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It's Accrual World: Accounting Terms in Business Documents

By Jay Richardson, Cosgrave Vergeer Kester LLP

The financial stakes are often high in transactional practice. Business and transactional attorneys are comfortable purveying terms common to the practice (asset sale, stock purchase agreement, representations and warranties, closing, etc.). When transactional attorneys use terms such as *income*, *book value*, *debts*, and *generally accepted accounting principles*, they may feel similar comfort. That comfort may be misplaced. Many accounting terms may have a meaning not intended by the drafter. Moreover, those terms may invoke a meaning by accountants that is quite different from what the drafter intended. Assume that "words are how you use them." If business transactional documents—including shareholder agreements, stock and asset sale agreements, operating agreements, and employment agreements—use accounting terms, transactional lawyers should know the language. The purpose of this article is to highlight several accounting terms that frequently appear in transaction documents and discuss their meaning to accountants (who may be called upon to interpret or implement the terms), and to propose alternative terms.

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A GAAP Recap

This article is a sequel to my December 2018 *Oregon Business Lawyer* article "Bridging the GAAP: Understanding References to Generally Accepted Accounting Principles of Business Transaction Documents." As noted in that article, GAAP is not a form of accounting; it is a set of rules for certain financial statements that accountants can follow when "accounting." Another set of financial statement rules is International Financial Reporting Standards (IFRS).

Following GAAP allows users of financial statements to compare financial statements of one company to another company. However, GAAP is not required for all companies and may not be the best measure of financial performance. Even if a company prepares its financial statements based on GAAP, there are still plenty of areas where a buyer and seller can disagree (e.g., warranty reserves, allowance for doubtful accounts receivable, contingent loss accruals and the existence of obligations, obsolete inventories and employee vacation and bonus accruals). If management or other readers can analyze a company based on its non-GAAP financial statements, why require GAAP?

In transaction documents, one party (usually the buyer) insists that a seller's financial statements are based on GAAP. Why ask a private company (e.g., seller) to go to the time and expense to create GAAP financials if existing financials are sufficient? Indeed, non-GAAP financial statements prepared in a consistent manner may be a reasonable substitute for GAAP financial statements. A seller should never represent that their financial statements are "prepared in accordance with Generally Accepted Accounting Principles" unless they know that they are.

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Acounting terms

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The newsletter committee was saddened to learn that Jay Richardson, the author of this article, passed away on November 12, 2022.

Jay was an accomplished lawyer and CPA who worked for several accounting and law firms, including KPMG, Price Waterhouse Coopers & Lybrand, and Zelutsky Klarquist Sparkman. At the time of his death, he was a partner at the Portland law firm Cosgrave Vergeer Kester LLP.

He was also an instructor at the Vancouver campus of Washington State University Carson College of Business, where he welcomed the opportunity to share with students his enthusiasm for the law.

Common Accounting Terms

Many transactional documents refer to terms that are familiar to accountants. Discussed below are some of the more common terms.

Financial Statements

If a transaction document refers to a company's "financial statements," the drafter should use their recognized names:

Balance Sheet. A balance sheet provides a snapshot of a company's assets, liabilities, and owners' equity using recognized classifications. A balance sheet is dated as of the end of the reporting period (e.g., month, quarter, year).

Income Statement. The income statement summarizes a company's revenues, expenses, and net income over the reporting period.

Statement of Owner's Equity. This statement summarizes changes in the owner's equity in each period (month, quarter, year).

Cash Flow Statement. The cash flow statement measures a company's cash generation from operating activities, investing activities, and finance activities.

Publicly traded companies, and some larger private companies, prepare all four. More often, private companies usually produce only the income statement and balance sheet and think of them as their financial statements. If you want a company's Statement of Owner's Equity and a Cash Flow Statement, you may have to ask for them by name.

Audit, Review, and Compilation

A CPA can audit, review, or compile a company's financial statements. Some companies generate financial statements without an opinion on the financial statements by a CPA.

A financial statement audit is the examination of a company's financial statements and accompanying disclosures by an independent CPA auditor. The result of this examination is a "report" by the auditor, attesting to the "fairness" of the financial statements. A CPA issuing audited financial statements assures that they adhere to GAAP and auditing standards.

In a review of a company's financial statements, the accountant offers limited assurance that there are no required material modifications to a company's financial statements for them to conform with GAAP. Unlike an audit, a review does not require the accountant to obtain an understanding of internal controls or to assess fraud risk or perform other types of audit procedures.

If financial statements are compiled, they are simply financial statements prepared by an accountant based on the amounts provided by a client. The accountant does not review or audit the amounts provided and therefore does not provide any assurances regarding the validity of the amounts.

If you want a company to produce audited or reviewed financial statements, be aware that both require considerable time, money, and effort. If you represent the seller, do not state that the seller's financial statements are audited, reviewed, or compiled unless they are. On a side note, you should not ask a CPA to do a "quick audit" of the numbers or the financial statements. There is nothing quick about an audit.

Material Terms

Many transaction documents use *material* in a wide variety of phrases: e.g., material adverse changes, material adverse effect, material default, material asset, materially increase, and even material tax returns.

Material Asset. Asset sale agreements frequently refer to material asset, e.g.:

> *"The Company will not sell, lease or otherwise dispose of any material asset or property."*
>
> *"Except for property disposed of in the Ordinary Course of Business, the Company has good title to, a valid leasehold interest in, or a valid license to use, all material assets reflected on the latest balance sheet as owned or used by the Company."* (The author found this phrase in a itransaction document. It is not clear what *used by the Company* means, but it may refer to leased assets.)

Without some objective reference, a material asset is in the eye of the beholder. Instead, the drafter may want to examine the company's financial statement and refer to specific assets, e.g.: "material asset means the land and improvements owned the company" or set a specific amount: "a material asset is any asset that has a fair market value exceeding $200,000."

Both definitions offer reasonable precision about what assets are material. If the thought of determining the fair market value of an asset is difficult (the asset is unique), the drafter can refer to the asset's historic cost: "all assets

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with a historic cost (after accumulated depreciation) exceeding $10,000." Using a precise definition of material has obvious advantage over a dispute about what is material.

Material Increase. This paragraph is in a letter of intent for a stock purchase:

> *"Pending execution of the Agreement, the Company agrees that it will not materially increase the annual level of compensation of any employee."*

Rather than facing a potential argument about what is a material increase, consider adding a more specific definition, e.g., "any increase that exceeds the greater of $5,000 or 5% of the employee's annual compensation."

Material Tax Returns. The author reviewed this representation and warranty clause:

> *"The seller has filed all income tax and other material returns relating to Taxes."*

This phrase suggests that there are "immaterial" returns. Perhaps the parties might feel that a tax return is immaterial, but the IRS would argue that all tax returns are material. As far as this author is aware, there is no "materiality" threshold in the Internal Revenue Code except for the Corporate Profits Minimum Tax that was part of the inflation Reduction Act of 2022. Materiality is a GAAP concept only. Thus, the author does not recommend using the words *Material Tax Returns*.

Other Material Terms. Many transaction documents use phrases such as *material adverse change*, *material adverse effect*, and *material default*. These phrases refer to an event or are related to a company's entire financial situation. Thus, some transaction documents define *material* as "any change, effect, event, occurrence, state of facts or development that, individually or in the aggregate with any other change, effect, event, occurrence, state of facts or development, is materially adverse to the financial condition or results of operations of the Company taken as a whole."

Referring to the Audit, Review and Compilation section above, rather than saying "financial condition or results of operations," the correct phrases would be *Balance Sheet and Income Statement* The author has also seen "any change, effect, event or condition that has had or could reasonably be expected to have a material adverse effect on the assets or operations of the Company."

The author suggests that both sides agree on a fixed amount for what is material, such as "$100,000" or "ten percent of Net Sales on Line 1 of the company's 2022 income tax return."

If materiality is not objective, the drafter may want to consider having materiality determined by an independent CPA, if they were asked to audit the company's financial statements. CPAs auditing a company's financial statements are not required to adjust the financial statements if the misstatement would not likely influence the user of the financial statement. Auditors of financial statements set materiality relying on professional judgment and other factors. If a company's financial statements are not audited or reviewed, a CPA would not compute materiality.

Income Statement Terms

Terms frequently found on an income statement can be a source of confusion, because companies can refer to similar accounting concepts differently.

