CARR McCLELLAN
INGERSOLL THOMPSON & HORN

PERSPECTIVES ON LAW

Celebrating 60 Years of Service to the Community

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CARR MCCLELLAN'S 60TH YEAR

It is with great pride that we publish this edition of *Perspectives* for we are looking forward to Carr McClellan's 60th birthday in September 2005. That pride is based on the knowledge that in our first 60 years we have made a positive difference in the lives of our clients and our community. It is also based on the conviction that our lawyers, paralegals and staff continue to make that positive difference and that as a Firm we are dedicated to carry that commitment forward for another 60 years.

Our founding partners, on whose values of integrity, hard work and dedication to client service our firm has been built, also laid the bedrock principle that is the *sine qua non* of a successful law practice: excellent lawyering. I am proud to say that our lawyers today continue to exemplify these attributes. The directors in our Civil Litigation & Dispute Resolution and Creditors' Rights & Bankruptcy Groups, including **Keith Bartel**, **Dan Morris**, **Mark Hudak**, **George Wailes**, **Mike McQuaid** and **Michelle Leu Zaccone**, bring varied skills and experiences to any disputes that need resolution, whether they be estate and trust matters, land use, real estate construction, or commercial controversies. **Luther Carr** would indeed be impressed by their skills. **Steve Anderson**, **Marion Brown** and **Golnar Yazdi**, who form the nucleus of our Estate Planning, Trusts & Wealth Transfer team, have taken our premier estate planning practice to new levels of financial and legal sophistication while maintaining an understanding of and sensitivity to family dynamics. **Jed McClellan** would be, and **Al Horn** is, exceedingly proud of their accomplishments. My fellow directors in our Corporate & Business Group, **Mike Telleen**, **Lage Andersen**, **Penny Greenberg**, **Ed Willig** and **Lori Lutzker** have transformed our practice into one that can serve the needs of traditional "bricks and mortar" businesses as well as enterprises of the "new economy" that need lawyers who understand financial engineering, deal structuring, intellectual property and how to be "deal makers." We are honored to carry on **Frank Ingersoll's** legacy. **Norm Book**, **Carol Schwartz** and **Lisa Stalteri**, our Real Estate group directors, have built on our firm's rich history of being at the forefront of the development of much of San Mateo County, and have expanded their talents to projects and transactions state wide. **Bob Thompson** would be in awe of the value they bring to our clients' real estate deals.

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REWARDING COMPANY FOUNDERS:

PART 2 - STOCK OPTIONS

By Ed Willig, Esq.

In the last issue of Perspectives, we explored one of the common types of equity compensation used by start-up companies: restricted stock. This article focuses on the other type of equity compensation commonly used by start-ups, as well as other enterprises: employee stock options.

Introduction

In thinking about employee stock options, it will be helpful to use an example: Sam Software has a business (called Software Co.) that is developing a new software product for the healthcare field. Software Co. previously issued restricted stock to its founders. It has recently raised $5,000,000 in equity financing and plans to increase its workforce from 6 employees to 35 employees over the next year. To attract and retain high quality employees, Software Co.'s Board of Directors plans to issue stock options to its employees.

The members of Software Co.'s Board of Directors are probably all familiar with the basics of employee stock options. An employee stock option is simply an agreement which entitles the holder of the option (often called the "optionee") to purchase a fixed number of shares for a specified period of time, regardless of changes in the fair market value of the shares.

The opportunity for an optionee is clear: if the optionee is granted an option to purchase shares of Software Co. now while Software Co.'s stock price is low and the value of Software Co.'s shares increases, the optionee will have the opportunity to take advantage of this appreciation by exercising the option and later selling the shares that are purchased.

Option Vesting

Most employee stock options "vest" over time. Traditional options use "installment" vesting, which means that the options vest and become exercisable over time. A common installment vesting structure which Software Co. might adopt would make 25% of the options granted to each employee exercisable one year after the option is granted (often referred to as a one-year "cliff"), with the balance of the options becoming exercisable in equal monthly installments over the

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PROTECTING IP ASSETS IN M&A DEALS

By Mark Cassanego, Esq. and Barry Parker, Esq.

