sold to an unrelated party and the gains are reinvested in a qualified opportunity fund within 180 days of the sale of the capital asset. Subject to the possibility of a step-up in basis discussed below, recognition of the capital gains may be deferred until December 31, 2026. Under the recently released proposed regulations implementing IRC Section 1400Z-2, the IRS clarified that taxpayers eligible to take advantage of the deferral include individual taxpayers, corporations (including REITs and RICs), partnerships, and certain trusts. A partnership may elect to defer part or all of the gain at the partnership level. If the partnership does not elect to defer the gain, a partner may elect to defer part or all of the partner's distributive share of the gain. Under the sunset provisions of the new tax law, the deferral election applies to capital gains recognized prior to December 31, 2026.

## Step-up in Basis

The second tax benefit is the possible step-up in basis on the deferred gain. If the investor holds the Qualified Opportunity Fund investment for five years, the investor receives a 10% step-up in basis on the deferred capital gains. If the investor holds the qualified opportunity fund investment two additional years, for a total of seven years, the investor receives an additional 5% step-up in basis, for a total of a 15% step-up in basis. Accordingly, for each \$100 of deferred gain held in a qualified opportunity fund investment for seven years or more, only \$85 of that gain will ultimately be subject to capital gains taxation. The proposed regulations allow taxpayers to make the step-up in basis election until December 31, 2047, thus allowing the step-up in basis after the initial designation expires on December 31, 2028. This provides the investor the opportunity to hold the qualified opportunity fund investment for the entire required ten-year holding period, plus an additional ten years, and allows investors to acquire qualified opportunity fund investments at any time prior to the December 31, 2028, expiration and still take advantage of the step-up in basis opportunity.

## Exclusion of Gain

The third tax benefit of the new opportunity fund tax provisions is the possible permanent exclusion of all of the gain on the appreciation in value of the opportunity fund investment. If the opportunity fund investment is held for ten years or more, all of the increase in value of the investment is excluded from capital gains taxation. In this scenario, the investor will pay capital gains tax on 85% of the capital gains deferred on the initial sale of the capital asset. However, any gains on the funds reinvested in the opportunity fund permanently avoid taxation.

## Qualified Opportunity Fund

As noted above, an investor has 180 days from the sale or exchange of a capital asset to invest the gains in a qualified opportunity fund. The fund must in turn hold at least 90% of its assets in qualified opportunity-zone property. The 90% standard is measured on the last day of the first six-month period of the taxable year of the fund and on the last day of the taxable year of the fund (more on qualified opportunity-zone property below).

*Continued on page 9*

# Opportunity Funds *Continued from page 8*

A qualified opportunity fund is defined in the IRC as “any investment vehicle which is organized as a corporation or partnership” for the purpose of investing in qualified opportunity-zone property. Since the term “organized” as a corporation or partnership was used, rather than “taxed” as a corporation or partnership, there was initially some question and concern whether a limited liability company satisfied the definition of a qualified opportunity fund. Fortunately, the proposed regulations issued October 19, 2018, answered this question in the affirmative, and clarified that a qualified opportunity fund includes entities treated for federal income-tax purposes as a corporation or partnership (thus including limited liability companies taxed as either).

## Qualified Opportunity-zone Property

The gains invested in the qualified opportunity fund must be used to purchase qualified opportunity-zone property. Qualified opportunity-zone property comes in three flavors.

The first is a capital or profits interest in a domestic partnership (or LLC) that qualifies as a qualified opportunity-zone business acquired after December 31, 2017.

The second is stock of a domestic corporation that qualifies as a qualified opportunity-zone business acquired after December 31, 2017, either directly from the corporation or through an underwriter solely in exchange for cash.

Finally, qualified opportunity zone property is defined as qualified opportunity-zone business property (addressed in detail below).