Sales and Revenue. To accountants, this is often the first line of an income statement. Sales and revenue include the money or accounts receivable generated from business operations, such as the sale of goods or services. Is that what the drafter meant when using these terms? Or do these terms include other sources of income, such as interest income and gain from the sale of assets? If you intend only to refer to income generated from normal recurring business operations, you may want to refer to the line item on the company's income statement or tax return that reflects your intent.

Gross Revenue and Gross Sales; Net Revenue and Net Sales. *Gross Revenue* and *Gross Sales* frequently appear on the first line of an income statement. Many companies then subtract sales discounts, sales returns and allowances from sales and revenue to arrive at Net Revenue or Net Sales. Thus, gross revenue and gross sales will be larger than net revenue and net sales. If the drafter wants to refer to net revenue and net sales, it may be wise to understand how the company computes sales discounts, returns, and allowances.

Gross Profit. Although *gross profit* may seem to be the same term as *gross revenue*, they can produce vastly different numbers. Gross profit is gross revenue less sales returns and allowances, and cost of goods sold (all the costs directly related to manufacturing and selling its products). Gross profit is always significantly less than gross revenue, so choosing the right term is critical.

Gross profit is sometimes confused with gross margin. Gross profit is the dollars that remain after a company's cost of goods sold are subtracted from its sales. Gross margin is a company's gross profit divided by its sales, and represents the amount earned in profit per dollar of sales. Gross profit is a whole number; gross margin is a percentage.

Income, Net Income, Net Earnings, Net Profit

Income, net income, net earnings, and net profit may (but not always) be colloquially referred to as the "bottom line" of a company's income statement.

Some practitioners think of the word *income* as net income, but that may not be the case. Some parties to a transaction may believe that income means the same as sales or gross revenue. *Income* by itself is not usually a word found on an income statement or tax return. The author recommends that a transaction document not use the word *income* without an appropriate modifier such as net, gross.

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Net income is a common term used in transaction documents. If you want to refer to financial statement net income, use the exact name from the income statement. If you want to refer to net income, but believe that the company's income-tax returns provide a more accurate statement of net income, you may want to use the net income term shown on the applicable return.

	C Corporation	S Corporation	LLC
Income Tax Term for Net Income	Taxable Income	Ordinary business Income (loss)	Ordinary business income (loss)
Location	line 30 form 1120	Line 21 form 1120S	Line 20 form 1065

The terms *net earnings* and *net profit* raise similar issues as net income. The author's review of many transaction documents has revealed that drafters intended net earnings to mean net revenue or net sales, as discussed above. In contrast, net profit is the amount of money a business has after it accounts for all expenses such as payroll, monthly rent, and taxes, as well as expenses without a cash basis, such as depreciation of an asset's value, cost of goods sold, and amortizations. Accordingly, the drafter should be careful which revenue-related term is relevant to the transaction.

Earnings Before Interest, Taxes, Depreciation, and Amortization

Transactions often refer to "earnings before interest, taxes, depreciation and amortization" (EBITDA). The concept behind EBIDTA is to arrive at a number that excludes non-cash elements (depreciation and amortization) as well as elements that are based on the company's capital structure or not necessarily related to its earnings potential (interest and taxes). Another phrase often seen is "Normalized EBIDTA" which generally excludes revenue and expenses that are not part of the "operations" of the company. EBITDA (or any derivation thereof) is not a term with obvious meaning. And just as important, what does "earnings" mean? Income on the company's internal financial statements? Income as shown on its income tax return? Earnings from normal operations? Revenue? Would the company's accountant know what term to use?

The author recommends that the drafter communicate with the client's accountant in advance to define what "earnings" is going to be; or in the alternative, be specific in the document by defining what "earnings" means.

Note: EBITDA is not a GAAP metric, so avoid saying "EBITDA under GAAP" or similar phrases.

Direct Expenses, Indirect Expenses, and Operating Expenses

Consider this sentence in an operating agreement:

"It is understood and agreed that from the compensation to be paid to Manager pursuant to Section 2.1 above, Manager shall be required to pay all expenses of Manager other than direct expenses of operating the Property."

The term *direct expenses* is not a financial-statement term. It is, however, a term often seen in cost accounting. Cost accounting attempts to capture a company's total cost of producing a product by assessing the direct (variable) costs of production as well as fixed costs, such as a lease expense. Examples of direct expenses are materials used to construct a product for sale, freight, labor, and payroll taxes. Examples of indirect expenses are those incurred by a company that are not directly assignable to a project, such as depreciation, fuel, utilities, and administrative salaries. If the company manufactures or constructs a product, indirect expenses are likely allocated based upon labor hours, machine hours or other consistent methodology.

By referring to direct expenses, the drafter uses a cost-accounting term in a service-related context (operating a property such as an apartment building). Even if cost-accounting principles are applicable to the management of an apartment, the drafter may want to define direct expenses further to avoid confusion:

"The direct expenses of operating the Property shall mean those on [list types of expenses from the income statement or line on the income tax return]."

Another common term in transactional documents is operating expenses. Some drafters believe that this term is a synonym of *direct expense*, but that is not necessarily true. An operating expense is an expense a business incurs through its normal business operations, which can include both direct and indirect expenses.

Recommendations

Before referring to accounting terms in a transaction document, the drafter should obtain a copy of the company's financial statement and select the relevant line item wanted and give it the same name as shown on the applicable financial statement. In addition, use the term consistently. For example, if revenue is relevant to the transaction, do not also refer to sales or income. If the drafter is uncertain about which term to use, refer to the relevant line on the company's income-tax return. For example, in a C Corporation, sales is line 1a of form 1120. Net sales is Line 1c. Gross Profit is line 3.

The author recommends that the drafter not attempt to define an accounting term by using other undefined accounting terms as shown in this definition of *Gross Revenue* in a transaction document:

"'Gross Revenue' means for a given fiscal period of the Company all cash, revenues and funds received by the Company from Company operations, including interest earned on Company accounts and reserves no longer required by this Agreement to be maintained by the Company, but excluding proceeds of Capital Contributions and Capital Events."

An analysis of all the issues this definition raises is beyond the scope of this article, but by now the reader can begin to see the importance of using and defining the correct accounting terms.

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Other Terms

Allocate and Distribute

In tax parlance, allocate and distribute have specific meanings. Pass-through entity income, deductions, losses, and credits are allocated. Allocation is automatic. Cash and property are distributed to owners. Distributions often require the approval of members, manager, directors, etc. The author saw this phrase in a transaction document:

> *"… adjusted for income distributed to the members?"*

Does that term mean income allocated to members or cash distributed to members? If cash distributed is not equal to income allocated, this phrase may cause problems.

Basis

A broad understanding of basis exists among transactional lawyers, but my CPA colleagues have confided to me that some attorneys attempt to redefine the word. Their recommendation is to accept the tax definitions of this term.

Goodwill

The sale of the assets of a business for a lump sum is considered a sale of each asset owned by the business, rather than a sale of a single asset (Rev. Rul. 55-79). When the buyer's basis in the assets is determined by reference to the consideration it paid for the assets, the residual method of allocation generally must be used to allocate the consideration among the assets for purposes of determining the buyer's basis in each asset and the seller's gain or loss on the sale of each asset. See Code Sec. 1060(c); Reg. Sec. 1.1060-1(b)(1)). The difference between the consideration and the fair market value of the assets is goodwill. One CPA told me that some transactional lawyers are not comfortable with the fact that goodwill is the "plug" number in an asset sale and try to define goodwill, causing confusion.

Terms Establishing a Purchase Price

Book Value

Drafters sometimes use *book value* in transaction documents to establish the purchase price of an equity interest (stock or membership interest). The term book value suffers from an inherent problem: the word value suggests a worth of the asset. Book value is not a statement of worth, value, fair value , or fair-market value. The only time when the book value of an asset might be its fair market value is when a company has recently acquired the asset in an arms-length transaction.

Historic cost is the basic GAAP principle for recording an asset on a company's financial records. If your transaction document refers to book value, are you referring to the cost of the asset on a company's balance sheet? Another definition of book value is the asset's historic cost less its accumulated depreciation. If you feel compelled to use book value, state which of these two options is the right definition.