The Brookings Institute recently reported that the value of "intellectual property" assets of S&P 500 companies has increased over the past twenty years from approximately 40% to over 80% of the companies' total value. It is not unreasonable to assume that a similar increase has taken place in privately held companies.

As a result of the increasing role intellectual property is playing in determining a company's total value, both buyers and sellers in merger and acquisition transactions must place greater emphasis on the critical assessment and transfer of intellectual property holdings, including the costs and risk associated with owning, deploying and protecting intellectual property assets.

In this article, we identify some of the key intellectual property issues to be addressed in the context of merger and acquisition transactions of privately held companies, regardless of whether a company is a "technology" company or not. All companies have intellectual property and many "low" or "no" technology companies have appreciable value in intellectual property.

Before discussing some of the key points, it is necessary to first define what we mean when we refer to "intellectual property." Traditionally, intellectual property or "IP" is commonly understood to mean the exclusive rights afforded patents, trademarks, trade names, copyrights and trade secrets. However, in the context of merger and acquisition transactions, IP should be thought of more expansively to include other "intangible" rights conferred under key contracts, such as purchase and supply agreements, licenses of any kind, asset transfer agreements, consulting agreements, employment agreements, proprietary rights and assignment of inventions agreements, confidentiality or non-disclosure agreements, non-compete agreements, leases, domain name registrations (which are really nothing more than a form of lease), development agreements, sales representative agreements, sponsorship agreements, advertising and marketing agreements, etc. In addition, IP includes more than traditional trade secrets such as customer and vendor lists or secret ingredients, processes, methods or formulas. Valuable rights in proprietary business plans and sales and marketing strategies are also intellectual property.

With an understanding of the breadth of what can constitute a valuable IP asset, the first step in the process of preparing to sell a business or purchase a business is to have an organized comprehensive plan to identify and analyze its IP assets. An IP audit, often known as a "due diligence" review, provides one not only with the facts necessary to identify IP assets, but it also uncovers risks affecting value and ultimately the terms and conditions of the transaction. A thorough due diligence review forms the basis for the proper drafting of the merger and acquisition agreement.

"... in the context of merger and acquisition transactions, IP should be thought of more expansively to include other 'intangible' rights conferred under key contracts ..."

The IP due diligence process is conducted with the aid of an IP Due Diligence List or IP Audit Checklist. The IP information gathered to complete the list should be protected by a confidentiality agreement signed by the parties who have agreed to explore a possible merger or acquisition. A comprehensive checklist will not only assist in identifying IP, confirming title and any security interests, liens, judgments and recordation issues affecting title, but will ensure that a rigorous assessment is conducted for current and potential litigation issues. Most importantly, it will be invaluable in determining what value should be placed on the company's IP.

For traditional IP assets such as patents, trademarks and copyrights, both buyers and sellers should independently confirm a seller's claim of ownership of each IP asset. In addition, both buyers and sellers should confirm that title in each IP asset is free and clear of third party claims, liens or security interest. Confirmation of ownership and clear title of IP assets is accomplished by conducting a thorough search of all appropriate government title and assignment records. A complete chain of title for each IP asset should be properly documented and recorded. It is important that these searches be conducted as early as possible in the merger and acquisition process to ensure that there is sufficient time to identify deficiencies in title or transfer documents, locate key persons and witnesses and secure and record all assignments necessary to convey free and clear title in the IP assets to the buyer. If the seller's portfolio of IP includes foreign IP assets, meaning patents, trademarks or copyrights secured under the laws of one or more foreign countries, the assistance of local counsel may be required to properly investigate and assess the status and title of the foreign IP assets.

In addition, for certain IP assets that require affirmative and periodic action to maintain and/or renew the IP, like patents and registered trademarks, searches should be conducted to ensure that all proper maintenance and annuity fees have been paid, that all required affidavits of use have been filed, and that all renewals have been secured from issuing government agencies.

