

# Arizona

Prepared by Lex Mundi member firm,  
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# DOING BUSINESS IN ARIZONA<sup>®</sup>

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*An Introduction to Laws  
Affecting Businesses in Arizona*

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# INTRODUCTION

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EDITORS-AT-LARGE

Generations of Arizona schoolchildren have memorized the “Five Cs” that made up the core of the state’s economy when it became the 48th U.S. state in 1912 and for many decades to follow - cattle, climate, cotton, copper and citrus. Today, while those influencers and industries remain important, Arizona enjoys a more evolved and diversified economy bolstered by job and population growth that outpaces the nation and most states.<sup>1</sup> Indisputably and proudly Southwestern with an innovative and contemporary edge, and boasting over 300 days of sunshine a year, Arizona offers a bright outlook for doing business in the state.

Those cloudless, sunny Arizona skies offer ideal conditions for testing and flying aircraft and UAVs (Unmanned Aerial Vehicles), for instance. Lower taxes, less burdensome government regulations, a competitive incentives package, and exceptional aerospace and engineering programs at the university level have led to Arizona’s top-10 rankings in Department of Defense contracts as well as in aerospace and defense manufacturing, aerospace exports and aerospace jobs. Consequently, Arizona is home to some of the world’s aerospace and defense industry giants, making Arizona America’s third-largest supply chain contributor for aerospace and defense and driving job growth in the state.<sup>2</sup>

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1 The Outlook, Economic and Business Research Center, The University of Arizona, “Arizona’s Third Quarter 2018 Economic Outlook Update,” <https://www.azeconomy.org/data/forecast-data/>

2 Arizona Commerce Authority, “Changing the Game: Arizona Industries, Aerospace & Defense,” <https://www.azcommerce.com/industries/aerospace-defense/>

Arizona is poised for continued growth and strong economic performance in high-tech and innovative industries, according to the 2018 outlook. In addition to aerospace and defense, top employment sectors include semiconductors, electronics, and software and IT. With significant investment in the state by major technology companies working on innovations such as driverless cars, Arizona also hosts more than 75 incubators, accelerators and co-working spaces around the state. From 2008-2014, the state's three public universities increased total R&D expenditures by 25%, during which they conducted more than \$6.7 billion of research.<sup>3</sup> As the sixth-largest data center market in the U.S. in 2017, Arizona was expected to see a significant swell in development and absorption of data center inventory in 2018.<sup>4</sup>

Arizona's healthcare, MedTech (medical technology) and bioscience industries are thriving, advanced by the state's generous research and development tax credits. The state's public universities are nationally recognized as leading research institutions with The University of Arizona ranked second in the nation by the National Science Foundation in physical sciences research for 2014 and Arizona State University named the most innovative school in the United States, ahead of MIT and Stanford in 2017 by U.S. News & World Report.<sup>5</sup> Two of the key strategies advanced in the Arizona Bioscience Roadmap are to improve STEM (science, technology, engineering and math) education, and to attract and retain top graduate students, doctoral and post-doctoral candidates, and physician-scientists. Carrying out these strategies has been a joint effort of the technology, bioscience and business sectors and is yielding results for Arizona's economy.<sup>6</sup>

Arizona boasts over 70 hospitals and healthcare systems with over 13,000 beds, including world-renowned institutions such as the Mayo Clinic and Barrow Neurological Institute, assuring employers that many quality healthcare options will serve their workers.<sup>7</sup> In 2017, Gallup-Sharecare ranked Arizona 15<sup>th</sup> in the nation in their State of American Well-Being Index.<sup>8</sup>

Tourism remains a strong business sector for Arizona due to the reliable destination climate and the vibrant resort, restaurant, sports and entertainment scene that flourishes throughout the state,

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3 Arizona Commerce Authority, "Changing the Game: Arizona Industries, Technology & Innovation," <https://www.azcommerce.com/industries/technology-innovation/>

4 AZ Big Media, "Phoenix data center market poised for massive growth in 2018," <https://azbigmedia.com/phoenix-data-center-market-poised-for-massive-growth-in-2018/>

5 Arizona Commerce Authority, "Changing the Game: Arizona Industries, Bioscience & Health Care," <https://www.azcommerce.com/industries/bioscience-health-care>

6 AZ Big Media, "Arizona's MedTech sector makes a big impact on Bioscience Roadmap," <https://azbigmedia.com/arizonas-medtech-sector-big-impact-bioscience-roadmap/>

7 American Hospital Directory, "Individual Hospital Statistics for Arizona," [https://www.ahd.com/states/hospital\\_AZ.html](https://www.ahd.com/states/hospital_AZ.html)

8 Gallup-Sharecare, "The 2015 State of American Well-Being Index," [https://wellbeingindex.sharecare.com/wp-content/uploads/2018/02/Gallup-Sharecare-State-of-American-Well-Being\\_2017-State-Rankings\\_FINAL.pdf](https://wellbeingindex.sharecare.com/wp-content/uploads/2018/02/Gallup-Sharecare-State-of-American-Well-Being_2017-State-Rankings_FINAL.pdf)

along with many natural wonders such as the Grand Canyon, red rocks of Sedona, and Saguaro National Park. In 2017, over 43 million people visited Arizona<sup>9</sup>, many via Sky Harbor Airport, 2018's ninth-busiest U.S. airport<sup>9</sup>. Tourism contributed \$22.7 billion in economic impact in 2017, supporting jobs and generating tax revenue.<sup>10</sup>

And the "Five Cs?" They continue to make strong contributions to Arizona's bustling economy<sup>11</sup>.