Using book value as part of purchase price calculation has appeal. First, historic cost is the basis for a company's balance sheet; thus the book value of an asset can be found within a company's financial records. Second, book value avoids the need for a costly appraisal. In most cases, however, book value understates the fair market value of a company's assets. Perhaps recognizing that book value understates the fair market value of a company's assets, some transaction documents modify book value. The following language from a buy-sell agreement showcases book value (and other accounting terms):

> *"The book value of the Company shall be determined as of the end of the month preceding the month in which the event requiring the determination of the purchase price occurs. Book value shall be determined from the books of the Company according to generally accepted principles of accrual accounting applied in a consistent manner by the accountants of the Company who customarily prepare the Company's financial statements, but observing the following principles:*
> *(1) All intangible assets shall be valued at cost less amortization taken for federal income tax purposes;*
> *(2) All accounts payable shall be taken at face amount minus normal discount, and all accounts receivable shall be taken at face amount minus normal discount and a reasonable reserve for bad debts;*
> *(3) All real property, machinery, furniture, fixtures, and equipment shall be taken at the valuation appearing on the Company's books of account, with adjustment for the depreciation taken on them;*
> *(4) Inventory and supplies shall be valued at cost or market, whichever is less;*
> *(5) All accrued and properly accruable taxes and assessments shall be deducted as liabilities;*
> *(6) The Company's book value shall be equal to its adjusted assets minus its adjusted liabilities."*

Note: Because no company uses accounting books, a more modern phrase would be *financial records.*

Accrue and Accrual

As it is "accrual world after all," let us review what *accrue* means to an accountant. As stated above, GAAP are widely accepted rules that are designed to produce clear, consistent, and comparable information on a company's financial statements. Cash accounting and accrual accounting are forms of accounting. Accrual accounting is the acceptable form of accounting under GAAP because it records transactions at the time they occur, which provides a clearer insight into a company's performance and trends. In contrast, cash accounting records transactions only when a company receives or makes a cash payment. In accrual accounting, the timing of actual cash payments is not important. By using accrual accounting, a company will match expenses with revenue. (Note that accountants are dealing with recent revenue recognition rules in

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ASC 606. GAAP rules have changed related to timing of revenues and other items, so it is critical that both sides of the transaction understand how the required methodology impacts the transaction.)

With that background, let us examine references to accrual and other terms in this book-value formula:

Language	Issues
… according to **generally accepted principles of accrual accounting** applied in a consistent manner by the accountants of the Company who customarily prepare the Company's financial statements	A company can produce accrual financial statements without following other rules of GAAP. Thus, the phrase "generally accepted principles of accrual accounting" is not necessarily incorrect. Did the drafter mean GAAP? If so, asking a company not using GAAP to produce GAAP financial statements is a significant request. If the company uses the cash method of accounting, did the drafter intend that the company convert its cash-basis statements to accrual-based financial statements? Was there something misleading about the Company's cash-based financial statements?
All **intangible assets** shall be valued **at cost** less amortization taken for federal income tax purposes	What is an intangible asset? Intangible assets often have value that exceeds the amount shown on a balance sheet. What is the reason for not valuing intangibles at fair market value, especially if the intangible asset was not purchased?
All accounts payable shall be taken at **face amount** minus **normal discount**, and all accounts receivable shall be taken at face amount minus normal discount and a reasonable reserve for bad debts.	*Face amount* is not a recognized accounting term; historic cost is the appropriate term if that is what the drafter intended. The phrase *normal discount* is not a recognized accounting term, and what is the difference between a discounted account receivable and an account receivable with an associated bad-debt reserve?
All real property, machinery, furniture, fixtures, and equipment shall be taken at the **valuation appearing on the Company's books** of account, with adjustment for the depreciation taken on them.	Is *valuation appearing on the Company's books* the same as historic cost? Real estate usually appreciates, so why value it at cost which is how it is recorded on the financial statements?
All **accrued and properly accruable taxes** and assessments shall be deducted as liabilities	Why accrue taxes and assessments when accounts payable are not accrued? Also, an accrued tax or assessment is a balance sheet item; the associated expense is deducted as an expense, not as a liability, on the income statement.

This book-value formula raises an important question: Is the value that may result from this complicated formula more reflective of fair market value than simply using book value, and worth the time and cost that this formula demands? If the drafter believes that a complicated formula is required, getting the advice of the company's accountant in advance about the application of the formula is recommended.

Earnings Formulas

Sometimes a transaction document uses a multiple of net "earnings" to compute the worth of its expected future performance and thus its value. Earnings formulas use a company's current and past earnings. The following formulas were found in two buy-sell agreements:

> *"The net profits of the Company for each of the 3 complete fiscal years preceding the date of determination of price for purposes of this Agreement shall be adjusted by adding all state and federal income taxes, accelerated depreciation in excess of straight-line depreciation, and salaries and fringe benefits paid to certain shareholder-employees."*

> *"The 'Agreed Value' shall be the book value of the Company plus the sum of the last three calendar years of the Company's net profits after taxes as determined by the Company's accountant. Book value shall be determined from the books of the Company using the method of accounting used to prepare the Company's income tax returns by the accountants of the Company. The net profits of the Company after taxes shall be calculated by the Company's accountant on an income tax basis for the last three calendar years before the event triggering the sale of the Ownership Percentage."*

The reader will note that both paragraphs refer to net profits. As we saw above, a more precise term is available. Why not refer to the applicable net income line (taxable income or ordinary business income) shown in the chart above? Also note that the second formula starts with capitalized earnings and then adds the company's "book value." Does this formula make sense (aren't both arguably ways to compute value, thus risking double-counting value)? Finally, the formulas require net profits to be calculated "after taxes." S corporations and LLCs normally do not pay taxes so what is the purpose of this reference?

Net Working Capital Adjustments and Asset-Related Terms

Net Working Capital Adjustments

Most sale agreements require the seller to maintain and subsequently deliver a certain level of working capital at closing. Without sufficient net working capital, a company may be unable to pay its expenses incurred in the ordinary course of operations (payroll, rent, etc.),

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in which case the buyer may need to make a capital infusion to cover such expenses.

A net working capital adjustment shifts the risk of insufficient working capital to the seller by lowering the purchase price if net working capital falls below the required amount. It is possible, however, that expenses incurred post-closing will not require such a capital infusion, in which case the buyer would not need to "make up the deficit."

Net working capital is not a financial-statement term. The commonly accepted finance definition of net working capital is current assets—e.g., cash, inventory, marketable securities, and accounts receivable—less current liabilities—e.g., accounts payable, payroll taxes payable, and wages payable. The components of current assets and current liabilities depend on the company's financial statements. For example:

- If the seller is a service company, is "work in progress" included in accounts receivable and thus a current asset?
- Should accounts receivable be adjusted for doubtful accounts? (Do not look to GAAP for a precise definition because it is not there; instead, GAAP merely states accounts receivable is valued at its "net realizable value."
- Is deferred compensation payable a current liability?
- If the company does not produce GAAP financial statements, should the company recognize accounts receivable and accounts payable?

The author recommends the company's accountant be involved to help the drafter calculate net working capital given the method of accounting used by the company.

Other Balance-Sheet Terms

A paragraph often seen in transaction documents is this:

"After Closing, Buyer shall (a) be able to pay its debts as they become due; (b) own property which has a fair saleable value greater than the amounts required to pay its respective debts (including a reasonable estimate of the amount of all contingent liabilities); and (c) have adequate capital to carry on its respective businesses."

Let us look at some issues created by this paragraph:

Language	Issues
… pay its **debts** as they become due	*Debts* is not a commonly used accounting term. As used is this paragraph, did the drafter intend to include both current liabilities (those due within a year) and long-term liabilities (those due in more than one year)? Rather than the vague term *debts*, consider using a term used in the company's financial statements, such as *current liabilities* or *current liabilities including but not limited to accounts payable, wages payable, taxes payable, etc.* Finally, if the company is on the cash basis, does this phrase require the company to accrue debts?
… own property which has a **fair saleable value** greater than the amounts required to pay its respective debts …	*Fair saleable value* has no commonly accepted definition. Did the drafter mean fair market value or the amount of cash the asset would bring in a "fire sale?"
… (including a reasonable estimate of the amount of all **contingent liabilities**) …	A contingent liability is an obligation that may but has not yet occurred. Thus, a contingent liability is a potential liability such as lawsuit judgment. Ascertaining a contingent liability and then estimating its potential value are complicated processes and depend on the likelihood of the liability being realized and the assumption that the liability can be estimated in the first place.
… have adequate **capital** to carry on its respective businesses	To an accountant, assets less liabilities equals capital. Does capital mean cash, cash and liquid assets, current assets?