A thorough review of key contracts should be conducted to determine whether there exists any restriction or prohibition on the assignment or transfer of the agreements or underlying rights and obligations and whether there are requirements for prior written consent of a party triggered by a merger and acquisition transaction. In addition, confidentiality agreements and nondisclosure provisions should be reviewed to ensure that the disclosure of agreements or certain licensed IP assets in the context of a merger or acquisition would not be violated.

An important purpose for conducting a disciplined due diligence review of the seller's IP assets is to permit the formulation of appropriate yet specific

representations and warranties in the acquisition agreement. Typically, acquisition agreements require a seller to represent and warrant that it owns or has acquired all appropriate rights and licenses to the identified IP assets. If any of these IP assets have liens against them, or are encumbered or have restrictions of any kind, the scope of the representation will need to be negotiated.

With respect to representations and warranties of non-infringement of third party IP rights, buyers will desire broad and absolute representations and warranties that the seller's IP assets are valid and do not infringe or violate any third party intellectual property or other proprietary right. In most instances, sellers will be hard pressed to provide such absolute representations and warranties. Depending on the circumstances of the transaction and the bargaining power of the parties, some sellers may insist on no such representations and warranties at the risk of devaluing its IP. More commonly, a seller will limit the representations and warranties of validity and non-infringement to the best of seller's knowledge at the time of the closing of the transaction and perhaps with regard to certain jurisdictions only, e.g., the U.S., Canada and nowhere else. It is important that both the buyer and the seller conduct their own independent IP due diligence review to ensure that the risks of infringement can be properly allocated in provisions of the merger or acquisition agreement.

One of the most important provisions for both buyers and sellers of any acquisition agreement is the indemnity provisions. When dealing with IP assets and the risks associated with them, special indemnity provisions should be considered. These provisions are often tied to the scope of the representations and warranties given by the seller. For example, buyers will typically demand that they be indemnified, defended and held harmless by the seller from all claims, liability, damages and expenses arising from or related to a breach of the seller's representations and warranties of ownership, clear title, validity and non-infringement. A buyer should carefully consider whether or not the seller will be in a position to defend effectively the buyer in the event of a third party claim for invalidity, infringement or breach of a proprietary right. If not, the buyer should include a provision that would allow the buyer to assume its own defense and/or settle the claim at its own expense, but hold the seller to the indemnity obligation for payment of all damages and expenses incurred as a result of defending and settling the claim. Sellers may desire limitations of liability for consequential damages arising from invalidity claims and infringement claims, but buyers typically try to exclude limitations of liability for indemnity obligations.

Finally, after one has identified the IP, assessed the risks and agreed to the transfer of the IP assets in a definitive agreement, one must ensure that the ownership of the IP is properly transferred. Assignments of patents, trademarks, trade names and copyrights all have specific and necessary language to ensure the proper and complete transfer of all rights, title and interest, including the right to seek and collect damages for past infringement. Importantly, an improperly drafted assignment can result in the permanent loss or abandonment of exclusive rights. Furthermore, assignments should be recorded with appropriate patent, trademark and copyright offices to protect the Buyer's title in the transferred IP assets.

". . . an improperly drafted assignment can result in the permanent loss or abandonment of exclusive rights."

Because intellectual property has become a more significant portion of companies' enterprise value, M&A participants should focus as much attention to it as is given to tangible assets. The first step is to understand the scope of the business' intellectual property assets. That step is followed by a due diligence analysis that leads to proper documentation to protect the IP value. With the assistance of experienced corporate and intellectual property counsel, the merger and acquisition transaction should proceed smoothly and without surprise or jeopardy of valuable IP assets.

Mark Cassanego and Barry Parker are members of the Corporate & Business Group.

succeeding 36 months. Under such a structure, if a Software Co. employee is granted an option to purchase 100,000 shares of Software Co.'s Common Stock, the employee must generally remain employed by Software Co. for one year before he or she can purchase the first 25,000 shares covered by the option, and must generally remain employed by Software Co. for four years before the employee can purchase all 100,000 shares and realize the full benefit of the options.