- Cattle - About 875,000 head of cattle are still raised in Arizona, and in 2016, sales surpassed \$1 billion.
- Climate - Climate accounts for population growth, the development of infrastructures throughout the state and Arizona's strength in tourism.
- Cotton- In 2017, there were yet about 200,000 acres of cotton grown in Arizona, making Arizona one of the top 10 leading producers of cotton in the U.S.
- Copper – Arizona still yields more copper than any other state and has held that distinction since 1910.
- Citrus – Along with Florida, Texas and California, Arizona grows grapefruit, lemons, limes and oranges across more than 20,000 acres of citrus farms. 95% of the U.S. lemon supply comes from California and Arizona.

From the state's storied past as an important part of America's "Wild West," to today's sophisticated and forward-looking Southwestern business hub, Arizona's evolution continues to be one that fosters business investment and supports business growth.

## Arizona-at-a-Glance

### CALLING ARIZONA HOME:

- While Arizona is one of the go-to spots for retirees, more than a quarter of the population was under 20 years old in 2017.<sup>12</sup>
- In 2018, Arizona was home to more than 1,200 small- and large-scale aerospace and defense companies.<sup>2</sup>

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9 Arizona Office of Tourism, "Economic Impact of Travel Industry in Arizona." <https://tourism.az.gov/research-statistics/economic-impact>

10 TripSavvy, "The 25 Busiest Airports in the United States," November 14, 2018, <https://www.tripsavvy.com/busiest-airports-in-the-usa-3301020>

11 The Republic/azcentral.com, "Arizona Then & Now: The Five Cs," <https://www.azcentral.com/story/travel/2017/02/28/arizona-then-now-five-cs/97960048/>

12 Phoenix Business Journal, "Phoenix tops U.S. in small-business wage growth, population gains; second for construction jobs," April 4, 2018 <https://www.bizjournals.com/phoenix/news/2018/04/04/phoenix-tops-u-s-in-small-business-wage-growth.html>



- Arizona hosts one of the fastest growing bioscience industries in the U.S. and Arizona State University, Northern Arizona University and the University of Arizona are nationally recognized as leading research institutions in a wide range of subsectors.<sup>2</sup>
- In 2018, Nebraska’s Creighton University announced it would invest \$100 million into a four-year medical, nursing, occupational and physical therapy, pharmacy, physician assistant and emergency medical services school on a healthcare campus in downtown Phoenix, further boosting Arizona’s strength in healthcare, medical education and research.<sup>2</sup>
- Arizona has one of the most climatologically stable states in the U.S. - one reason the state is home to more than 50 major data centers.<sup>2</sup>
- Arizona offers one of the lowest costs of doing business in the United States, primarily because of low taxes and small state government. While the national average of per-capita income going to taxes is 9.9 percent, here the number is only 8.4 percent. In addition, Arizona’s taxes on property, gas and personal income remain low compared to the rest of the country.<sup>2</sup>

#### **GROWING IN THE GRAND CANYON STATE:**

- With job growth that has been well above the national average since 2014, Arizona job growth is forecast to average 1.4% per year during the 2018-2048 period.<sup>1</sup>
- Phoenix, Arizona’s largest metropolis, ranked first in the U.S. in 2018 for small-business wage gains and second in the country for adding construction jobs.<sup>13</sup>
- Arizona’s population is predicted to rise from 7.1 million in 2018 to 10.2 million by 2048. That translates into average growth of 1.2% per year, double the national pace of 0.6% per year.<sup>1</sup>
- On a per capita basis, real personal income in Arizona is predicted to rise at a solid pace during the next 30 years (2018-2048) at 1.7% per year - slightly above the national pace of 1.6% per year.<sup>1</sup>
- Education, health care and construction led the charge in Arizona job growth in 2018, with leisure and hospitality also posting solid gains.<sup>1</sup>
- While the Phoenix metropolitan area drives the Arizona economy, Tucson is expected to post significant gains in jobs in the coming years based on the strength of increases in federal procurement spending, and construction spurred by housing affordability.<sup>1</sup>
- Arizona is poised to add 1 million new residents between 2018 and 2026 as well as more than 500,000 jobs that will continue growing the state’s economy.<sup>14</sup>

