Business & Litigation Update Summer 2008

PUBLISHED ON

May 1, 2008

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From the Desk of the Managing Partner

By: Timothy G. Dietrich

Like you, we watch with interest and some concern news reports suggesting that change is on the way: turbulence in financial markets, explosive growth in energy and commodity prices, evidence of inflation and recession and the political tug-of-war common to an election year. Change will occur, without regard to whether we are ready or receptive. Undoubtedly, that change which does occur will affect all of us in various ways, presenting both obstacles and opportunities. We are quite clear that our task as advisors and advocates is to come to a profound understanding of how this change will affect our clients and to assist them in steering clear of the obstacles and capitalizing on the opportunities.

We have all heard the conventional wisdom that, during times of change and economic difficulty, risk and disagreements abound and litigation often becomes unavoidable. By the same token, during times of change those who are keen judges of risk identify opportunities, often requiring transactions that must be consummated quickly and cost effectively. We are prepared to work with you on both counts:

• Our Litigation Group has, over the past year, represented clients in an impressive array of matters, including substantial commercial disputes, patent litigation, First Amendment cases and as plaintiff's counsel in the nationally prominent Snyder v. Westboro Baptist Church case, representing the father of a U.S. soldier killed in Iraq against protestors at his son's funeral.

• Our securities, finance, tax and corporate attorneys have, in recent months, participated in "must close" transactions, counseled public companies on governance issues and addressed some of the unexpected results of turmoil in capital markets.

Barley Snyder remains firmly committed to our tradition of forging long term relationships with our clients based on trust, practice excellence and superior service. We will reach out to understand and learn how this pervasive change is affecting you. Please let us know how we can be of help.

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Okay, You Think You Might Be Sued. Now What? Litigation Holds and the World of Electronic Discovery

By: David J. Freedman

Imagine one of the following scenarios: The real estate deal has gone bad; the problem employee has finally been fired; or somebody has been injured. It doesn't really matter what the incident is. Something unfortunate has happened related to your company's operations, and you're fairly sure there is going to be a lawsuit. What do you do now? You know that at some point your company is going to be called upon to provide documents and data to the other side during discovery. But you haven't been sued yet. As best you can tell, you've got three options. Option A, sit back and relax. Since no lawsuit has been filed there is nothing to do at this time. Once the suit is filed, you'll hire lawyers and they will take care of everything. Option B, fire up the shredder! Sabotage the other side's case by deleting and destroying all relevant documents and data. If there are no documents or data, the other side's case will crumble like a house of cards. Option C, take reasonable steps to ensure that all potentially relevant documents are preserved, suspend all normal document and data destruction policies with respect to the information relating to the potential lawsuit and convene a committee to oversee this process with members from your legal and IT departments, along with a responsible individual from the department most likely to have information relating to the subject matter of the potential lawsuit.

So what's the best answer? Obviously, Option B is out of the question. That's easy. If you feel otherwise, you should probably put a criminal defense lawyer on retainer because you will likely face a fairly stiff jail sentence for contempt of court or obstruction of justice at some point in your career. What about between Option A and Option C? Most companies these days seem to be using the Option A approach. If you are in this boat, your company could be in for some choppy weather in the future. Option C is the correct answer if you want to make sure that your company is able to effectively present its best case in court.

You might be asking yourself, "Why should we do anything before a lawsuit is filed?" Well, common law litigation principles require parties to a civil lawsuit to preserve all documents that they know, or should know, might contain information relevant to the subject matter in controversy. After all, if parties were permitted to actively destroy information relating to a dispute, that would thwart the court's truth-finding process. Courts interpreting this doctrine have long held that this duty may arise before litigation has commenced if the party "reasonably anticipates litigation." Sometimes that can be an easy thing to determine. The other side of the bad real estate deal leaves the table at closing proclaiming, "I'll see you in court!" The fired employee files a charge of discrimination with the EEOC or the Pennsylvania Human Relations Commission. You receive a letter from the injured individual's lawyer demanding compensation. Your duty to preserve has kicked in if any of these events occur.

Without such an obvious event, determining whether you reasonably anticipate litigation becomes more difficult to gauge. Best practices dictate that you err on the side of preserving earlier as opposed to later. If you have any inkling that a lawsuit might come about or if you have undertaken your own investigation in preparation for a potential lawsuit, then you should presume that you have a duty to preserve, and immediately initiate a "litigation hold" for all relevant information and documents.