An alternative vesting scheme which is more complex is known as "reverse vesting." In this scheme, all of the options can be exercised initially, but Software Co. can repurchase all of the shares for their original purchase price if the employee's employment terminates (so that the optionee receives no benefit from the options). This repurchase right terminates (and the shares vest) in installments over time, often in a manner similar to an installment vesting schedule. For example, if Software Co. issues a reverse vesting option to purchase 100,000 shares to one of its employees using the four year vesting schedule described above and the employee exercises the option in full when it is granted but resigns after one year of employment, Software Co. could repurchase 75,000 shares for their original purchase price and the employee would be entitled to retain 25,000 shares.

Reverse vesting is less common than installment vesting but has several advantages over it. If a reverse vesting option is immediately exercised and certain requirements are met:

• The employee can vote the shares covered by the option immediately.

• The employee may be able to exercise the option and not recognize any taxable income until the shares are sold.

• The employee's holding period for income tax purposes will start immediately.

• The employee's holding period for securities law purposes will start immediately, rather than when the option becomes exercisable.

Income Tax Effects

For income tax purposes, there are two principal types of stock options: incentive stock options, which meet the requirements of Internal Revenue Code Section 422 (often referred to as "ISO's") and nonqualified options, which do not meet the requirements of Section 422. Assuming that an option is exercised by paying the exercise price in cash, the differences between these two principal types of options are summarized below:

Nonqualified Options:

• There is no tax on grant of option.

• When the option is exercised, the optionee recognizes ordinary income equal to the difference between the fair market value of the shares when the option is exercised and the exercise price (the "Spread").

• Appreciation in the shares after option exercise is taxed as capital gain.

". . . the Financial Accounting Standards Board ("FASB") issued a statement requiring employers to recognize in their financial statements the compensation cost associated with employee stock options . . ."

• The employer deducts the Spread when the option is exercised.

Incentive Stock Options:

• There is no tax on grant of option.

• No tax when the option is exercised, and all gain on sale of the shares is capital gain, if (a) the optionee does not dispose of the shares within a specified time period (a "Disqualifying Disposition") and (b) the Spread is not taxed under the alternative minimum tax. (The Spread is a preference item for purposes of the alternative minimum tax.)

• The employer cannot deduct the Spread, unless a Disqualifying Disposition occurs.

Incentive stock options must meet a number of requirements; for example, they can only be issued to employees, must be approved by a company's stockholders, and cannot first be exercisable by any optionee for more than $100,000 in purchase price per year. Most of these requirements do not apply to nonqualified options.

Because all of the gain from an Incentive Stock Option may be taxed as capital gain (absent a Disqualifying Disposition or payment of the alternative minimum tax), an employee will generally prefer to receive an Incentive Stock Option. On the other hand, because an employer will only obtain a deduction from its taxable income in connection with a nonqualified option, many employers prefer to issue nonqualified options.

Accounting Effects

Historically, employers like Software Co. have been permitted to account for the expense associated with employee stock options in footnotes to their financial statements, rather than recognizing the expense in their financial statements.

In December 2004, the Financial Accounting Standards Board ("FASB") issued a statement requiring employers to recognize in their financial statements the compensation cost associated with employee stock options and certain other equity compensation transactions. This cost is to be measured based on the fair value of the options, determined using a variety of methods.

The new statement has been highly controversial (especially in high technology industries) and is expected to reduce the number of options issued by some companies that may be concerned about the negative impact large option grants will have on their earnings. The new statement goes into effect for larger publicly held companies in mid-2005 and for most smaller publicly held companies and companies that are not publicly held beginning in 2006.

Securities Law Compliance

Employee stock options are securities, and each issuance of an employee stock option must comply with both federal and state securities laws. Most privately held companies take advantage of Securities and Exchange Commission Rule 701, which permits the issuance of employee stock options without any filings with the SEC if certain requirements are met. Most stock option plans meet the requirements of Rule 701, although larger privately held companies sometimes must rely on a

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EMPLOYMENT LAW

RESOLUTIONS FOR CALIFORNIA EMPLOYERS IN 2005

By Valerie Menager, Esq.