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13 U.S. News and World Report, “Best Places to Live,” April 11, 2018, <https://realestate.usnews.com/places/arizona/phoenix>

14 Phoenix Business Journal, “Arizona set to add 500,000 jobs during next eight years,” August 6, 2018 <https://www.bizjournals.com/phoenix/news/2018/08/06/arizona-set-to-add-500-000-jobs-during-next-eight.html>

## **A GREAT PLACE TO VISIT...AND LIVE**

- The total number of Arizonans employed in tourism was 194,000 in 2017.<sup>12</sup>
- In 2018, U.S. News and World Report ranked Phoenix at 19 in its rankings of 125 cities under the category of “Best Places to Live.”<sup>12</sup>
- A Wall Street Journal index listed Sky Harbor Airport as the third-best in the nation in a study called “The Best of the Biggest Airports.”<sup>15</sup>
- Visitor spending saves Phoenix locals more than \$1,000 per year in taxes,<sup>13</sup> while statewide visitor spending supports over 187,000 jobs.<sup>9</sup>
- The Grand Canyon receives close to five million visitors each year.<sup>16</sup>
- Between 60 and 70 percent of Arizonans are from somewhere else, but are happy to find themselves in a culture that embraces outsiders.<sup>17</sup>

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15 The Wall Street Journal, “The Best of the Biggest U.S. Airports,” November 14, 2018 <https://www.wsj.com/articles/the-best-of-the-biggest-u-s-airports-1542204004>

16 National Park Service, “Grand Canyon History & Culture,” July 22, 2018 <https://www.nps.gov/grca/learn/historyculture/index.htm>

17 Medium.com, “7 Reasons Arizona is a Great Place to Live and Work,” Doug Ducey, February 14, 2017 <https://medium.com/@dougducey/7-reasons-arizona-is-a-great-place-to-live-and-work-or-better-yet-move-to-d3a6e07f5c6d>



# SELECTED LEGAL SUBJECTS FORMS OF BUSINESS OWNERSHIP

CHERYL A. IKEGAMI

**A**RIZONA'S corporate laws were designed to ensure profitable cultivation of Arizona's natural resources and foster a fertile environment for investment and innovation. Consistent with this central concern, Arizona's Constitution authorized the formation of corporate entities and established the Arizona Corporation Commission (ACC). The ACC's broad responsibilities extend beyond the regulation of public service utilities. It is authorized to administer the Arizona Securities Act, as well as Arizona laws relating to the creation and regulation of corporations, associations and limited liability companies. The ACC is also empowered with the related rule-making, enforcement and investigative powers to effectively carry out those responsibilities. In addition to the Arizona Secretary of State, the ACC plays an important role in the formation, operation and termination of Arizona businesses.

Arizona's courts also play an important role. The decisions of the ACC are subject to administrative and judicial review. In addition, the jurisdiction of Arizona's superior courts extends to suits by and against corporations and other business entities, resulting in a body of judicial opinions guiding individuals in their selection and operation of business ownership forms in Arizona.

An individual may choose among several alternate forms of ownership to make an investment or to conduct business in Arizona. The choice of form of ownership is important, because it affects not only the manner in which the investment or business will be operated, but also the extent to which federal and state laws will apply. The choice will determine who will make management decisions, whether owners will be liable for investment or business-related obligations, whether interests in

the investment or business can be easily transferred and how the owner's income tax liability will be determined.

The five most common forms of ownership in Arizona are sole proprietorships, corporations, general partnerships, limited partnerships and limited liability companies. Each form of ownership offers specific advantages. The following should be considered when selecting a form of ownership:

- required formalities,
- suitability of the form of ownership as a vehicle for raising capital and borrowing funds,
- method by which the owners manage and control the business,
- manner of dividing profits and losses,
- extent to which owners may be personally liable for business obligations,
- ability of owners to transfer their interests,
- effect of an owner's death, bankruptcy or withdrawal upon the continuing existence of the business, and
- record-keeping requirements.

The objectives of the owners can sometimes be accomplished through a combination of forms of ownership when a single form would not suffice. The following chart summarizes these criteria.

Foreign persons also may use forms of ownership initiated or created outside of Arizona or the United States to take action or conduct business in Arizona. Foreign corporations and other types of business entities or associations are permitted to do business in the state. However, foreign persons may encounter reluctance on the part of local lenders or merchants to do business with businesses organized outside the United States. For this reason, foreign persons may wish to use one or more entities organized in Arizona, or in another state of the United States, to make investments or to conduct business. Generally, a business organized under Arizona law can be a subsidiary or affiliate of a foreign business organization.