Conclusion

This article is not an exhaustive tome covering every accounting term that may reside within a transaction document. Before inserting any term that could be an accounting term, the drafter should either gain an understanding of what the term may mean by study of the company's financial statements, consultation with the company's accountant, or both. Given the many terms introduced in this article, one final transaction document example is appropriate especially this time of year: If you represent Santa Claus, who needs to value a new workshop, *net present value* is probably not the right term to use. ◆

Update: Oregon State and Local Taxes

By Alee Soleimanpour, Kelly Riggs, and Nyika Corbett; Schwabe, Williamson & Wyatt PC

Alee Soleimanpour is a tax attorney. He recently left Schwabe, Williamson & Wyatt.

Kelly Riggs is employment attorney with Schwabe Williamson & Wyatt. She is a member of the firm's Healthcare and Life Sciences and Natural Resources industry groups. She provides advice and counseling to help clients navigate complex employment matters.

Nyika Corbett is an employment attorney with Schwabe Williamson & Wyatt. She works collaboratively with clients to find the most efficient ways to resolve their business and employment disputes.

As we move into 2023, it is helpful to look at a few of the newer state and local taxes in effect. This article focuses on the Metro Supportive Housing Services Tax (Metro Tax), the Preschool for All Tax (Preschool Tax), Pass-Through Entity Tax (PTE Tax), and the Paid Leave Oregon employee and employer contributions (Paid Leave Oregon).

Metro Tax

Metro is the regional government for the Oregon portion of the Portland metropolitan area, covering portions of Clackamas, Multnomah, and Washington counties.

In May 2020, voters in greater Portland approved Measure 26-210 to help end homelessness across the region. The Metro Tax consists of a personal income tax component and a business income tax component. Both components will remain in effect through December 31, 2030, unless reauthorized by voters on or before that date.

Personal Income Tax Component

The personal income tax component calculation differs, depending on county residency. That residency determination turns on issues such as one's "domicile" and "abode."(See Metro Code 7.05.020; see also OAR 150-316-0025.) Each taxpayer must consider whether they reside within Metro boundaries to determine whether the personal income tax component of the Metro Tax, described below, applies.

For individuals within Metro boundaries, the Metro Tax imposes a 1% tax on a resident's entire Oregon taxable income of more than $125,000 for individuals, and $200,000 for couples filing jointly. Metro Code 7.05.020 defines Oregon taxable income as:

> *[T]he taxable income of residents or part year residents as reported or as reportable to the State of Oregon for personal income tax purposes.*

For individuals who reside outside of the Metro area, the Metro Tax imposes a 1% tax on the nonresident's Metro Taxable Income of more than $125,000 for individuals and $200,000 for couples filing jointly.

The Metro Code defines *District* as the territory within Metro's jurisdictional boundary, and Metro Code 7.05.020 defines Metro Taxable Income as:

> [I]ncome attributable to sources within the District less deductions from income attributable to sources within the District. This includes, but is not limited to:
>
> a. Wages received by a nonresident tax filer attributable to work performed within the District;
>
> b. Items reported to a nonresident tax filer attributable to the tax filer's ownership interest in a pass-through entity that does business in the District and reports tax items attributable to that ownership interest to the taxfiler on a Schedule K-1; and
>
> c. Income and expenses from a sole proprietorship or disregarded entity attributable to business in the District and reported on a nonresident tax filer's individual return.

An individual can conduct business in a number of ways: as an employee, through a partnership, or through a sole proprietorship. Metro Code 7.05.020(c) addresses the latter scenario. In addition, under Metro Code 7.06.100, if an individual is a part-year resident of the District, the individual's taxable income includes the tax filer's Oregon taxable income for the portion of the year in which the individual was a Metro resident, and includes the tax filer's Metro Taxable Income for the portion of the year in which the individual was a nonresident.

Finally, given the imposition of the business income-tax component, discussed below, under Metro Code 7.06.090(a), a tax filer is allowed a deduction from taxable income for pass-through income that is subject to the business income tax. The deduction is limited to the individual owner's or partner's distributable share of income on the Metro business income-tax return. Nevertheless, if the taxable income shown in that return is zero, the tax filer is not allowed a deduction.

Business Income Tax Component

The Metro Tax also imposes a 1% tax on profits from businesses with gross receipts of more than $5,000,000. Metro Code 7.07.050 provides a few exemptions to the business income tax; most notably, it does not apply to sole proprietorships and disregarded entities, as those are subject to the personal income-tax component discussed above.

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If you are a nonresident (i.e., do not live in the Metro), you are only subject to the Metro Tax on your Metro Taxable Income.

The tax applies to net income from businesses within Metro's jurisdiction that have more than $5 million in gross receipts, regardless of the geographical area in which those funds are acquired. For more information, see the Frequesntly Asked Questeions documents available on the Metro website at https://www.oregonmetro.gov/public-projects/supportive-housing-services-tax.

Withholding and Administration

Under Metro Code 7.06.120(a)(2), withholding is mandatory for all employees who work in the Metro area and earn $200,000 or more during the calendar year. This applies equally to resident and nonresident employees. Under Metro Code 7.07.120(a)(3), employees who earn less than $200,000 during the calendar year may choose to opt in or opt out, based the employee's tax situation. Employers must pay withheld taxes at the same time as federal and state taxes. The taxes should be remitted to the City of Portland.

Finally, tax filers will need to submit and file their Metro Tax Personal Income Return and Metro Tax Business Income Return by April 15 of the following year for the tax year at issue.

Preschool Tax

On November 3, 2020, Multnomah County voters approved a measure to establish a tuition-free preschool program. The Preschool Tax is in addition to the Metro Tax.

General Framework

The Preschool Tax calculation differs depending on whether or not one is a resident of Multnomah County.

For individuals who reside in Multnomah County, the Preschool Tax imposes a 1.5% tax on a Multnomah County resident's entire Oregon taxable income of more than $125,000 for individuals and $200,000 for couples filing jointly. The Preschool Tax imposes an additional 1.5% tax on an individual's income over $250,000 and on a joint filers' income over $400,000.

For individuals who reside outside of Multnomah County, the Preschool Tax imposes a 1.5% tax on the nonresidents' Multnomah County taxable income of more than $125,000 for individuals and $200,000 for couples filing jointly.

The Preschool Tax imposes an additional 1.5% tax on an individual's income over $250,000 and on a joint filers' income over $400,000.

Credits and Deductions

The Preschool Tax contains two provisions that address the issue of double taxation. The first, under Multnomah County Code (MCC) sec. 11.524(A), is a deduction for pass-through income that is subject to tax under the Multnomah County business tax. The second, under MCC sec. 11.526, is a credit for Multnomah County residents who are taxed on the same property by another jurisdiction. Such a credit enables equity between resident and nonresident taxpayers.

Withholding and Administration

The withholding provisions in the recently adopted Multnomah County Code resemble those in the Metro Tax. Under MCC sec. 11.534(B), withholding is mandatory for all employees who work in Multnomah County and earn $200,000 or more. Under MCC sec. 11.534(C), employees who earn less than $200,000 during the calendar year may choose to "opt in" or "opt out" based the employee's tax situation. All payments are due by April 15th of the following year. Finally, the City of Portland Revenue Division will be collecting the tax on behalf of Multnomah County.

PTE Tax

Relevant Background

In 2017, as part of the Tax Cuts and Jobs Act, Congress enacted section 164(b)(6) of the Internal Revenue Code (Code). Code section 164(b)(6) effectively limited the federal deduction of state and local taxes (SALT) to $10,000 per year for any tax year beginning after December 31, 2017, and before January 1, 2026. States, primarily those with high SALT, sought to circumvent the new cap.

In 2018, Connecticut became the first state to pass such a workaround. Soon after, other states quickly passed similar laws to bypass Code section 164(b)(6)'s SALT cap. In creating these workarounds, the state legislatures were focused on the fact that Code section 164(b)(6) only applied to the individual, not the entity. With this in mind, the states created laws to shift the SALT back to the entity, either forcing the entity (or allowing it to elect) to pay the tax, take the deduction, and get a credit for paying the SALT. In effect, this would provide the individual owners of a limited liability company or S corporation (collectively, PTEs) a SALT deduction that was no longer limited by Code section 164(b)(6)'s SALT cap.

On November 9, 2020, the Internal Revenue Service (IRS) issued Notice 2020-75. In that notice, the IRS stated it would propose regulations to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or an S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment. As stated in Notice 2020-75, sec. 3.01, the purpose behind the forthcoming proposed regulations would be to "provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations." Before the issuance of Notice 2020-75, the IRS had not issued any guidance in regard to the efficacy of PTE workarounds, and states and practitioners alike were left to a largely uncertain landscape.