California employers need to take action to comply with employment laws that became effective as of January 2005. Listed below are some recommended actions to help keep your company in legal compliance this year.

I. New Mandatory Harassment Prevention Training Required for All Supervisors in Companies with 50+ Employees

California law now requires two hours of classroom or other interactive training for each supervisory employee of a California business employing 50 or more employees. All supervisors who are employed as of June 30, 2005 must be trained in 2005, unless they have received such training in the past two years. Individuals who are subsequently hired or promoted into supervisory positions must be trained within six months. After this initial training supervisors must receive follow-up training every two years.

Compliance with this new statute does not make an employer immune from exposure for liability in a workplace harassment lawsuit. However, now that the legislature has enacted this law, an employer who does not comply with these training requirements will be at an increased risk for an award of punitive damages in the event of a workplace harassment claim. In addition, if you are audited by the Department of Fair Employment & Housing (DFEH) and do not have this training program in place, you can be ordered to comply. The statute only places a mandatory training requirement on California employers with 50 or more employees, including temporary service employees, independent contractors and employees located out of state. However, it is highly advisable for California employers with less than 50 employees to have a similar training program for all supervisory employees.

We recommend all California employers immediately resolve to:

1. Identify all employees in "supervisory authority"-a term which is broadly defined in this statute;

2. Identify a good source of supervisory training such as that offered by our firm;

3. Create a tracking system ensuring that on-going and new supervisors periodically receive this training.

". . . an employer who does not comply with these training requirements will be at an increased risk for an award of punitive damages . . ."

II. Registered Domestic Partners Insurance Benefits to be provided under California Law but not under Federal Law

Effective January 1, 2005, the California Domestic Partner Rights and Responsibilities Act (DPRRA) grants *registered* domestic partners the same rights, benefits, duties and responsibilities that spouses have *under California law*. This new law affects all policies that provide spousal/dependent coverage. DPRRA changes employers' obligations under California law but does not affect employers' obligations under federal law. As a result, employers may face difficulty in its implementation. Listed below are examples of areas where California and federal law diverge in their treatment of an employee's domestic partner:

- Federal COBRA does not provide continuation of health care coverage for registered domestic partners but Cal-COBRA does provide continuation of health care coverage for registered domestic partners.
- Employees of companies with 50 or more employees taking a leave of 12 weeks or less to care for a seriously ill registered domestic partner are eligible to return to their same or similar job under the California Family Rights Act ("CFRA"), but have no similar protection under the Federal Medical Leave Act ("FMLA").

Adding to the complexity of implementing DPRRA, the legislature has also enacted the California Insurance Equity for All Families Act (AB 2208) that requires group health care service plans and insurance companies to offer health coverage for a registered domestic partner that is equal to coverage offered to a "spouse." AB 2208 applies to all health care service plans, and group health insurance policies issued, amended, delivered or renewed in California on or after January 2, 2005, but does not apply to self-funded plans.

In light of DPRRA and AB 2208, we recommend that employers immediately resolve to:

1. Determine whether to establish a policy requiring an employee's domestic partner to verify their status as a registered domestic partner. If you decide to establish this policy, you may also need to verify the marriage status of a spouse applying for benefit coverage.

2. Carefully review your family leave policies to ensure that the circumstances under which employees are eligible to take family or medical leave are clearly defined and are consistent with new statutory requirements under both California and federal law.

3. Review your other benefits, such as bereavement and sick pay, to make sure they provide benefits for an employee's domestic partner similar to the benefits they already provide for an employee's spouse.

4. Review all company health and life insurance policies to ensure that the coverage and/or benefits provided to an employee's registered domestic partner are the same as provided to an employee's spouse. You may want to consider holding a special open enrollment period for employees' domestic partners.

5. Review all COBRA and Cal COBRA procedures to ensure that the eligibility of domestic partners for the continuation of medical benefits is being appropriately determined with regard to relevant federal and California law.

The Employment Group at Carr McClellan welcomes the opportunity to assist your company in achieving these resolutions, and with any other employment law issues that you may face in 2005.

Valerie Menager is a member of the Employment Group.