Additional helpful information about corporate forms or filings of existing entities can be found at the following websites:

- Arizona Corporation Commission: [www.azcc.gov](http://www.azcc.gov)
- Arizona Secretary of State: [www.azsos.gov](http://www.azsos.gov)



## Chart: Entity Considerations

	Sole Proprietorship	Corporation	General Partnership	Limited Partnership	Limited Liability Company
Organizational Formalities	Generally none	Articles of incorporation and certificate of disclosure must be filed; directors' meeting must be held; bylaws must be adopted; shares must be issued	Oral partnership agreement is permitted; advisable to adopt written partnership agreement	Certificate of limited partnership must be filed; advisable to adopt written limited partnership agreement	Articles of organization must be filed; advisable to adopt written operating agreement
Capitalization and Debt Financing	Capital limited to amount committed by proprietor; ability to obtain financing generally limited to financial condition of proprietor	Capital raised through issuance of shares; significant freedom to develop share structure best suited for corporate needs; debt financing may require shareholder guarantees	Partners free to structure their respective capital obligations as they may agree; ability to obtain financing generally limited to financial condition of the partners	Partners free to structure their capital obligations as they may agree; absent limited partner guarantees, ability to obtain financing generally limited to financial condition of the general partners	Members free to structure their respective capital obligations as they may agree; debt financing may require member guarantees
Control	Exclusively vested in proprietor	Vested in board of directors; members are subject to election and removal by shareholders	Partners have equal voice in all management decisions unless the partnership agreement establishes different management rights	Typically exercised by general partners with rights of limited partners to ratify certain decisions, including sale of assets and liquidation	Vested in managers or members, depending on management structure
Profits and Losses	Exclusively allocated to proprietor	Dividends generally allocated among shareholders in accordance with stock ownership; exception for holders of preferred stock, who may be given dividend rights superior to common shareholders	Significant freedom to allocate among partners in partnership agreement	Significant freedom to allocate among partners in partnership agreement	Significant freedom to allocate among members in operating agreement
Personal Liabilities	Generally unlimited personal liability	Liability of shareholders generally limited to investment in shares	Generally unlimited personal liability imposed on the partners except in the case of a limited liability partnership	General partners generally have unlimited personal liability except in the case of a registered limited liability partnership; liability of limited partners generally limited to contributions made or agreed to be made	Liability of members generally limited to investment in membership interests

	<b>Sole Proprietorship</b>	<b>Corporation</b>	<b>General Partnership</b>	<b>Limited Partnership</b>	<b>Limited Liability Company</b>
<b>Transferability of Interest</b>	Assets of proprietorship generally freely transferable	Shares freely transferable unless restricted by articles, bylaws, agreement or securities laws	Generally requires agreement of all partners to admit new partners	Transfer of any general partner's economic interest typically requires consent of all partners; limited partner may substitute another party if permitted under partnership agreement or by consent of all partners	Generally consent of members needed for transfer of membership interest
<b>Continuity of Existence</b>	No continuity; death terminates proprietorship	A corporation has perpetual existence unless otherwise specified in the articles; continuity not disrupted by events affecting shareholders	Withdrawal, bankruptcy, death or termination of existence causes dissolution of partnership unless remaining partners elect to continue business in accordance with partnership agreement	Dissolution of a limited partnership occurs as specified in the certificate of limited partnership or in the partnership agreement, or with the written consent of all of the partners. Dissolution may also occur upon the withdrawal of a general partner if there is no remaining general partner, unless all limited partners or a lesser number specified in the partnership agreement agree to continue the business and appoint one or more new general partners	Generally, withdrawal, bankruptcy, death or expulsion of the last remaining member causes dissolution unless otherwise provided for in an operating agreement
<b>Taxation</b>	Not a separate taxable entity; income or loss exclusively allocable to proprietor	Generally a separate taxable entity that pays tax on entity profits; additional tax results to shareholders upon distribution of dividends	Not a separate taxable entity; income or loss generally allocable to partners in accordance with partnership agreement	Not a separate taxable entity; income or loss generally allocable to partners in accordance with partnership agreement	Not a separate taxable entity; income or loss generally allocable to members in accordance with operating agreement
<b>Reports</b>	Preparation of tax returns	Annual reports must be filed with the ACC; corporation must provide annual financial reports to shareholders; preparation of annual tax returns	Preparation of tax returns; maintenance of books and records	Preparation of tax return; maintenance of books and records	Preparation of annual tax returns except in the case of certain single member companies; maintenance of books and records

## **Sole Proprietorships**

**S**OLE proprietorship describes the direct ownership of a business enterprise by a single individual or single marital community of husband and wife. The characteristics are summarized in the preceding chart and detailed in the following paragraphs.

### **ORGANIZATIONAL FORMALITIES**

No formalities are involved nor documents required to organize a sole proprietorship. However, if the owner conducts business operations under a name other than the owner's name, a certificate of "fictitious name" must be recorded with the county recorder of each county in which the business is conducted.