So, how does one comply with this duty to preserve? It used to be that all you had to do was contact the relevant individuals from your organization and request a copy of their paper files. Two years ago, however, the U.S. Supreme Court unanimously approved changes to the Federal Rules of Civil Procedure that made electronic documents and data just as discoverable as the paper sort with which we are all used to dealing. As a result, "litigation holds" now must preserve not just paper documents but also electronic documents and data stored anywhere, including on the hard drives of your company's computers, your company's networks, thumb drives, personal digital assistants (aka PDAs or Blackberry devices) and employees' personal email accounts and home computers. Some judges interpreting these new rules have expressed a preference that a party use technology to preserve documents in their "native" electronic format. As a result, it will no longer suffice to implement a litigation hold that simply instructs employees to print out and save all relevant emails.

The rules do not provide specific guidelines regarding how precisely a party must implement a litigation hold with respect to electronically stored information. At a minimum, however, the rules require that a party protect relevant documents and data stored electronically from destruction pursuant to a document retention policy or the automatic purging functions of an entity's network or email system.

What happens if you fail to initiate an appropriate litigation hold? Failure to properly preserve documents can have disastrous results. Under the doctrine of spoliation, a court may impose a sanction on a party for negligent or intentional destruction of documents or information relating to a lawsuit. That sanction may take the form of a monetary penalty. For example, in a recent decision the U.S. District Court for the Southern District of California imposed an order requiring Quaalcom, Inc. to pay $8.5 million in attorneys' fees to its litigation opponent, Broadcom Corp., for failure to properly preserve over 46,000 emails relating to the lawsuit. More often, a court will enter an order preventing the failing party from presenting evidence. Some courts have even entered judgment against the failing party without any evaluation of the underlying merits of the case. In other words, failure to implement a proper litigation hold can result in a party losing its lawsuit before it even starts.

On the other hand, implementation of an appropriate litigation hold entitles a party to several discovery defenses that can reduce the oftentimes oppressive costs associated with the production of electronically stored information. For example, the federal discovery rules contain a "safe harbor" provision that protects a party from court sanction for any information "lost as a result of the routine, good faith operation of an electronic information system." A party, however, has no entitlement to the "safe harbor" provision unless it implements a litigation hold designed to preserve relevant electronically stored information. Similarly, the federal discovery rules allow a party to argue against producing any discovery, including electronically stored information, on the basis that such a production would impose an undue burden on the producing party's operations. That argument, however, is unavailable if the party claiming undue burden has failed to implement a proper litigation hold. As a result, failure to implement an appropriate litigation hold could result in your company having to comply with expensive discovery demands that can artificially alter litigation incentives.

In the end, what can we take away from this discussion? First, your company's duty to implement a litigation hold may arise before a claim is ever filed. Second, an appropriate litigation hold should include provisions for the preservation of electronically stored information in its native format in addition to traditional paper documentation. Third, failure to implement an appropriate litigation hold endangers your company's ability to effectively defend a lawsuit and may result in the imposition of significant financial penalties.

As this discussion makes clear, an appropriate litigation hold is essential to ensuring that a company is able to put forward its best argument in court. Although designing and implementing a litigation hold might seem like a daunting process, Barley Snyder's attorneys and our in-house Litigation Technology Support Team have the experience, knowledge and resources to assist you with this process. Just keep in mind that involving counsel and IT personnel in the process at the earliest possible stage is paramount to ensuring that your litigation hold survives court scrutiny.

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Beware the DeFacto Merger--Potentially More Than You Bargained For

By: Joshua J. Knapp

When a business decides to acquire all of the assets of another company, the deal usually benefits both the buying and selling companies. The seller receives increased liquidity and is able to unload "stuff" it no longer needs, while the buyer usually receives a good bargain on equipment and/or facilities that can, in turn, be put back to productive use.