OUT OF BOUNDS

By Mark Hudak, Esq.

The poet Robert Frost observes: “Good fences make good neighbors,” but a fence of any quality will make for neighborhood troubles if it turns out to be on the wrong side of the property line.

A neighbor's encroachment is one of the most common – and vexing – problems encountered by real estate owners. You are planning improvements for your property, the city requires a survey, and you discover that your neighbor's fence is a couple of feet over the property line. You offer to rebuild the fence at the property line and he threatens you with a lawsuit. Now what?

In most cases, your neighbor must remove the fence.

By fencing off a portion of your property, the neighbor is gaining exclusive use of it. This is equivalent to ownership. In California, a neighbor can acquire ownership rights to a part of your property through the doctrine of adverse possession. However, strict legal standards must be met, including the requirement that your neighbor pay the property taxes assessed on the enclosed area for at least five years. Because property taxes usually are assessed on an entire lot, it is nearly impossible for your neighbor to pay the taxes attributable to the two feet of your property inside his fence. Unless he has paid those taxes, he cannot acquire your property.

Your encroaching neighbor may claim that he has acquired a prescriptive easement over your property. A prescriptive easement is a limited right to use another's property. It is created by open, continuous and unpermitted use of the property in question for a period of five years. A prescriptive easement might come about if your neighbor had cut across the back corner of your property, wearing down a beaten path, or regularly parked his car in an area that turned out to be on your land. Can your neighbor claim that he has been using the land behind the fence for so long that he now has a prescriptive easement over it?

Several recent decisions by the California Court of Appeals have rejected this theory. *(Kapner v. Meadowlark Ranch Association* (2004); *Harrison v. Welch* (2004); *Mehdizadeh v. Mincer* (1996)). These cases hold that an easement must be for a limited use. By enclosing the area behind the fence and excluding the true owner, the neighbor was making more than a limited right of use – he was exercising the equivalent of full ownership. Therefore, these cases reason, the encroaching neighbor must meet the strict requirements for adverse possession, including the payment of taxes, rather than the looser requirements for an easement. Since the tax requirement for adverse possession cannot be met, these cases all require that the fence be removed.

Would your neighbor ever have a right to keep his fence on your property?

“. . . a neighbor can acquire ownership rights to a part of your property through the doctrine of adverse possession.”

Possibly. Under the “agreed boundary” doctrine, if the exact location of a property line is uncertain, two owners agree to put the fence where they think it belongs, and the fence remains for five years, the fence becomes the new property line. This is a dangerous exception to the general rule on fences, because prior owners of your and your neighbor's properties may have reached an informal agreement years before and not disclosed it. However, proof of such an agreement in the distant past is hard to come by, and your neighbor bears the burden of proving the agreement.

What if your neighbor's encroachment is a structure, rather than a fence? This might involve a corner of his house, a retaining wall, or an accessory building – all more difficult and costly to move than a fence. Different rules apply. Most courts will apply the “relative hardship” doctrine. The courts will consider three requirements: the encroaching neighbor must be innocent in the placement of the encroachment, he would suffer significant injury if forced to move the encroachment, and his hardship must be greatly disproportionate to the hardship you would suffer if the encroachment remains. If your neighbor clearly meets these standards, a court may allow the encroachment to remain and award you monetary damages for the loss of use of your property.

An illustration of this doctrine is found in *Hirshfield v. Schwartz* (2001). In that case, the defendants had installed an elaborate landscaping scheme, including a koi pond, deck, putting green, stone wall and waterfalls. Portions of these improvements were built over the property line. The court found that the cost of removing these encroachments and the impact on the remaining landscaping scheme would be substantial. In comparison, the effect on plaintiffs' use of their property was slight. Therefore, the court permitted the encroachments to remain and awarded monetary damages to the plaintiffs instead.

In the *Harrison v. Welch* case mentioned above, the Court of Appeal used the same analysis to reach the opposite conclusion. In that case, the defendant had built a woodshed and installed some undistinguished landscaping on the plaintiffs' property. The court found that the cost of removing these encroachments was not great. In comparison, the encroachments prevented the plaintiffs from placing a driveway on that portion of their lot or installing a fence along the common boundary line. The court ordered the defendant to remove her encroachments.