### **CAPITALIZATION AND DEBT FINANCING**

In a sole proprietorship, the owner's ability to obtain capital and financing is likely to be limited by the owner's net worth or financial strength, which tends to limit proprietorships to smaller businesses.

### **MANAGEMENT AND CONTROL**

The operation of a sole proprietorship is within the owner's sole control. The owner is not required to keep a written record of management decisions. Because there is a single owner, there can be no management conflicts, except as between husband and wife in a marital community proprietorship. Under Arizona's community property laws, husband and wife have equal rights in, and equal control over, community property, unless they otherwise agree.

### **PROFITS AND LOSSES**

A sole proprietor retains all profits and bears all losses of the business. If the owner should enter into any agreement with another for the sharing of income or expenses relating to a business or investment, the agreement may create a general partnership, with unintended consequences.

### **EXTENT OF OWNER'S LIABILITY**

Because a sole proprietorship is not a separate legal entity, it does not protect its owner from personal liability for business obligations. A sole proprietor has unlimited personal liability for the debts and obligations of the business, even, as to matters arising before the sale or termination, after the business is sold or terminated. Insurance can be purchased to protect the sole proprietor's personal assets from some liability risks.

## **TRANSFERABILITY OF INTEREST**

The sale of a sole proprietorship can be accomplished through a sale of the assets used in the business. Assets, as a general rule, are freely transferable, but restrictions may apply to some. For example, the sale of a franchise might be restricted by the terms of the franchise agreement. Similarly, if assets are pledged to secure a loan, then sale will likely be restricted by the loan documents.

## **CONTINUITY OF EXISTENCE**

A sole proprietorship has no continuity of existence independent of its owner and ends upon the owner's death.

## **TAX CONSIDERATIONS**

Because a sole proprietorship is not a separate taxable entity, the income or loss from operation of the proprietorship is included with the owner's other income or loss in calculating the owner's taxable income. Taxes are further discussed in the "Taxation" chapters.

## **RECORD KEEPING REQUIREMENTS**

A sole proprietorship is not subject to any special reporting requirements. The owner is required to file federal and state income tax returns, payroll tax returns for employees, license applications and other regulatory reports applicable to the business being conducted. In license applications for certain businesses, the owner may be required to disclose more information regarding the owner's personal affairs than if the business were a partnership or corporation.

## **LIMITED LIABILITY COMPANY ALTERNATIVE**

Operation of a sole proprietorship is one option available to an individual desiring direct ownership of a business enterprise. Under Arizona law, individuals also have the option of organizing a separate legal entity to conduct business, including one known as a limited liability company (LLC). An individual can form an LLC by filing articles of organization with and paying a nominal filing fee to the ACC. Though an LLC is subject to greater statutory regulation than a sole proprietorship, an LLC has the benefit of providing its members with a shield against personal liability greater than their investment in the LLC. In addition, for federal income tax purposes, unless the individual elects to the contrary, an LLC with a single member is disregarded and the individual member is taxed on the LLC's operations in the same manner as if that person were operating a sole proprietorship.

## **CONCLUSION**

The principal advantage of a sole proprietorship is that the owner has exclusive control. The owner does not need to obtain the consent of partners, directors or shareholders. Another advantage is simplicity. No formalities are required to organize or maintain a proprietorship. The chief shortcomings

of a sole proprietorship are the exposure of all the owner's personal assets to the liabilities of the business and the difficulties that may be encountered in obtaining sufficient funds to finance the business.

## Corporations

**C**ORPORATIONS, popular vehicles for making investments or conducting business, can accommodate wide variations in the number of owners (shareholders), ranging from the corporation in which all the outstanding shares are owned by one person, to the "closely held" corporation, in which the shares are held by a limited number of persons, to the "publicly held" corporation, in which share ownership is held by hundreds or thousands of shareholders. Arizona also authorizes or recognizes alternative corporate forms, including not for profit corporations, professional corporations, business development corporations and benefit corporations. Arizona laws governing corporations are designed to permit corporate operations with minimal "red tape." The information below applies to a typical business corporation.

### ORGANIZATIONAL FORMALITIES

Several formalities must be observed in forming a corporation. The incorporator (i.e., the person who forms the corporation) must file the corporation's articles of incorporation and a certificate of disclosure with the Arizona Corporation Commission (ACC) with the accompanying filing fee. A corporation's articles of incorporation must include the following information:

- The name of the corporation, which must include one of the following words (or an abbreviation): "association," "bank," "company," "corporation," "limited" or "incorporated." Subject to limited exceptions, the name selected for a corporation must be distinguishable from that of any existing Arizona corporation, limited partnership or limited liability company, any foreign corporation, limited partnership, or limited liability company that is registered in, or otherwise authorized to conduct business in, Arizona, as well as certain fictitious or trade names of other entities.
- A statement of the character of the business that the corporation initially intends to conduct (the business that the corporation may conduct, however, is not limited to that which is stated).
- The aggregate number of shares of stock that are authorized for issuance. A corporation's articles of incorporation usually authorize a greater number of shares than the corporation intends to issue in connection with its formation. This provides flexibility to issue additional shares in the future without amending the articles of incorporation.