Even assuming good faith on behalf of all parties, however, there remain circumstances in which the purchasing company may unwittingly acquire a bit more than it bargained for--in the form of liability as a successor in interest to the selling company's creditors. It is therefore important for companies contemplating this type of transaction to know the risks up front and ensure that the language of any agreement expressly captures their intent as to the assumption of liability.
This is especially so in light of a recent flurry of decisions involving potential successor liability under Pennsylvania law. Over the last three years, opinions addressing this area have come out of the Pennsylvania Supreme Court, the U.S. Court of Appeals for the Third Circuit, and all three U.S. District Courts in Pennsylvania. These cases aggressively seek to remove ambiguity from the analysis of facts under the successor liability law in Pennsylvania. In this potentially less forgiving environment for litigants, it is more critical than ever that companies do everything reasonably possible to ensure that they "get it right" from the start and that their true intent is reflected in any asset purchase agreements they enter.

Normally, successor liability in the asset purchase context is a non-issue. After all, the general rule in Pennsylvania is that the purchasing company does not take over the selling company's debts and liabilities simply by purchasing the seller's assets. This is notably in contrast to the rule in the merger context, where the target business is subsumed, debts and all, into the acquiring company. There are, however, several recognized exceptions to the general "no transfer of liability" rule in the asset transfer context.

It is settled law in Pennsylvania that a purchasing company may be found to have assumed the debts and liabilities of the selling party where it is established that:

(1) the purchaser expressly or implicitly agreed to assume liability;

(2) the transaction amounted to a consolidation or merger;

(3) the purchasing corporation was merely a continuation of the selling corporation;

(4) the transaction was fraudulently entered into to escape liability; or

(5) the transfer was without adequate consideration and no provisions were made for creditors of the selling corporation.

The exceptions drawing by far the most interest of late involve de facto merger and continuation (paragraphs 2 and 3 above). Although they are listed separately, courts typically regard these doctrines as one and the same (or at least as "interrelated") because they are each determined by answering the question whether, despite the asset transfer, there remains a continuity of ownership and control over the business.

In determining whether a transaction may constitute a de facto merger or a continuation, courts look to the following factors:

(1) There is a continuation of the enterprise of the seller corporation, so that there is a continuity of management, personnel, physical location, assets, and general business operations;

(2) There is a continuity of shareholders which results from the purchasing corporation paying for the acquired assets with shares of its own stock, the stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation;

(3) The seller corporation ceases its ordinary business operations, liquidates, and dissolves as soon as legally and practically possible; and

(4) The purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation.

All recent decisions in this area have carefully applied all four of the above factors and maintain that none of the factors is alone dispositive. However, the "continuity of ownership" factor is plainly regarded by federal courts as far and away the most important. Indeed, although the Pennsylvania Supreme Court has yet to comment definitively on a preferred approach, the Third Circuit has clearly stated its belief that the continuity factor is "key," and that although a full analysis may be completed under all four factors, a "strong presumption" arises against imposing successor liability if this factor is not established.

The focus of the continuity of ownership analysis is whether the transaction at issue involved the delivery of ownership interests or shares in the purchasing company in exchange for the assets purchased. In other words, do substantially the same people own and control the purchasing company after the transaction as owned and controlled the selling company prior to the transaction? Courts will rely on this test in identifying situations where shareholders of a corporation try to retain assets by artificially cleansing them of liability.

There is no bright line rule as to what percentage of ownership must be acquired by the seller in the new company to constitute "continuity of ownership." However, recent decisions by the U. S. Bankruptcy Court in the Eastern District of Pennsylvania have found that ownership interests of 71% and event 41.26% in the new company were sufficient to constitute continuity of ownership. Meanwhile, the U.S. District Court for the Eastern District of Pennsylvania has found that de facto merger had not been established when the seller acquired only 3.1% of outstanding shares in the purchasing company.

It should be reiterated that continuity is only one factor of a very fact-sensitive analysis involving three other factors to consider. Therefore, those percentages deemed sufficient in one case may have very little bearing on a court's determination in another case. Of course, in cases where no stock at all is exchanged, there is a strong presumption that there is no continuity of ownership, and therefore, no de facto merger.

Given its preeminence in the Third Circuit analysis, the continuity of ownership issue should be the focus of any company's assessment of successor liability exposure in an asset purchase agreement. This assessment should be focused on whether, despite the sale of all of a company's assets to another company, the seller would arguably retain ownership and control such that the transaction merely results in a restructured or reorganized form of the seller. Especially in transactions which would include the exchange of stock or ownership interests in the purchasing company, businesses should be very careful in choosing whether to enter such an agreement in the first instance, and, of course, in crafting any proposed agreement so as to preserve the intent of the parties involved.