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Following the issuance of Notice 2020-75, it appears that the IRS is at least acknowledging the efficacy of these PTE workarounds.

Specifically, Notice 2020-75, sec. 3.02(2), provides that a PTE making a specified income tax payment may take a deduction for the payment when the PTE computes its taxable income for the tax year in which such payment is made. Notice 2020-5, sec. 3.02(1) defines "specified income tax payment" as any amount paid by a PTE to a state, a political subdivision of a state, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the [PTE]. The definition also:

- Encompasses such payments made to Domestic Jurisdictions even if the payment is the result of an entity election (i.e., election-based PTE workaround)
- Includes any amount paid by the PTE, regardless of whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income liabilities under the Domestic Jurisdiction's tax law, and
- Specifies that Specified Income Tax Payments made by PTEs do not constitute an item of deduction if a partner or an S corporation shareholder takes such amount into account separately under Code section 702 or Code section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the tax year.

Following the issuance of Notice 2020-75 and the lead of many states before it, Oregon decided to enact PTE workarounds of its own to circumvent Congress's new cap.

Oregon's PTE Law

On July 19, 2021, Governor Kate Brown signed Senate Bill 727 (SB 727)—sponsored by the Committee on Finance and Revenue—into law, with an effective date of September 25, 2021. SB 727 applies to tax years beginning on or after January 1, 2022, and before January 1, 2024.

SB 727 is an election-based PTE workaround and allows PTEs to elect to be liable for and pay a pass-through business alternative income tax (PTE Tax) if the PTE consists of individuals subject to the personal income tax under ORS Chapter 316, or entities that are PTEs that are owned entirely by individuals subject to the personal income tax under ORS Chapter 316.

For purposes of SB 727, a PTE means "a partnership or S corporation or a limited liability company electing to be treated as a partnership or S corporation." Sec. 2(4). A partnership means "a syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation or venture is carried on in this state." Sec. 2(3).

Calculation and Reporting of PTE Tax

A PTE can only elect to pay the PTE Tax if all members of the PTE consent to the election. The PTE must make such an election annually on or before the due date, including extensions, of the PTE's return. A PTE may not make the election retroactively. A PTE can only revoke its election if it is on or before the due date of the PTE's tax return and only if all members agree to the revocation.

Once a PTE elects to be subject to the PTE Tax, the PTE Tax is imposed on the sum of each member's share of distributive proceeds from the entity for the tax year (Total Distributive Proceeds). The PTE Tax rate is: 9% on the first $250,000 of Total Distributive Proceeds, and 9.9% on Total Distributive Proceeds in excess of $250,000.

The payment of the PTE Tax is due on the date the PTE's return is due under ORS Chapter 316, as set forth in ORS 314.385. SB 727 then allows the PTE member (i.e., partner or shareholder) a credit against taxes that are otherwise due under ORS Chapter 316. That credit must equal the PTE member's pro rata share of the PTE Tax paid by the PTE. If, however, the amount of the PTE member's credit plus the sum of amounts allowable as payment of tax under ORS 316.187 or 316.583, other tax prepayment amounts, and other refundable credit amounts, exceeds the tax imposed under ORS Chapters 314 and 316, then the PTE member will receive a refund in an amount equal to the excess.

Paid Leave Oregon

In 2019, the Oregon legislature passed the Paid Family Medical Leave (PFML) Act, establishing a paid family and medical leave insurance program for Oregon workers that will be funded by employee contributions. After pandemic-related delays finalizing regulations and preparing for implementation, the program—now branded as Paid Leave Oregon—is finally taking effect. While some clarifying regulations are still pending, most of the key provisions have now been finalized and contributions to the Paid Leave Oregon fund are set to begin in January 2023.

Overview

Beginning in September 2023, the Paid Leave Oregon program will allow Oregon employees to take up to 12 weeks (or in some situations, up to 14 weeks) of paid time off for certain qualifying family and medical leave reasons. The program will be funded by employer and employee contributions to a fund administered by the Oregon Employment Department (OED). While an employee is on paid leave, the OED—not the employer—pays the employee.

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Alternatively, employers may comply with the PFML Act by establishing an equivalent plan, which the OED must approve in advance.

Covered Employers

All employers with at least one employee in Oregon are subject to the PFML Act. Self-employed individuals, independent contractors, and tribal governments are not required to comply with the PFML Act, but may elect to participate in and make contributions to the Paid Leave Oregon program.

Contributions

The Paid Leave Oregon program will be funded by employer and employee contributions, beginning January 1, 2023.

The OED will determine the contribution rate annually, subject to a statutory maximum of 1% of an employees' wages (as defined by ORS 657.105, which aligns with the definition of "wages" for Oregon Unemployment Insurance tax purposes). The contribution rate for 2023 is 1%.

Employees contribute 60% of the total contribution rate. Employers must withhold employee contributions from employees' pay, similar to payroll-tax withholding.

Employers with 25 or more employees must contribute the remaining 40% of the contribution rate. Employers with fewer than 25 employees will not be required to contribute the employer portion, but must still withhold employee contributions and provide leave to their employees.

Benefits

To receive Paid Leave Oregon benefits, an employee must work in Oregon, experience a qualifying family, medical, or safe leave event, and meet certain eligibility requirements outlined in the statute and regulations.

Eligible employees may take up to 12 weeks of paid leave per benefit year for several qualifying events:

- Family Leave: to care for and bond with a child during the first year after the child's birth or placement through foster care or adoption, or to care for a family member with a serious health condition. It applies to any qualified employee regardless of gender.
- Medical Leave: to care for the employee's own serious health condition
- Safe Leave: to seek medical, legal, or law enforcement assistance for the employee or the employee's minor child or dependent related to domestic violence, harassment, sexual assault, or stalking

Employees may take up to two additional weeks of paid leave for limitations related to pregnancy, childbirth, or a related medical condition, including but not limited to lactation, for a total of up to 14 weeks in a benefit year.

Employees may take paid leave under the Paid Leave Oregon program in continuous or intermittent periods, in increments as short as one workday.

Employees who have been employed by an employer for at least 90 days before taking family or medical leave under the Paid Leave Oregon program are entitled to be restored to their prior jobs.

The amount an employee is paid during leave depends on how much they earn; some employees may receive 100% wage replacement, but some may receive less.

Assistance Grants

Small employers with fewer than than 25 employees may apply for an assistance grant to help offset additional labor costs when an employee takes paid leave. The employer must commit to paying employer contributions for eight quarters, beginning when the grant is approved. In order to receive a grant, employers must be able to show that they either hired a replacement worker or incurred significant additional wage-related costs due to the employee's leave, e.g., payroll records showing increased time worked by other employees. Employers are limited to up to ten grants per year, one per employee. Applications will be available beginning September 2023.

Equivalent Plans

To be exempt from paying required quarterly contribution payments to the Paid Leave Oregon program, a covered employer must have in place an approved equivalent plan, which provides equal or greater benefits to their employees. The OED regulations outline specific requirements and processes for equivalent plans, and establish deadlines by which employers must submit an equivalent plan application to be exempt from paying quarterly contributions. Employers must apply for re-approval annually for three years after OED initially approves the employer's equivalent plan.

Self-employed Individuals and Independent Contractors

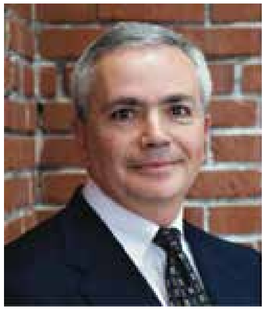
Although the PFML Act does not apply to self-employed individuals or independent contractors, those individuals may elect to opt into the program by providing a notice of election and making premium contributions to the OED. Such elections must be for a period of not less than three years. The OED has issued final regulations outlining the details and procedures for these individuals to participate in the Oregon Paid Leave program. Information can be found at https://paidleave.oregon.gov/self-employed/Pages/default.aspx.

Tribal Governments

Tribal governments—defined as "a federally recognized sovereign Tribal government whose borders lie within this state or an intertribal organization formed by two or more of those governments"—also are not required to participate in Paid Leave Oregon. However, they may elect to participate in the program with respect to some or all of their businesses. Voluntary participation is for a period of not less than three years. ◆

Hybrid Offices

By Mark J. Fucile; Fucile & Reising LLP



Mark Fucile practices throughout the Northwest in two primary areas: legal ethics, and product liability defense. He also has substantial experience in Oregon real estate condemnation. In addition, Mark teaches legal ethics as an adjunct for the University of Oregon School of Law at its Portland campus.