- The name, address and signature of each incorporator who files the articles of incorporation. Incorporators need not be shareholders of the corporation, nor Arizona residents.
- The name, street address and signature of the corporation's initial statutory agent and the address of the corporation's known place of business if different from that of its statutory agent. Every corporation doing business in Arizona must appoint a statutory agent to receive formal notices and to accept service of process in lawsuits filed against the corporation. A statutory agent must be either a corporation or limited liability company formed in, or authorized to do business in, Arizona or an individual who is a resident of Arizona. A statutory agent, although merely ministerial, is important because service of process gives a court jurisdiction and starts the running of the time within which the corporation must respond in order to avoid entry of judgment by default against it. If a corporation changes its known place of business or statutory agent, it must file a statement of change with the ACC. A statutory agent must also notify the corporation and the ACC of any change in its address.
- The name and address of each initial director of the corporation.

The articles of incorporation may also include other provisions not in conflict with applicable laws, including:

- provisions eliminating or limiting the liability of directors to the corporation or its shareholders for monetary damages for actions taken or any failure to take action as a director with certain specified exceptions; and
- a provision permitting or making obligatory indemnification of a director for liability for any action taken or not taken as a director subject to certain exceptions.

Within 60 days after the ACC approves the filing, either the articles of incorporation must be published in a newspaper of general circulation in the county of the known place of business for three consecutive publications or the ACC must input the information regarding the approval into a specified database.

The certificate of disclosure must identify and describe certain criminal convictions of or judicial actions against all persons who, at the time of its delivery, are officers, directors, trustees, incorporators and persons controlling or holding more than a 10 percent interest in the corporation, as well as a brief statement disclosing whether any person who, at the time of its delivery, are officers directors, trustees, incorporators and persons controlling or holding more than a 20 percent interest in the corporation and who have served in any such capacity or held a 20 percent interest in any other corporation during the bankruptcy or receivership of the other corporation. An updated certificate of disclosure must be delivered to the ACC within 60 days of initial filing to cover any person who is then an officer, director, trustee or 10% holder and who was not covered by the initial disclosures.

After filing the articles of incorporation and the certificate of disclosure, the directors named in the articles of incorporation must hold an organizational meeting to elect officers and transact other appropriate business. The adoption of corporate bylaws is among the first items of business. The bylaws of a corporation set out the details of corporate governance and normally contain provisions relating to the conduct of business and to the rights and powers of shareholders, directors and officers. Bylaws must be consistent with Arizona law and with the articles of incorporation.

### **CAPITALIZATION AND DEBT FINANCING**

Proceeds from the sale of a corporation's shares normally provide a principal source of capital for the corporation. An Arizona corporation may issue any number of shares, up to the maximum number of shares that are authorized for issuance in its articles of incorporation. The board of directors establishes the price for each share to be issued. Payment for shares may be made to the corporation in cash, other property or in past services actually performed for the corporation. Promissory notes and promises of future services cannot be used as valid consideration for the issuance of shares.

Shares of a corporation are "securities" under both federal and state securities law. In issuing shares, care must be taken to ensure that all applicable securities law requirements are satisfied.

An Arizona corporation has great flexibility to issue various classes of shares, each with different rights, to develop a share structure suited to its needs. For example, as a means of attracting additional investors and selling additional shares, the corporation may issue shares that provide preferred rights, such as a right to dividends or a first right to the proceeds on the sale of corporate assets, or in the event of dissolution of the corporation. The corporation also may issue shares that lack voting rights or that provide either limited or preferential voting rights.

In general, subject to applicable securities laws, shares can be sold by the corporation to any party at any time. However, the articles of incorporation may grant "preemptive" rights to existing shareholders, giving them the first opportunity to purchase additional shares in proportion to the number of shares already held by them. Preemptive rights are often useful in closely held corporations to preserve the relative proportion of share ownership among the existing shareholders.

Funds needed for corporate operations can also be obtained through the sale of debt securities, such as bonds or debentures. Bonds and debentures are repaid over a period of time with interest. They do not grant the holder any ownership interest in the corporation, but they rank ahead of stock in payment priority. Additionally, corporations can borrow money from financial institutions. A corporation that is new, closely held or thinly capitalized may encounter difficulty in borrowing funds, unless its shareholders personally guarantee the corporation's repayment obligations.

## **MANAGEMENT AND CONTROL**

Management of a corporation is vested in its board of directors. Each director must be an individual. Generally, there is no limit to the number of directors that a corporation may have. The number of directors is normally fixed in accordance with the articles of incorporation or bylaws. Directors are required to manage the business of the corporation in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation. Directors need not be shareholders of the corporation nor Arizona residents unless the articles of incorporation or bylaws so provide.