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Is Exporting Becoming Essential?

By: James R. Adams

Growth

In 2006, South Central Pennsylvania companies shipped $5 billion of goods overseas -- an increase of 47% over 2005. U.S. exports generally are increasing at 4 times the rate of increase for the overall economy. In 2007, United States exports increased by 12.2%.

A report prepared jointly by the Institute For The Future and the software company Intuit projects that by 2018 half of U.S. small businesses will be involved in international trade.
The international marketplace is thriving.

Reasons

The weak dollar makes it less expensive for foreign companies to purchase goods in the U.S. It also makes it less expensive for those foreign companies to produce their goods here and then ship them overseas. Consider exchange rate issues when pricing your product. Second, the international marketplace is growing, with China being the best example. From 2002 until 2007, the volume of semiconductors exported to China tripled. Third, recently signed free trade agreements level the playing field in several ways -- eliminating or reducing the rate of tariffs, providing greater security for intellectual property, and reducing restrictions on U.S. investment in foreign marketplaces.

Opportunities

On December 14, 2007, the United States-Peru Trade Promotion Agreement Implementation Act became law. When Peru has met certain requirements, 80% of the consumer and industrial products exported from the U.S. to Peru will immediately become duty free. After growing at a steady rate of 4% annually for the preceding 4 years, in 2007, the economy in Peru grew by 7.5%. Significant opportunities for U.S. export include equipment, services, and parts related to mining machinery, transportation equipment, construction, and oil and gas exploration.

The United States is the world's second largest coal producing and coal consuming country, second only to China. As such, the U.S. is recognized for its clean coal technology -- something needed in China and other rapidly growing markets, including Australia, Brazil, India, Mexico, New Zealand, South Africa, South Korea, and the European Union. The U.S. Department of Commerce has estimated that over the next 20 years, U.S. exports to these countries may hit $36 billion. Opportunities may exist for U.S. companies regarding design, production and installation of breakers, screeners, cleaners, generators, emissions abatement equipment, air pollution control equipment, and more.

Issues

Financing sales to foreign companies can be risky. However, banks with international financing expertise can reduce the risk by having purchases covered before shipment with wire-transferred funds or letters of credit. The U.S. Export-Import Bank offers insurance policies that can protect small businesses against the possibility of risks of nonpayment, including both commercial circumstances and local civil unrest.

Like the U.S., other countries also have legislative and regulatory requirements that can impact sales.

• Commencing June 1, 2008, Pennsylvania manufacturers and chemical producers exporting to Europe may need to pre-register chemicals used in production of their products. The Registration, Evaluation, and Authorization of Chemicals (REACH) requirement of the European Union mandates that the source and nature of certain chemicals used in production must be revealed in a registration filed prior to the product arriving in the EU country. It presently appears this only will be required of larger manufacturers, but that situation may change as implementing regulations are adopted.

• Companies exporting certain electrical goods into Europe also have new requirements under the Waste Electrical and Electronic Equipment directive (WEEE) and the Restriction of the Use of Certain Hazardous Substances directive (RoHS). These are intended to reduce the amount of hazardous waste entering landfills by prohibiting the use of certain chemicals and limiting others. Producers can be held financially responsible for the collection and treatment of such wastes.

• Japan and many other countries have imposed strict quality compliance rules. Other nations have imposed requirements which almost seem to be designed to restrict imports from the U.S.

Assistance

As indicated by the numbers mentioned above, these and other hurdles are being vaulted by Central Pennsylvania businesses at increasing rates. There are both commercial and governmental entities available with expertise and the sole purpose of assisting businesses to comply with production, shipping, financing, and other requirements.

The International Business Development arm of the Pennsylvania Department of Community and Economic Development has 16 international representatives located from Australia to Taiwan. They are Pennsylvania employees, paid with our tax dollars, whose responsibility is to help Pennsylvania businesses succeed in the international marketplace. They provide and follow up on leads and can help smooth most aspects of international business transactions. Through the assistance of this group, one Barley Snyder client presently is looking to export product to Russia, for the first time. Another Barley Snyder client is looking at a joint venture with an Australian company interested in partnering their technology and manufacturing skills.