This article originally appeared as a two-part series in the June and July/August 2022 issues of *Multnomah Lawyer*, a publication of the Multnomah Bar Association.

One of the most significant impacts of the pandemic on the legal profession was on where lawyers work. Before the pandemic, most lawyers primarily worked in "brick and mortar" offices. In the wake of the pandemic, many lawyers are now working in "hybrid" arrangements in which they spend part of their time in traditional offices and part working from home offices.

Inside the Brick and Mortar

So far, this new dynamic has influenced law offices in two fundamental ways. First, many firms now find themselves with excess space and are examining the possibility of either subletting portions of their offices or becoming subtenants themselves. Second, although before the pandemic lawyers often worked beyond traditional offices in a variety of settings when traveling, hybrid arrangements envision lawyers and staff working from home more routinely. Each aspect of hybrid work touches on different law firm risk management considerations. First, we'll survey risk management issues arising when firms share space with other lawyers and non-lawyers.

Sharing space is nothing new. OSB Formal Opinions 1991-50 and 1991-2 addressed sharing space with, respectively, other lawyers and non-lawyers over 30 years ago. Just as practicing law is not the same as it was 30 years ago, however, risk management issues from sharing space have also evolved. In this column, we'll look at two: confidentiality and conflicts.

Before we do, two preliminary comments are in order. First, although we will focus on confidentiality and conflicts, this is not an exclusive list of risk management issues that can flow from shared space. OSB Formal Opinion 2005-2 (rev 2021), for example, addresses referrals among office-sharers. OSB Formal Opinion 2005-12 (rev 2015), in turn, discusses law firm names when lawyers share space.

Second, insurance considerations can also come into play whether a law firm is the landlord or the tenant. Although the PLF basic plan in Oregon does not involve a renewal questionnaire, excess policies usually do, and will often ask whether a law firm shares space. Firms considering subletting their space or becoming subtenants should discuss this with their carrier to understand any implications this may pose for continued coverage. Carriers are also a great resource for practical guidance in this area. The PLF, for example, has a set of suggested guidelines for office sharing available for download in the forms section of its website.

Confidentiality

Confidentiality is one of our bedrock duties —whether painted against the backdrop of the lawyer confidentiality rule (RPC 1.6), the attorney-client privilege (OEC 503), or work product (ORCP 36B(3)). Although older office-sharing opinions offer useful analytical insights, they are often framed in terms of landline telephones and paper files. The technological transformation in law practice that began before the pandemic and accelerated rapidly over the past two years has impacted sharing space as well. At the same time, the human dimension to protecting confidentiality in shared space cannot be overlooked.

On the technological side, the transition to mobile telephones and cloud-based email and files has largely put the confidentiality accent on ensuring that firms sharing space have their own secure networks. Preferably, printers should not be shared and should be stationed where sensitive materials are not visible to other office-sharers who do not work for the law firm involved.

On the human side, modern offices are often more open and use more glass internally than in years past. This can put a premium on closing doors or using internal soundproof telephone "booths" for confidential client calls and ensuring that sensitive documents are not left visible to non-firm office-sharers in either offices or conference rooms. Similarly, confidential conversations should not be held in locations where non-firm office-sharers might overhear, such as break rooms or reception areas. For firms that have long had their own space, these human considerations may mean retraining lawyers and law firm staff alike.

Conflicts

OSB Formal Opinion 2005-50 (rev 2014) addresses situations where office-sharers are representing opposing parties in the same lawsuit. It is an updated, albeit pre-pandemic, version of its 1991 cousin.

The current opinion, like its predecessor under the former Oregon Code of Professional Responsibility, does not foreclose office-sharers handling opposite sides of the same case as long as appropriate confidentiality safeguards are in place.

Especially when sharing space with non-lawyers, conflicts (and other risk management implications) can also arise in more subtle ways. A non-lawyer, for example, may look to the lawyer for legal advice over coffee in the break room and, without much forethought,

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Hybrid Offices *Continued from page 12*

the lawyer may have inadvertently acquired a client. The standard for determining whether an attorney-client relationship exists in Oregon is twofold and was set out in the paradigm case of *In re Weidner*, 310 Or 757, 770, 801 P2d 828 (1990). Under the *Weidner* test, a putative client must subjectively believe the lawyer is representing the client and that subjective belief must be objectively reasonable under the circumstances.

Importantly for present purposes, neither a written engagement agreement nor the payment of fees is necessary for an attorney-client relationship to be recognized. Returning to our illustration, what seems to the lawyer as simply a friendly conversation over break room coffee may appear altogether different to the non-lawyer suitemate who is earnestly looking for legal advice from a knowledgeable professional.

Beyond the Brick and Mortar

We'll now discuss the risk management aspects of home offices at which many lawyers split their time in "hybrid" work arrangements.

As with sharing space, working outside a traditional office is nothing new. In fact, the last CLE program I did in early 2020, before the pandemic overran so many aspects of our lives, was on "mobile lawyering." Although there were a few early adopters of completely "virtual offices," most of the focus on mobile lawyering was on lawyers who were traveling and accessing firm electronic resources from places such as hotels and airport departure lounges. With the move to formal hybrid arrangements, working from home offices has become "institutionalized" in the sense that firms will likely be found responsible for those arrangements in both an ethical and liability sense. Firms, therefore, should institute policies appropriate to their size and focus to communicate and monitor their expectations about how home offices are managed now that they are effectively integrated into the firm's overall practice.

In this section, we'll focus on supervision and confidentiality. By focusing on these, I don't want to leave the impression that these are the only areas that law firms need to think about. For example, employment law issues raised by remote work should be reviewed.

Similarly, this column assumes that the home office component of the hybrid arrangement is in the same jurisdiction as the firm's physical office. The ABA issued an ethics opinion in late 2020—Formal Opinion 495—addressing remote work in jurisdictions where a lawyer is not licensed. This opinion, together with any applicable guidance in the state involved, should be read closely by firms with lawyers who are working fully remotely in a location where they are not licensed.

Supervision

We have both regulatory and civil duties to supervise law-firm lawyers and staff. RPCs 5.1 and 5.3 speak to the former. Common law, in turn, has long made law firms vicariously liable for the malpractice of individual firm lawyers and staff. Firms discovered the challenge of "remote" supervision during the pandemic. Hybrid work arrangements don't necessarily lessen that challenge.

The most recent edition of the ABA's *Profile of Legal Malpractice Claims* was published just before the pandemic and covered 2016 through 2019. The ABA's *Profile* series is the preeminent national set of malpractice statistics compiled by the ABA in cooperation with malpractice insurers throughout North America. The series has been published periodically since 1985. For the most recent period, nearly 20% of malpractice claims nationally were due to "administrative errors." That general percentage has remained stubbornly persistent since the series was first published in 1985. Although case management software has seen dramatic improvements over time, having law firm lawyers and staff closely monitor impending deadlines remains essential. The Profile series suggests this was a difficult task for many firms even when lawyers and staff were in the same place. A physically dispersed workforce that is at the heart of the hybrid approach will require even closer attention to the mundane but critical supervisory tasks of monitoring and meeting key—and sometimes very unforgiving—deadlines.

Confidentiality

The abrupt shift to remote work in early 2020 caused many lawyers and their firms to adjust "on the fly." Kitchen tables became desks and closets became telephone booths. Before the pandemic, there was nothing novel about lawyers and staff working out of hotel "war rooms" while in trial in other cities or returning calls or emails from coffee shops when traveling for business meetings or depositions. What was "new" for many lawyers, however, was using a dedicated space within their home as a semi-permanent office. Firms, in turn, found themselves with, effectively, disparate locations for which they were responsible but didn't control.

Moving forward

Hybrid working arrangements put a premium on both individual lawyers and their law firms applying the lessons learned during the pandemic to this "new normal."

For individual lawyers, the duty of confidentiality doesn't change simply because we are working from home rather than a traditional office. RPC 1.6(c) makes plain that the duty of confidentiality is not location dependent: "A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client." This means that we generally need to take the same steps to protect client confidentiality at home as we would in a traditional office. In terms of technology, networks should be secure and software routinely updated. Beyond technology, space should be configured to assure client calls remain confidential and a modest investment in a paper shredder can be essential.