Meetings of the board of directors may be held within or outside Arizona and, unless the articles or bylaws provide otherwise, may be held by conference telephone or other communications equipment. Again, unless the articles of incorporation or bylaws provide otherwise, the directors may also take action by unanimous written consent without holding a meeting. Unless a different number is specified in the bylaws or articles of incorporation (but not less than 1/3 of the full board), a majority of directors constitutes a sufficient number of directors, or "quorum," necessary for the transaction of business at a meeting of the board. If a quorum is present when a vote is taken, the affirmative vote of a majority of the board present at the meeting is required to approve a matter unless the articles of incorporation or bylaws require a greater vote.

A corporation's shareholders elect the directors. At the annual election of directors, the shareholders have the right to "cumulate" their votes by multiplying the number of votes they are entitled to cast by the number of directors to be elected and casting all such votes for one candidate or allocating votes in any manner among the candidates. Under this system of "cumulative" voting, shareholders can elect directors in rough proportion to the percentage of shares they own.

If the articles of incorporation provide, and to the extent that it does not infringe upon the shareholders' cumulative voting rights, the board of directors may be divided into a "staggered board" usually consisting of two or three groups. With a staggered board, only the directors in a particular group stand for election at each annual meeting, so only a half or third of the board is elected in any given year. Staggered boards promote continuity of management by preventing a shareholder or group of shareholders from replacing all of the directors at a single annual shareholder meeting.

Subject to certain exceptions, the shareholders may remove one or more of a corporation's directors from office for any reason at a shareholders' meeting called expressly for that purpose. If less than the entire board is to be removed, no director may be removed if the votes cast against removal would be sufficient to elect the director to the board under the cumulative voting system. Subject to certain exceptions, any vacancy on the board of directors may be filled by either the remaining directors or the shareholders. The replacement director holds office until the next election of directors.

Shareholders enjoy rights in addition to the rights associated with the election and removal of directors. A board must submit various matters to the shareholders for approval, including most amendments to the articles of incorporation of the corporation. If a publicly held corporation is listed on a stock exchange, shareholder approval of certain stock issuances and other matters may also be required. The board may also submit other matters for shareholder approval, even if not technically required, including bylaw amendments and certain “self-dealing” transactions in which officers or directors have an interest.

If the directors desire to sell, lease, exchange or otherwise dispose of all or substantially all of the corporation’s property, other than in the usual and regular course of the corporation’s business, a majority of the outstanding voting shares of the corporation must generally approve the transaction. The Arizona statutes also provide for certain entity restructuring transactions, including mergers, conversions, share exchanges and similar transactions and provide the requirements, including the votes needed, for each such type of restructuring transaction. Approval by shareholders holding a majority of the outstanding voting shares of each corporation is required in most instances. However, Arizona law also permits the articles of incorporation or, in some cases, the board of directors to require a greater vote than would otherwise be required by law.

If a shareholder disagrees with (or “dissents” from), among other things, a sale or disposition of all or substantially all of the corporation’s assets or a merger of the corporation with another corporation, subject to certain limitations, the shareholder may, by complying with certain notice and other statutory requirements, require the corporation to purchase his or her shares. If the corporation and the dissenting shareholder cannot agree on a value for the shares, the corporation must request a court to determine their value. These “dissenters’ rights” do not extend to holders of shares of an Arizona corporation registered on a national securities exchange (e.g., NYSE or NASDAQ), nor to a class or series of shares that are held by 2,000 or more shareholders of record, unless the corporation’s articles of incorporation otherwise provide.

In certain cases, Arizona law provides rights to existing management to avoid the effects of hostile takeovers. For example, the voting rights of shares of issuing public corporations that are acquired in a control share acquisition may be limited. An issuing public corporation would include certain publicly held companies and companies that elect to be subject to such rules in their articles of incorporation if certain additional conditions are satisfied. In addition, subject to certain conditions, an issuing public corporation may be prohibited from engaging in any business combination (such as a merger or share exchange) with any interested shareholder (or affiliate) for a period of three years after the date on which the person became an interested shareholder. Generally, an interested shareholder is a 10% holder of corporation stock or an affiliate or associate of the issuing public corporation who was a 10% holder within the prior three years.

The officers of the corporation are responsible for the day-to-day operation of the corporation. Their authority is determined by the board of directors or described in the bylaws. The corporation may have such officers as the shareholders or directors deem appropriate. The board of directors appoints the officers, and the officers may then appoint one or more other officers or assistant officers if authorized by the bylaws or the board of directors. The same individual may hold more than one office. Any officer may be removed at any time by the directors. However, if provided by contract, an officer may be entitled to severance compensation or to continued employment in some other capacity.