Bob Elsas is the Regional Manager of International Trade in the Philadelphia Small Business Administration office on international trade. He is a constant source of encouragement, information, and expertise regarding the international marketplace. The Small Business Administration supports export seminars and trade shows in the U.S. and overseas. The office offers a number of specific tools available for Pennsylvania businesses seeking to enter and then expand on their access to foreign buyers of their products.

There are more opportunities for assistance. The U.S. Commercial Service has 100 Export Assistance Centers in the United States and 150 more facilities overseas. These 250 offices exist solely to help U.S. companies export their goods and services. They can, as just one example, provide due diligence on your proposed customer, including credit reports, banking and financial information, sales figures, etc. The World Trade Center of Central Pennsylvania is an association of businesses in our area which are interested in international trade. They hold expos, teaching sessions, and offer opportunities to learn from your peers. This WTC is one of approximately 300 World Trade Centers in more than 90 countries.

Jade International, in Delaware County, Pennsylvania, is a private company focused exclusively on helping U.S. businesses import and export goods properly around the world -- freight requirements, customs requirements and others. It is but one of many such consulting groups that are available on a fee basis.

Many sources of information and assistance are available to address business issues such as, "What price should I charge in Korea?" or "What are customary payment terms in Greece?" or "How can I distribute my product in South Africa?"

How to Start?

Give us a call. Helping our clients thrive is what we do. It may involve getting you in touch with people, as occurred with the Russian and Australian examples above, or just discussing the overall concepts. We have helped our clients successfully address these issues in most of the major world markets.

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A Year of Change in Intellectual Property

By: Salvatore Anastasi

The last year has been a busy one in the intellectual property arena, both nationally and within our Barley Snyder Intellectual Property Team. Some highlights:

The U.S. Patent and Trademark Office (USPTO) attempted to revise the rules of practice in patent cases relating to continuing applications, requests for continued examination, and the number of claims contained in a single application. Although the rules were scheduled to take effect on November 1, 2007, on October 31, 2007, the U.S. District Court for the Eastern District Court of Virginia issued a Preliminary Injunction permanently enjoining the U.S. Patent and Trademark Office from implementing the new rules. All U.S. patent applications therefore are continuing to be examined under the old rules at least until an appeal by the USPTO is decided.

The USPTO recently implemented the PDX document exchange program which facilitates the electronic exchange of priority documents between the U.S., Japanese and European Patent Offices.

Barley Snyder was among a limited number of participants chosen to assist the U.S. Patent and Trademark Office in testing a new electronic filing program that enables the filing of U.S. patent applications and related documents directly online through the U.S. Patent and Trademark Office website. The electronic filing program is now available to the public, and Barley Snyder exclusively files all U.S. patent applications online. U.S. patent applications and related documents which are filed online are afforded instant online status tracking.

In 2007, the U.S. Patent and Trademark Office implemented a program for electronically requesting European and Japanese priority documents through the U.S. Patent and Trademark Office website. Barley Snyder now exclusively requests all European and Japanese priority documents through the U.S. Patent and Trademark Office website, which results in decreased costs to our clients.

Barley Snyder tested and implemented patent application software that cooperates with Barley Snyder's word processing system to increase efficiency and the quality of international and domestic patent applications.

Barley Snyder is among a limited number of participants chosen to assist the U.S. Patent and Trademark Office in testing a new electronic outgoing communication program that enables the U.S. Patent and Trademark Office to send notifications of new communications from the U.S. Patent and Trademark Office by email. As a result of the testing and user feedback the electronic outgoing communication feature is now available to the public. It enables instant notification of new communications from the U.S. Patent and Trademark Office regarding pending U.S. patent applications.

Barley Snyder is among a limited number of participants chosen to assist the U.S. Copyright Office in testing a new electronic filing program that enables the filing of copyright registrations directly online through the U.S. Copyright Office website. Once testing is complete the electronic filing program will be available to the public. Copyright registrations which are filed directly online will be afforded a faster processing time, online status tracking, earlier effective date of registration, lower filing fees, and the ability to pay filing fees online.

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Do You Own Your Employees' Inventions?