For firms, a recent ABA opinion on virtual practice—Formal Opinion 498 (2021)—noted pointedly on the duty to supervise: "Practicing virtually does not change or diminish this obligation." Depending on firm size and practice, informal arrangements may be feasible. In many others, however, firms may implement written policies and expectations that are formally acknowledged by those working from home. In still other situations, firms may choose to provide the technology for home offices and supervise that technology directly through the firm's IT department. ◆

Uses and Abuses of Integration Clauses in Contracts

By William J. Ohle, Schwabe, Williamson & Wyatt PC

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In the September issue of this newsletter, I addressed the ancient and more modern applications of the parol evidence rule, and mentioned the importance of the "integration clause" when drafting contracts of significance. Here, I will look a little closer at the use of integration clauses—also referred to as merger clauses because they ostensibly merge all of the prior terms and negotiations into a single document—and how, under modern jurisprudence, they can be useful.

To summarize, the parol evidence rule holds that once a contract has been written down in final and complete form, evidence of earlier, contrary, terms cannot be considered when looking to enforce the contract. ORS 41.740. When construing a writing, judges and arbitrators are supposed to:

> *simply [] ascertain and declare what is, in terms or in substance, contained therein, not to insert what has been omitted, or to omit what has been inserted; and where there are several provisions or particulars, such construction is, if possible, to be adopted as will give effect to all.*
> ORS 42.230.

There are, however, so many exceptions to the parol evidence rule that it is essentially meaningless as a stand-alone concept. In practice, when a contract comes under dispute, all bets are off, and everything related to the negotiation and formation of the contract is fair game. The problem is that evidence of contract negotiations is always relevant to determining if the language of the contract is truly final and complete, or as the case law calls it, "integrated," and what the written words actually mean. To be honest, the English language (in which most contracts we encounter are written) is a mess and even the most careful drafter cannot avoid every ambiguity—let alone the perception of ambiguity—or the limits of others to comprehend what the words actually mean. What is complete, unambiguous, and obvious to one person, can be complete gibberish to another. Imagine trying to decipher the terms of an agreement written in Elizabethan English. (My college Shakespeare instructor would be horrified at my lack of understanding.)

This brings us to what it is practical to do with the parol evidence rule and integration clauses. Integration clauses are specific language in a written contract that expressly state that this writing is the final and complete expression of the parties' agreement and that it "merges" into this one document all of the parties' intent. A simple example of an integration clause can be found in the standard AIA Document A201®™ – 2017, Section 1.1.2, which reads, in part:

> *The Contract represents the entire and integrated agreement between the parties hereto and supersedes prior negotiations, representations, or agreements, either written or oral.*

It should be noted from the outset that there are generally two occasions when integration clauses are triggered. The first, and most straightforward, is when the parties have been in a pre-existing contractual relationship, but are extending or changing the prior contract. The question then becomes: Is there anything from the prior contract that survives and continues in the new contract, even though it is not expressly stated in the new contract? An example of this is found in *Warren v. Smart Choice Payments, Inc.*, 306 Or App 634, 475 P3d 444 (2020), where the parties had entered into a series of employment and independent contractor agreements. The question became whether or not an arbitration clause in an earlier agreement survived to the current agreement. The Court of Appeals ruled it had not, for two interrelated reasons: first, there was an integration clause; and second, the arbitration terms were inconsistent with language in the most recent contract that spoke of disputes resolved by "lawsuit." Thus, while the integration clause was important, it was not definitive.

This also highlights the issue of "partial" or "complete" integration. A partially integrated contract only addresses some, but not all, terms of a contract. Thus, parol evidence can be used to add terms to the contract, but not contradict those that are unambiguously stated. A completely integrated contract supposedly cannot be supplemented or contradicted. But one person's contradiction is another person's interpretation, and like all terms of a contract, even whether a contract is partially or completely integrated will turn on whether it is complete and unambiguous—something which we will see below depends on the extrinsic evidence.

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Integration clauses *Continued from page 14*

This article is part of a series on miscellaneous contract provisions in common business, commercial, and real-estate agreements. When disputes arise, these overlooked provisions can determine the fate of a transaction. If not closely examined in the context of every agreement, they can provide grounds for litigation or threats of litigation.

The second occasion is whether negotiations prior to the formation of a contract can supplement or even alter the terms of the supposedly "final" writing.

An example of this is found in *Oregon Trail Elc. Cons. Coop v. Go-Gen Co.*, 168 Or App 466, 7 P3d 594 (2000) where, despite an integration clause, both the trial court and the Court of Appeals freely examined extrinsic evidence of the negotiations to determine the "meaning" of a price escalation clause. In fact, the court considered the extrinsic evidence not because the specific clause at issue was ambiguous on its face, but to determine if the language had some hidden meaning. In the end, the court found that the only testimony of merit (that of one of the drafting attorneys) supported the plain language. In doing so, the court rejected the idea that the integration clause precluded the examination of the parol evidence, stating that the courts can always look at extrinsic evidence, even if the only reason is to rule out some unstated interpretation.

So this brings us back to the questions of what good are the parol evidence rule and integration clauses. Neither prohibit the consideration of extrinsic evidence or the potential for extrinsic evidence, either in the form of prior agreements or pre-contractual negotiations, from altering the meaning of apparently unambiguous contract language. The best answer is that there is no such thing as a magic bullet when it comes to contract drafting. English is simply too complicated, as is the subject matter of complex transactions. Written contracts themselves are at best summaries of the parties' intent. Both the parol evidence rule and integration clauses are important, but incomplete, tools that must be used in conjunction with addressing, as best one can, the specifics of the transaction and the intent of the parties in the agreement itself.

Also be aware that all prior agreements and pre-contract negotiations will be at issue, whether the language is ambiguous or not.

Keep detailed records of negotiations, carefully draft emails, and keep notes of negotiations. If a dispute arises, they will be the best—if not the only—corroborating evidence of a contract's meaning. When drafting what is or is not to be included in the written agreement, be specific. If there is a prior contract, either expressly exclude the entire agreement by name and date, or specify what provisions survive and which are excluded. If prior course of conduct or trade practices are to be excluded, be as specific as possible by describing the prior conduct or what trades are at issue. Further, although Oregon does not allow for a blanket exclusion of reliance on fraud or misrepresentation in the formation of a contract through an integration clause—See T*eague Motor Co. v. Rowton*, 84 Or App 72, 77, 733 P2d 93 (1987)—a well negotiated list of recitals at the start of a contract can be expressly stated to limit the material subjects that form the core of the parties' bargain.

Finally, you can never fully trust the content of an agreement, written or otherwise. Documents can be misinterpreted, witnesses lie, and the system of enforcement is far from infallible. Draft your contracts clearly and thoroughly and use integration clauses. Hope for the best, but plan for the worst. Anticipate that in any dispute extrinsic evidence will be at issue. Document negotiations and keep your file, correspondence, and notes in a place where you can find them. ◆

CLE Seminars

2023 Uniform Commercial Code/ Commercial Law Update
Friday, January 6, 2023/10:00–11:00 AM
Webcredenza Audio Webcast

This program will provide a wide-ranging discussion of developments under the many articles of the UCC, including secured transactions, investment notes, sales, and equipment leasing.

More information and registration on the OSB website.

Capital Calls—Agreements to Contribute More Capital Over Time
Wednesday, January 11, 2023/10:00–11:00 AM
Webcredenza Audio Webcast

This program will provide a practical guide to planning "capital calls" in closely held businesses, including how to adjust the financial and governance rights of the company's owners.

More information and registration on the OSB website.

The Oregon Attorney Assistance Program: Providing Confidential Help For 40 Years

By Brian Welch, Oregon Attorney Assistance Program

Bryan Welch joined the Oregon Attorney Assistance Program as an attorney counselor in 2015. He is a Certified Alcohol and Drug Counselor and former family law attorney. He speaks regularly on topics related to lawyer well-being.

The past couple of years have been stressful for many people, and that certainly includes lawyers. On top of the usual demands of practicing law, changes to home and office work environments, managing family and work responsibilities—all while trying to get work done and care for ourselves and those we care about—have added more stress. Fortunately, the Oregon Attorney Assistance Program has been there throughout to help lawyers adjust.

What Is the OAAP?