## Qualified Opportunity-fund Business Property

While a qualified opportunity fund may be a corporation, partnership, or limited liability company, ultimately, the fund must own qualified opportunity-zone business property, which is defined as tangible property used in a trade or business, acquired by purchase from an unrelated party after December 31, 2017. The original use of the property must commence with the qualified opportunity fund, or the fund must substantially improve the property, and during the holding period by the fund, substantially all of the use of the property must be in a qualified opportunity zone. Revenue Ruling 2018-29 explores in detail the “original use” and “substantial improvement” requirements for qualified opportunity-zone business property.

In order for a partnership (LLC) or corporation to be a qualified opportunity-zone business, it must conduct a trade or business in which substantially all of the tangible property used by the business is qualified opportunity-zone business property, at least 50% of the gross income of the business is derived from the active conduct of the business, a substantial portion of any intangible property is used in the active conduct of the business, and less than 50% of the average aggregate unadjusted basis of the property is attributable to nonqualified financial property. Last, but certainly not least, the property may not be a private or commercial golf course, country club, massage parlor, hot-tub facility, suntan facility, a facility used for gambling or any store, the principal business of which is selling alcohol for off-premises consumption.

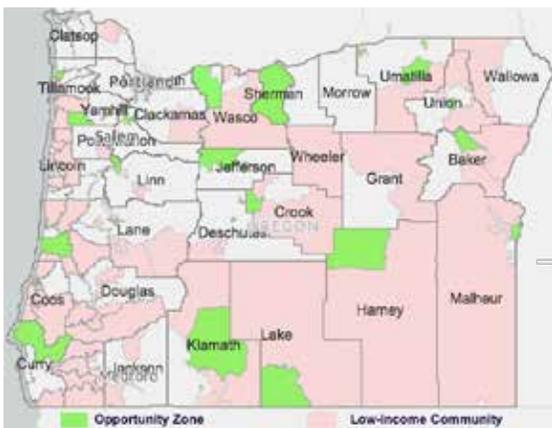
Notwithstanding the very technical and involved IRC definitions for a qualified opportunity fund business property, the IRS allows the fund to self-certify that it is a qualified opportunity fund.

## Conclusion

As with any tax incentives in the IRC, there are numerous qualifications, definitions, and limitations applicable to the new Opportunity Fund incentives. A deep dive into IRC Subchapter Z, the proposed Treasury regulations, and Revenue Ruling 2018-29 is necessary to confirm eligibility for any of the three possible tax benefits. It is also important to remember that while a qualified opportunity fund may be established at any time, the initial deferral of gain and the opportunity to take advantage of the step-up in basis and the exclusion of gain is limited by the December 31, 2026 sunset of that provision of the 2017 Tax Cuts and Jobs Act. ♦

## Footnotes

1. [https://www.cims.cdfifund.gov/preparation/?config=config\\_nmtc.xml](https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml)
2. <http://www.arcgis.com/home/webmap/viewer.html?webmap=cbda5a53dfb442639272847a9c58fccd&extent=-127.6532,40.3744,-113.4699,47.1025>



# Business Law Section News

## 2018 Business Law Section Annual Report

By David Ludwig, Section Chair

### Activities and accomplishments

In 2018, the Section carried out its mission through activities of its Executive Committee and its subcommittees. The 2018 subcommittees are: CLE Subcommittee (chaired by Kara Ellis Tatman); Communications Subcommittee (chaired by Genevieve AuYeung Kiley); New Business Lawyers Subcommittee (chaired by William J. Goodling); Scholarship Subcommittee (chaired by Thomas M. Tongue); Outreach Subcommittee (chaired by David G. Post); Legislative Subcommittee (chaired by Valerie Sasaki); Nominating and Member Recruitment Subcommittee (chaired by David R. Ludwig); and Castles Award Subcommittee (chaired by Justine B. Denton).