Contrary to popular belief, the mere existence of an employer-employee relationship does not entitle the employer to an assignment of ownership of any inventions which an employee may create during the employment relationship. In fact, the general rule is that the employee owns all rights to any inventions that the employee creates during the employment relationship even though the employee conceived the invention during the course of his/her employment. Because the employee owns the invention, the employee can therefore prohibit the employer from making, using, selling or importing the invention without the employee's permission if the employee obtains a patent for the invention.

The only way for an employer to ensure that the employee is obligated to assign ownership in any inventions that the employee conceives during the course of employment is to have the employee sign an employment contract that expressly requires the employee to assign all rights to any inventions to the employer. This type of employment contract is typically presented to the employee at the beginning of the employment relationship and is required to be signed by the employee prior to being employed. If an employee has not entered into this type of employment contract at the beginning of the employment relationship, then this type of employment contract can later be presented to the employee for signing in conjunction with additional consideration, such as the receipt of a promotion, bonus or salary increase.

In the absence of an employment contract that expressly requires the employee to assign all rights to any inventions to the employer, the employer may still own the rights to the invention if the employee was hired for the specific purpose of solving a problem or developing a device or process which results in the invention. In other words, the employee's hiring contract must show by express terms or unequivocal inference that the employee was hired for the express purpose of producing the thing invented for the rights in the invention to transfer from the employee to the employer. A contract for general employment, on the other hand, will not serve to transfer the rights in the invention to the employer. The employee can therefore prohibit the employer from making, using, selling or importing the invention without the employee's permission if the employee obtains a patent for the invention.

Absent an employment contract or employment relationship that transfers the rights to an employee's invention to the employer, the employer may still have the right to use the employee's invention even though the employer does not own the invention. This right is commonly referred to as a shopright and generally entitles the employer to a royalty free license to make or use the employee's invention. In order to obtain a shopright, the employer must show that the employee made the invention using the employer's time, materials, facilities or equipment. Whether a shopright exists is determined by a factual analysis of the circumstances surrounding the development of the invention and the employee's activities with respect to the invention. However, a shopright will only be found when equity and fairness demand that the employer be allowed to use the invention with respect to its business.

While courts normally grant employers a shopright in employee inventions, courts hesitate to assign the rights in an employee's invention to an employer absent an employment contract that expressly requires the employee to assign all rights to any inventions to the employer. Therefore, the only way for an employer to ensure that the employer will own all rights to any inventions created by an employee is to have the employee sign an employment contract that expressly requires the employee to assign all rights to any inventions to the employer.

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IRS Announces New Reporting Requirements for Tax-Exempt Entities with Outstanding Tax-Exempt Bonds

The Internal Revenue Service (IRS) issued a revised version of Form 990 in final form on December 20, 2007. Form 990 must be filed annually by most tax-exempt, Section 501(c)(3) organizations.

Under Sections 103 and 145 of the Internal Revenue Code, organizations qualified under Section 501(c)(3) of the Code may benefit from tax-exempt bonds issued by state and local governments. The proceeds of the tax-exempt bonds typically are loaned by the state or local government issuer to the Section 501(c)(3) organization at or near the same interest rates borne by the bonds. The continued tax exemption of the interest on the bonds depends upon, among other things, ongoing compliance by the 501(c)(3) organization with restrictions on the use of assets financed with the bonds and certain arbitrage limitations and requirements. Based on the results of targeted surveys, the IRS found significant noncompliance with record keeping and record retention requirements relating to tax-exempt bonds issued for the benefit of 501(c)(3) organizations. As a consequence, the IRS announced that it would impose new and expanded annual reporting requirements for 501(c)(3) organizations with outstanding tax-exempt bonds.

The revised Form 990 Schedule K requires that information be provided regarding each tax-exempt bond issue with an outstanding principal balance of more than $100,000 of which the tax-exempt organization is beneficiary. Schedule K comprises four parts:

Part I requests general information, including the issuer's name and EIN, date of issue, CUSIP of the final maturity, issue price, purpose of the bonds, whether such bonds have been defeased, and whether the issuer of the bonds is an "on behalf of" issuer.

Part II requests information regarding the use and investment of proceeds of the bonds, including, for each issue, the total proceeds, proceeds held in a reserve fund, proceeds deposited to a refunding or defeasance escrow, proceeds used for capital expenditures, working capital expenditures and issuance costs, and unspent proceeds. It also requests the year of substantial completion of the financed project and "yes" and "no" answers regarding whether each issue of bonds accomplished a current or advance refunding, whether a final allocation of proceeds has been made, and whether adequate books and records are maintained to support the final allocation of proceeds.