Of course, there are many potential variations on these facts, so it is difficult to predict in advance what improvements your neighbor could impose on your property with a court's blessing.

What if the encroachment is a tree rather than a man-made improvement. Again, the outcome depends on the circumstances. Generally, you have the right to trim any branches of the tree that extend onto your property, but you must exercise reasonable care in doing so. See, *Bonde v. Bishop* (1952). If the tree falls over, whether by Act of God

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RULES FOR RAFFLES

IGNORANCE WAS BLISS BUT NOW IT'S FOLLY TO BE UNWISE

By Penelope Greenberg, Esq.

Until quite recently, raffles in California were illegal (a misdemeanor subject to a fine of up to $1000 and/or up to six months in jail) – a fact that most people either did not know or chose to ignore. Tired of having to turn a blind eye to the situation, local law enforcement and the nonprofit community helped change the law in 2000. As a result, effective July 1, 2001, raffles are now perfectly legal – if the nonprofit conducting them has the requisite status and follows the prescribed rules. Despite this beneficial development, many nonprofits remain unaware of the law or its requirements and are still conducting raffles that are technically illegal, a fact noted in a study done by the California Department of Justice after the law had been in effect for two years.

Raffles are regulated by the California Attorney General's Registry of Charitable Trusts, which is part of the Department of Justice. The AG's website, www.caag.state.ca.us/charities, provides much helpful information, including necessary forms. The telephone number for inquiries about the Nonprofit Raffle Program is 916-445-2021.

While the Registry of Charitable Trusts has generally adopted a combination of education and warnings when noncompliant raffles come to the Attorney General's attention, that approach probably will not last forever. Therefore, board members, employees, volunteers and others involved in charitable raffles would be well advised to spend a few minutes learning the new rules and making sure their organizations are following them. As regulatory programs go, this one is pretty simple.

Nonprofits that may legally conduct raffles are those that are tax exempt under one of ten different sections of the California Revenue and Taxation (R&T) code and that have been qualified to conduct business in California for at least one year before conducting the raffle. (In other words, you may not create a new nonprofit and promptly hold a raffle. You have to wait a year.) The ten R&T sections include charitable organizations (501(c) (3)s), fraternal organizations, veteran's organizations, chambers of commerce, civil leagues, recreation clubs, religious corporations, homeowners' associations, and others.

Each raffle must be registered ahead of time. The Application for Registration (form NRP-1) is a one-page form that can be filled out online and then downloaded from the website. The form must be signed by a "fiduciary," which is a director, officer, or other person, such as the Executive Director, occupying a position of responsibility with the nonprofit.

"... many nonprofits remain unaware of the law or its requirements and are still conducting raffles that are technically illigal ..."

The completed and signed registration form, along with a $20 registration fee (payable to the Department of Justice), must be mailed to the Registry of Charitable Trusts by September 1 for raffles to be conducted during the following twelve months (September 1 through August 31). If the nonprofit does not file until after September 1, it must file at least 60 days before the date of the raffle. No raffle may be held until written confirmation of registration is received.

After the raffle is held, a two-page Nonprofit Raffle Report (form NRP-2) must be filed. The due date is the end of the twelve-month period (September 1 through August 31), but the practical approach is to file the report immediately so as not to lose track of the information or forget to file. The report has three parts. The first part asks for the organization's basic identification. The second part asks about the money raised. The third part lists seven statements and asks whether they are true or false. (The answer to all seven needs to be true, as all are requirements for a legal raffle.)

Summarized, the seven are as follows:

1. At least 90% of the total funds received from the sale of raffle tickets must be used for the nonprofit's own charitable purposes or the charitable purposes of another qualifying nonprofit. (Although not mentioned in the statement, the funds cannot be used to benefit a purpose outside of California. Also, organizations may use funds from other sources to pay for the costs of conducting the raffle, if the 10% allowed for such administrative expenses is not sufficient.)