Highlights of the Section's 2018 activities include planning and holding its annual full-day CLE on various business topics and three quarterly CLE seminars, including one in Eugene and one livestreamed from Portland to Bend and Medford; publishing the Section's newsletter; engaging in the 2018 Oregon State Bar Law Improvement Program that resulted in one legislative proposal to be submitted to the 2019 Oregon Legislature; having a proposal submitted to and approved by the Oregon Law Commission to form a work group on the Revised Uniform Limited Liability Company Act; expanding the Young Lawyers Subcommittee to include persons who are not members of the Section's Executive Committee and authorizing a separate budget for such subcommittee; and planning a social event in Portland co-hosted by the Section and the Oregon Society of Certified Public Accountants.

### Budget

The Section has approximately 930 members and anticipates that membership levels will remain about the same in 2019. Section revenues, generated primarily through member dues, were budgeted to be \$29,800 for 2018, and Section expenses were budgeted to be \$37,680. Actual Section revenues and expenses for 2018 are expected to total approximately \$29,730 and \$36,040, respectively. The Section's cash balance as of December 31, 2018, is expected to be approximately \$43,277.

The Section's members approved a dues increase from \$30 to \$35 at its annual meeting on October 10, 2018.

### Legislative issues

The Executive Committee approved and submitted a legislative proposal for an amendment to the Oregon Business Corporation Act that permits corporations to ratify defective corporate actions. After reviewing the proposal, the Oregon State Bar Public Affairs Committee voted to submit such proposal to the 2019 Oregon Legislature for its consideration.

The Executive Committee also approved and submitted a proposal to the Oregon Law Commission (OLC) to form a work group to consider submitting to the Oregon Legislature a legislative proposal to adopt the Revised Uniform Limited Liability Company Act (RULLCA) or a version of it. After reviewing the proposal, the OLC voted to form such a work group.

### Recommendations for 2019

In 2019, the Section intends to continue to fulfill its mission by providing and expanding useful information through its CLE programs and newsletter, reaching out to the Section's younger members and to members outside of the Portland metropolitan area, recognizing efforts and

achievements of certain individuals through its awards and scholarships, advocating for the improvement of business law through legislative proposals, and supporting Oregon's business community through social events with business leaders and professionals in related industries. ♦

## Subcommittee Reports

### Continuing Legal Education

The Business Law Section held its annual all-day CLE program on Friday, November 2, 2018, at the Multnomah Athletic Club in Portland. The theme was "Business Law 2018—Law Practice in the Modern (and Digital) Age." Members of the planning committee were: Anne Arathoon, Justin Denton, James Hein, Benjamin Kearney, David Post, Kara Ellis Tatman, and Tyler Volm.

On November 16, 2018, the Section hosted a conversational-style CLE presentation by the Honorable David Brewer and Donald Churnside at the Oregon Electric Station in Eugene. The topic was "How to Avoid Post-Closing Disputes in Business Transactions." Judge Brewer and Mr. Churnside discussed practical drafting and negotiation issues that could help transactional and business attorneys better avoid post-closing litigation and disputes. The event also included a reception with food and drinks, sponsored by Arnold Gallagher, PC. The Business Law Section looks forward to providing more live programs in Eugene and other cities around the state.

### Outreach

On October 25, the OSB Business Section co-hosted a social at Departure with the Oregon Society of CPAs. It was a nice evening of casual conversation and good food, and it was great to visit with our friends at OSCPA. We look forward to doing so again in the future.

### New Business Lawyers

The subcommittee meets monthly and its members participate in six working groups: education, mentorship, social, pro bono, law schools, and newsletter.