Part III requests information regarding private use. It also asks whether bond counsel is routinely engaged to review management contracts or research agreements, whether the 501(c)(3) organization was a partner in a partnership or member of a limited liability corporation that owned property financed by the bonds, and whether the organization has implemented practices and procedures to ensure post-issuance compliance. Part III further requires identification of the percentages of private use that result from use of financed assets by entities other than 501(c)(3) organizations or state or local governments and from unrelated trade or business use.

Part IV requests information relevant to arbitrage compliance for each issue, including whether the issue is variable rate, whether there is a hedge or guaranteed investment contract associated with the issue and , if so, certain details of such hedge or GIC, whether any exception to rebate is applicable, and whether any rebate has been paid.

Please note that the requirement to complete Schedule K will not apply to any bonds issued before 2003 and will be phased in for post-2003 bonds. Schedule K will first be required for tax year 2008 (i.e., for returns filed in 2009); however, only Part I must be completed for tax year 2008. For all subsequent tax years, Part I through IV must all be completed.

These new annual reporting requirements impose a substantial additional obligation on Section 501(c)(3) beneficiaries of tax-exempt bonds to collect and maintain the required information. Section 501(c)(3) organizations should start early to put in place and implement systems designed to gather the necessary information and, in fact, begin gathering the information to complete the new Schedule K which must be filed in its entirety for the tax year 2009.

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The Benefits of Employee Stock Ownership Plans

By: Mark A. Smith

Employee stock ownership plans (ESOP) can be both a means of obtaining low-cost capital and providing employees an opportunity to share in company ownership.

Interest in ESOPs may be attributed to the following factors:

• Due to certain provisions of the tax law, ESOPs may be attractive financing vehicles and allow companies to increase leverage at attractive rates;

• Employee productivity may be enhanced when employees share in company ownership;

• An ESOP can provide a market for stock that would otherwise be difficult or impossible to sell.

Overview of ESOP Arrangements

An ESOP is an employee retirement plan designed to invest primarily in employer stock. The primary requirements for an ESOP are set forth in the Internal Revenue Code. However, as employee benefit plans, ESOPs also are subject to the Employee Retirement Income Security Act of 1974, which is enforced by the Department of Labor.

An ESOP is set up as a trust for the benefit of employees of a sponsoring company. In an ordinary (nonleveraged) ESOP, the employer contributes stock to the plan or the plan purchases it with employer contributions. The requirements for participation in the ESOP are established by the sponsoring company and set forth in a written ESOP agreement.

In general, the Internal Revenue Code requires that the ESOP be structured and operated in a nondiscriminatory manner. A broad cross-section of the sponsoring company's employees must be allowed to participate in the ESOP, and the plan cannot discriminate in favor of highly compensated employees. An ESOP is required to invest primarily in the sponsoring company's equity securities.

An ESOP creates a tax-advantaged market for the stock of closely held businesses. In addition to serving the primary purpose of providing retirement benefits for eligible employees, this unique tool makes possible tax-favorable strategies for shareholder liquidity, capital formation, and business succession, and can serve as an estate planning vehicle for the current owners.

Nonleveraged and Leveraged ESOP

There are two distinct types of ESOPs, namely, a nonleveraged ESOP and a leveraged ESOP. In a nonleveraged ESOP, the employer establishes a qualified retirement plan to which employer stock is contributed or which has purchased employer stock using money that was not borrowed.

In a leveraged ESOP, funds are borrowed to acquire employer securities. A leveraged ESOP can be used to convey ownership of the employer to the employees more quickly than if stock was purchased annually with employer contributions. The employer, in turn, can benefit from a cash infusion if the leveraged ESOP buys stock from the employer.

A typical leveraged ESOP transaction operates as follows:

• The employer, or a selling shareholder, contracts to sell shares of the employer's stock to the leveraged ESOP at fair market value;

• The ESOP borrows the money from a bank or other qualified lender to purchase the shares;

• The ESOP uses the loan proceeds to pay the employer or selling shareholder for the company stock;

• The ESOP holds the company stock in a suspense account until it can be allocated to specific employee accounts as the loan is repaid; and

• The employer makes annual contributions and dividend payments, if any, to the ESOP in the amount needed to repay the principal and interest.