2. The officers, directors and members of the nonprofit may not benefit personally from the proceeds of the raffle.

3. None of that 90% may be used to pay anyone for conducting the raffle. (Also not mentioned in the statement is the requirement that anyone paid in connection with operating the raffle must be an employee of the nonprofit conducting the raffle.)

4. No gaming machine, apparatus or device (such as a slot machine) may be used to conduct the raffle.

5. No person or entity, other than the nonprofit or another eligible nonprofit, may have any financial interest in the raffle.

6. The raffle may not be conducted in, and no raffle tickets may be sold or redeemed in, any racetrack, satellite wagering facility, or gambling establishment.

7. The internet may not be used to promote or sell raffle tickets, although the raffle can be announced on the nonprofit's website, if the organization regularly maintains a website.

In other words, the idea is to keep raffles homegrown and out of the hands of any kind of professional gambling interests.

Not covered by the registration or reporting forms are certain other requirements for an approved raffle. (Perhaps they aren't set out in the forms because they are so obvious, to wit, the part of the raffle ticket that goes in the fish bowl

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Our directors could not be so successful without the able assistance of bright, skillful and dedicated special counsel, associates, paralegals and support staff. We are very fortunate to have in place one of the strongest teams the firm has ever had.

Our 60-year legacy is a stable foundation on which we have built a new generation of service to our clients. Although practicing law is not quite like what it was in 1945, we are proud to say that the same values of integrity, hard work and dedication to client service are still provided to every client, every day. Thank you for allowing us to continue to serve you. We look forward to doing so for another 60 years.

Mark Cassanego is President of Carr McClellan.

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different exemption because Rule 701 contains share number and value limitations that apply for rolling 12-month periods.

In contrast to federal securities law compliance, compliance with the California stock option exemption can be more difficult. Under California law, the issuance of employee stock options is exempt from California's qualification requirement only if the stock options meet a number of prerequisites, including disclosure of the employer's annual financial statements to all optionees, minimum vesting requirements, and the filing of a notice (and payment of a filing fee) with the Department of Corporations.

Stock options have long been an important element of compensation for start-ups competing for top talent. Despite complex federal and state oversight and the additional burden of new accounting regulations coming online in 2005-2006, stock options will continue to be an integral part of compensation for company founders and executives. Before you decide to issue stock options, make sure you understand the advantages and disadvantages of the various vesting schemes and that you are prepared to comply with all tax, accounting and securities requirements.

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Property Line Disputes, *from page 6*

or through negligence by your neighbor, he has the obligation to remove it. *Mattos v. Mattos* (1958).

A tree located on your neighbor's property may extend its roots into your yard. You do not have an absolute right to remove the roots, as the surgery may well kill the tree. You will be allowed to trim the encroaching roots, but you must do so without causing unreasonable injury to the tree or your neighbor's property. *Booska v. Patel* (1994). The court may consider whether the roots are damaging your property and whether there are alternatives to removing the roots that still will preserve your property.

If you discover that your neighbor's fence/garage/oak tree is really on your property, can you just remove it? Self-help is rarely advisable. Because the rules relating to encroachments frequently call for balancing of interests, a court determination and order for removal are the best protection.

To share your fence story with the author, please contact him at 650-342-9600.

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Rules For Raffles, *from page 7*

(or whatever) and the stub that the purchaser keeps must each be numbered with the same number, which cannot be like the number on any other ticket. Furthermore, winners must be chosen by drawing tickets out of the aforementioned container and the drawing must be done by a real person who is at least 18 years old.)

Hospitals, educational institutions, and religious organizations that hold property for religious purposes do not have to register or report, but otherwise must comply with the rules. Raffles (by any type of organization) in which the tickets are given away free and indiscriminately are not regulated by the law, but if "donations" are "suggested," the raffle tickets are not "free."

As the title of this article notes, ignorance of the illegality of raffles once was bliss. It allowed well-meaning people to raise funds for deserving purposes. But now that the law has caught up with common sense, it is time to trade ignorance for understanding and download those forms and send them in.

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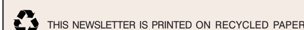
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