The Oregon Attorney Assistance Program (OAAP) is a free, voluntary, confidential service provided by the Oregon State Bar Professional Liability Fund (PLF) to assist members of the legal community with well-being and personal challenges. This can include stress management, career dissatisfaction or transition, depression, anxiety, and other mental health issues. We also help with substance misuse, adjusting to retirement, trauma and vicarious trauma, and relationship stress. The OAAP helps by providing short-term individual counseling, referrals to community resources, support groups, workshops, CLE seminars, and other educational programs. Our services are available to all lawyers, judges, and law students in Oregon, and we can also provide limited services to family members and staff.

One thing that sets the OAAP apart from other support services is that the professionally trained counselors here have also practiced law. We've been where you are and have experienced what you've experienced. Frequently, lawyers will tell us that it's often difficult for friends, family members, and sometimes therapists or other sources of support to understand the pressures that lawyers face, or the language and environment in which they work, and that it's helpful to be able to talk to someone who understands what it's like to be a lawyer. We have a lot of experience to draw from. During 2022, the OAAP is celebrating 40 years of providing quality service to the Oregon legal community, making us the third-longest-serving lawyer assistance program in the country.

Challenges Within the Legal Profession

If you are concerned about your personal or professional well-being, you are not alone. In 2016, the American Bar Association, in conjunction with the Hazelden Betty Ford Foundation, surveyed more than 13,000 U.S. lawyers about their well-being. The survey found problematic substance use among lawyers at the rate of 20%—nearly twice as high as that of the general public. Rates of depression were reported at 28%—more than three times that of the general U.S. adult population. Reported rates of anxiety (19%) and stress (23%) were also considerably higher than those of the general population. In addition, 61% of lawyers surveyed reported challenges with anxiety during their career, and 45% reported having depression at some point. And that was before the pandemic.

In 2021, both Bloomberg and the Institute for Well-being In Law conducted surveys that reported high levels of "burnout" across the profession, with Bloomberg reporting 51% of lawyers feeling "burned out," and IWIL reporting 61%. Because of the concerns mentioned in these surveys, in 2021 the OAAP had more than 2,000 contacts with members of the legal community for personal assistance. In addition, we presented more than 40 CLE seminars and workshops, which reached more than 1,500 individuals. Topics included lawyering during the pandemic, secondary trauma in the time of COVID, awareness of mental health and substance-use issues, managing stress in the practice of law, burnout, and healthy solutions for lawyer well-being.

What OAAP Counselors Do

On any given day, an OAAP counselor might take a call from a lawyer who is looking for a referral for a personal therapist, meet with someone (over Zoom, by phone, or in person) to discuss challenges with work-related stress, help connect a law student with substance abuse recovery resources, or meet with a lawyer at their office to help with overcoming procrastination. We might make arrangements for a person to enter treatment (and perhaps drive them there), help a lawyer make a plan to find more meaningful work, take a call from a judge who is concerned about the well-being of a colleague, or hear from

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someone who just needs to vent because of a difficult interaction with a client or colleague. We might help someone experiencing extreme anxiety because of a potential malpractice issue, or someone having a mental-health crisis.

Many legal professionals who have reached out to us over the past two years have called for help with the effects of the pandemic. Often, they report feeling isolated and disconnected from their work. For some, alcohol, THC, or opiate use has increased as they looked for ways to mitigate the stress. For others, it might be problematic internet use like phone addiction or pornography, or increased challenges with personal or professional relationships. And yet, for each person who calls, we know there are many others who find it too difficult to ask for help.

The OAAP provides three confidential recovery meetings per week for lawyers, judges, and law students who are interested in changing their relationship with alcohol, THC, opiates, stimulants, or other substances. These meetings are currently available by teleconference, and soon, in person as well. For more information contact Bryan Welch at 503.226.1057 ext. 19, bryanw@oaap.org or Doug Querin at 503.226.1057 ext. 12, douglasq@oaap.org.

The OAAP is Confidential

One problem that was highlighted by the 2016 ABA survey—and the subsequent report of the National Task Force On Lawyer Well-being that developed as a result—was that lawyers face significant barriers to accessing help for themselves or others when they need it. According to the task force report, concerns about confidentiality and fear of professional repercussions were high on this list of obstacles. Therefore, it is imperative to know that all communications with the OAAP are completely confidential and will not affect your standing with the PLF or the Oregon State Bar. No information can or will be disclosed to any person, agency, or organization (including the Oregon State Bar and employees of the PLF) outside of the OAAP, without your consent. Contacts with us are kept strictly confidential pursuant to PLF policies, Oregon State Bar bylaws, and Oregon Rule of Professional Conduct 8.3(c)(3). In addition, under ORS 9.568, contacts with the OAAP are neither discoverable nor admissible in any OSB disciplinary action or civil proceeding. The only exceptions to confidentiality are to avert a serious, imminent threat to your health or safety or that of another person, and to comply with legal obligations such as child abuse and elder abuse reporting. All this ensures you have a safe and confidential place to seek assistance when needed.

Helping Others

We often get calls from those who are concerned about the well-being of a colleague, family member, or staff member. When you call us because you are concerned about someone else, we can collaborate to decide the best way to approach the situation and help the person about whom you are concerned. Sometimes, people hesitate to call with a concern because they don't want to "get someone in trouble." Remember: We don't report information that is given to us. All information you provide is confidential, and we will take no action without your consent.

If you prefer, we can help you develop the skills and confidence to approach the person yourself. Outreach is often more effective when it comes directly from someone the person knows. Compassion, candor, and patience can go a long way toward opening a door for a person to get help.

If instead it seems best that the OAAP communicate directly with the person, we can discuss effective ways for us to do that. We will also confer about whether you want us to reveal your specific concern to the person. If you don't want us to reveal your name, we won't. We will reach out confidentially and offer our services.

Helping Ourselves

We know that there are things we can do to help support our individual well-being. Being intentional about maintaining our social network, reconnecting to our sense of purpose and meaning, recognizing and celebrating successes (both ours and that of our colleagues), and having a gratitude practice are all evidence-based techniques for improving our mental health. And of course, attending to the basics like sufficient sleep, moderate exercise, healthier food choices, access to health care, and moderation of substance use are all important as well. Now is a good time to do a "well-being checkup" to see if there are any changes you might want to make. And if you find that you have developed some patterns you need help in changing, give us a call or visit www.oaap.org. We can help. ◆

This article originally appeared in the October 2022 issue of *Elder Law Newsletter*, a publication of the Oregon State Bar.

2022 Business Law Section Annual Report

By Anne Arathoon, Executive Committee Chair

Activities and Accomplishments

The Business Law Section has approximately 970 members. It serves its members through the following subcommittees: the Continuing Legal Education & Annual Meeting subcommittee (chaired by Melissa Jaffe); the Legislative subcommittee (chaired by James Hein); the Outreach subcommittee (chaired by Brian Jolly); the Newsletter subcommittee (chaired by Jeffrey Tarr); the New Business Lawyers subcommittee (chaired by Joe Cerne); the Nominating and Member Recruitment subcommittee (chaired by Anne Arathoon); and the Castles Leadership Award subcommittee (chaired by Jeffrey Tarr).

Highlights of the Section's 2022 activities include:

- Planning and producing its annual CLE program on various business topics (held virtually on November 2 and 3)
- Planning and producing an additional CLE (*Building Trust Across Difference: How Cultural Differences Impact the Attorney-Client Relationship*)
- Publishing the Section's quarterly newsletter for its members
- Submitting a memorandum to the Oregon Law Commission requesting to form a work group to study updating Oregon's corporation statutes
- Holding virtual panel discussions for law students at Oregon law schools during which Oregon business lawyers shared experiences, answered questions, and provided insight into life as a business lawyer in Oregon

Budget

Section revenues are generated primarily through member dues. Section revenues through November 30, 2022, were $30,075 and expenses were $23,639. The Section's cash balance on November 30 was $55,999.

Legislative Matters

During 2022, the Executive Committee developed and submitted a proposal to the Oregon Law Commission to form a work group to review and consider whether to replace the Oregon Business Corporation Act with the 2016 update of the Model Business Corporation Act published by the Corporate Laws Committee of the American Bar Association Business Law Section.

In addition, the Legislative subcommittee monitored legislative developments from the Oregon Legislature's 2022 session and reported on the progress of the Oregon Law Commission's work group relating to the modernization of Oregon's limited liability company act.

Recommendations for Upcoming Year

In 2023, the Section intends to continue to fulfill its mission by providing relevant information to its members through its CLE programs and newsletter, providing opportunities to connect and network with the Section's more junior members and members outside of the Portland metropolitan area, recognizing efforts and achievements of individuals through its awards and scholarships, and advocating for the improvement of business law through legislative work. ◆

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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