Both the IRS and the Department of Labor (DOL) have published detailed and explicit regulations that define and restrict the operation of leveraged ESOPs. Compliance with these regulations is necessary so that the basic leveraged ESOP transaction, i.e. the ESOP's leveraged acquisition of employer stock from the employer, will be exempt from the Code's and ERISA's prohibited transaction rules. Of particular relevance is a strict limitation in these regulations on the ESOP's ability to use or pledge its assets as collateral. The only permitted loan collateral the ESOP can give is the actual shares of employer stock it acquires in the leveraged transaction. There is a strict rule that the ESOP lenders have no recourse against the ESOP other than this permitted collateral. So, in particular, the ESOP cannot otherwise encumber its assets by means of a separate loan guaranty, without thereby engaging in a prohibited transaction under the Code and ERISA.

Allocation and Vesting of Benefits

ESOPs are required to allocate the sponsoring company's stock to participants in accordance with the allocation formula specified in the ESOP agreement. The allocation formula must be nondiscriminatory. Typically, the allocation formula is based on the annual compensation of each participant and may take into account the participant's length of service with the sponsoring company. Allocated shares are held by the ESOP trust in individual accounts maintained for the plan participants. The ESOP participants may vote the shares allocated to their accounts, and the ESOP trustees must vote unallocated shares.

The Internal Revenue Code permits three-year cliff vesting (no vesting until the end of three years of service and then the employee is 100% vested) or six-year, pro-rata vesting (20% vesting after two years with an additional 20% vesting in each year through year six). Full vesting automatically occurs upon a participant's attainment of retirement age and usually upon a participant's death or total and permanent disability.

Advantages of an ESOP

A number of tax incentives for employers and shareholders can make ESOPs a lower cost method of raising capital than conventional financing.

An ESOP that meets the requirements of a qualified plan is exempt from Federal income tax. Contributions to an ESOP are deductible by the sponsoring company on its Federal income tax return, including the principal payments for the loan. Cash dividends paid on stock held by an ESOP are also deductible by the sponsoring company subject to certain limitations.

ESOP participants do not pay tax on their interest in the ESOP (including contributions by the sponsor and increases in the value of the sponsor's stock) until they receive distributions from the trust.

As a shareholder liquidity tool, an ESOP enables major shareholders of closely held businesses to sell their highly appreciated closely held stock to an ESOP and defer federal income taxes on the gain from the sale. The sale must meet the following requirements:

(1) The ESOP must own at least 30% of the value of the employer's stock after the sale and must continue to own it for at least three years.

(2) The proceeds from the sale must be reinvested by the selling shareholder in "qualified replacement property" within a prescribed "replacement period." The qualified replacement period is a fifteen month period beginning three months prior to the date of the sale. Qualified replacement property is broadly defined to generally include stocks and bonds of domestic corporations.

(3) Neither the selling shareholder, nor any person who is a member of the selling shareholder's family, nor any person who owns more than 25% of value of any class of outstanding company securities, can accrue benefits under the ESOP related to the shares purchased.

(4) If the ESOP disposes of any shares within three years after acquiring them from a selling shareholder from a seller electing nonrecognition treatment, the company will be subject to a 10% excise tax. An ESOP can also facilitate estate planning since a lifetime sale of shares by a business owner can reduce the amount of illiquid assets in the owner's estate and increase the amount of cash available to pay off the estate's expenses.

Disadvantages of ESOPS

A leveraged ESOP initially appears to be a money-saving alternative for a company in need of low-cost capital because, if the company borrows from a bank, it can deduct only the interest payments on the loan. When a leveraged ESOP is used, contributions to an ESOP to pay both principal and interest are fully deductible. The hidden cost of the ESOP transaction is that, by definition, an ESOP dilutes the ownership of a company. Furthermore, ESOPs are required to provide participants who are age 55 or over and have 10 years of plan participation with the option to diversify their account. Nonetheless, in the right circumstances, a leveraged ESOP can be an appropriate method to meet corporate financial needs.

Business owners, plan sponsors or administrators who have questions about ESOPs or would like assistance are encouraged to contact either Mark Smith at msmith@barley.com (717-399-1526) or Harry Booker at hbooker@barley.com (717-399-1561).

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