If you would like to get involved with the subcommittee or its activities, please reach out to the subcommittee's chair, Will Goodling of Stoel Rives LLP, at 503.294.9501 or [william.goodling@stoel.com](mailto:william.goodling@stoel.com)

# Upcoming Events

## CLE Programs

### 34th Annual SEC Reporting & FASB Forum

*Practising Law Institute Webcast*

December 17 & 18, 2018/5:00 a.m. PST

[https://www.pli.edu/Content/Seminar/34thAnnualSECReportingFASBForum/\\_/N-4kZ1z0ztjw?Ns=sort\\_date%7c0&ID=328756](https://www.pli.edu/Content/Seminar/34thAnnualSECReportingFASBForum/_/N-4kZ1z0ztjw?Ns=sort_date%7c0&ID=328756)

### Fresh Ethics: Technology and the Rules of Professional Conduct

*Webinar*

December 18, 2018/10 a.m.–11 a.m. PST

<http://www.mesacle.com/regs/webreg.php?BarID=13701&EventID=1218181>

### Nuts and Bolts of Corporate Bankruptcy 2018

*Practising Law Institute Webcast*

December 18 & 19, 2018/6:00 a.m. PST

[https://www.pli.edu/Content/Seminar/NutsandBoltsOfCorporateBankruptcy2018/\\_/N-4kZ1z0ztfy?Ns=sort\\_date%7c0&ID=357155](https://www.pli.edu/Content/Seminar/NutsandBoltsOfCorporateBankruptcy2018/_/N-4kZ1z0ztfy?Ns=sort_date%7c0&ID=357155)

### Planning with S Corporations

*Audio Seminar via Telephone*

December 19 & 20, 2018/10 a.m.–11 a.m.

<https://or.webcredenza.com/program?id=73801>

### Federal Legislative Update

Sponsored by the OSB Taxation Section

December 27, 2018/Noon

Red Star Tavern/503 SW Alder, Portland

RSVP: Justin Hobson at [hobsonj@lanepowell.com](mailto:hobsonj@lanepowell.com); phone: (503) 778-2136

### Internal Investigations in the #MeToo Movement: Assessing the Risks and Rewards

*Multnomah Bar Association CLE Program*

January 29, 2019/3:00–5:00 p.m.

World Trade Center, Mezzanine/26 SW Salmon, Portland

<https://www.mbabar.org/education/upcoming-mba-cle-classes/internal-investigations-in-the-metoo-movement-assessing-the-risks-and-rewards>

### The Break-Up: Terminating Ownership Interests in Closely-Held Businesses

*Multnomah Bar Association CLE Program*

February 26, 2019/3:00–5:00 p.m.

World Trade Center, Mezzanine/26 SW Salmon, Portland

<https://www.mbabar.org/education/upcoming-mba-cle-classes/the-break-up-terminating-ownership-interests-in-closely-held-businesses>

### ABA Business Law Section Spring Meeting

March 28–30, 2019

Vancouver, B.C.

<https://www.americanbar.org/events-cle/mtg/inperson/329422423/>

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## Job Postings

### Kilmer, Voorhees & Laurick, PC

Excellent opportunity for equity ownership. Kilmer, Voorhees & Laurick, a ten-lawyer firm in the heart of NW Portland specializing in civil litigation for more than 30 years, is looking to bring on an experienced lawyer with an established client base. Competitive benefits and compensation with good return on individual collections. Collegial environment with experienced attorneys across a broad spectrum of practice areas. Confidential inquiries to [carson@kilmerlaw.com](mailto:carson@kilmerlaw.com).

**Keith A. Mobley** is interested in talking to lawyers about joining him in a Dufur-based law practice as he prepares for retirement. He has a number of business clients and also represents the intergovernmental agency that provides middle-mile fiber in Wasco County to users, including Google. Contact him at [mobley@ortelco.net](mailto:mobley@ortelco.net) or 541.993.2086.



Business Law  
Section

The mission of the Oregon State Bar Business Law Section is to provide excellent

service to the diverse group of business-law practitioners throughout the State of Oregon by providing regular, timely, and useful information about the practice of business law, promoting good business lawyering and professionalism, fostering communication and networking among our members, advocating improvement of business law, and supporting Oregon's business infrastructure and business community.

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*Articles in this newsletter are for informational purposes only, and not for the purpose of providing legal advice. The opinions expressed in this newsletter are the opinions of the individual authors and may not reflect the opinions of the Oregon State Bar Business Law Section or any attorney other than the author.*