### **PROFITS AND LOSSES**

Profits are shared by the shareholders in the form of dividends. Generally, dividends are distributed to shareholders proportionately in accordance with share ownership. Unless the articles of incorporation otherwise provide, and subject to certain restrictions (some of which are described below), dividends are declared and paid at the discretion of the board of directors. Holders of preferred shares may enjoy preferential rights to dividend distributions.

Subject to any restriction contained in the articles of incorporation, a corporation may pay dividends in cash, in property or in its own shares. A distribution of dividends may not be made if the corporation is not able to pay its debts in the normal course of business. Also, payment of dividends is not permitted when the corporation's total assets would be less than the sum of its total liabilities plus, unless the articles permit otherwise, the amount needed to satisfy the preferential rights of shareholders on dissolution.

Losses incurred by a corporation may reduce the payment of dividends to shareholders and the price obtainable by shareholders upon a sale of shares. Except in the case of a "Subchapter S" corporation, the losses incurred by a corporation are not shared by the shareholders on a current basis. See "Tax Considerations" below in this chapter.

### **EXTENT OF OWNERS' LIABILITY**

As a general rule, each shareholder's liability for corporate obligations is limited to the shareholder's investment in the shares of the corporation. This insulates the shareholder's other assets from the debts and other obligations of the corporation.

In some situations, however, a court may "pierce the corporate veil" and disregard the corporation as a legal entity that is separate and distinct from the shareholder, with the effect of making the shareholder personally liable for the corporation's obligations as if the corporation were a proprietorship or partnership.



The corporate veil may be pierced by a court if the corporation is not sufficiently capitalized to meet the obligations reasonably foreseeable for a business of its size and character. Other factors that may lead a court to pierce the veil and disregard the corporation as a distinct legal entity include whether the corporation was used to defraud creditors, whether the corporation's property was used for the personal use of the shareholders in question (sometimes called "co-mingling" of assets), whether the corporation failed to maintain a separate corporate identity, whether the corporation failed to maintain adequate records and whether the corporation disregarded corporate legal formalities. Arizona courts seldom grant relief to corporate creditors under the theory of piercing the corporate veil except in extreme factual circumstances. By providing adequate capital to the corporation, by undertaking honest business practices, by maintaining a distinct line between the corporation's assets and those of its shareholders and by paying attention to simple corporate formalities, use of the corporate structure can easily be maintained to protect the shareholders' separate assets from claims of the corporation's creditors.

### **TRANSFERABILITY OF INTERESTS**

The ownership interests of shareholders in a corporation are usually represented by share certificates, but can be uncertificated. In most cases, these are freely transferable. Reasonable restrictions on share transfers may be imposed by the corporation's articles of incorporation or bylaws or by the provisions of an agreement among the shareholders if the existence of such restriction is noted conspicuously on each share certificate. The board of directors of an Arizona corporation may authorize the issuance of shares without certificates as long as the shareholder receives relevant information regarding his/her/its rights. Federal and state securities laws may also impose restrictions on the transferability of shares.

### **CONTINUITY OF EXISTENCE**

An Arizona corporation will have perpetual existence unless its articles of incorporation provide otherwise. A corporation with perpetual existence will not terminate until formal steps are taken to dissolve the corporation. The death, bankruptcy or transfer of shares of any shareholder will not interrupt the continuing existence of a corporation.

### **TAX CONSIDERATIONS**

Generally, a corporation is treated for both federal and state tax purposes as a taxable entity, separate and apart from its shareholders. A corporation computes its taxable income or loss each year and pays tax at the corporate level on its taxable income. After payment of income taxes, if the corporation distributes dividends to its shareholders, the shareholders usually must include the dividend distributions in their own individual taxable income. Consequently, corporate profits

are taxed twice, once when earned by the corporation and a second time when distributed to the shareholders.

Certain corporations may avoid the liability for corporate-level income taxes by filing an election under Subchapter S of the Internal Revenue Code. A corporation can make this election only if, among other requirements, it has permissible shareholders, including individuals (other than non-resident aliens), estates, certain trusts and certain tax-exempt entities. Corporations owned in whole or in part by other corporations, by partnerships or by non-resident aliens are not eligible to make the Subchapter S election and cannot avoid liability for corporate-level income taxes. Classification of foreign persons as resident or nonresident aliens is discussed in the chapter "Immigration." Tax considerations are further considered in the chapter on "Taxation."

### **RECORD KEEPING REQUIREMENTS**

Every Arizona corporation is required to file an annual report with the ACC that includes, among other things, the following information:

- the name of the corporation and the state or country under which law it is incorporated;
- the corporation's address and the name and address of its statutory agent;
- the address of its principal office;
- the names and business addresses of the directors and principal officers of the corporation;
- a statement of the nature of the corporation's business;
- the number of authorized and issued shares for each class of shares;
- a certificate of disclosure containing the same information as set forth in the certificate of disclosure filed with the articles of incorporation; and
- the name of each shareholder who holds more than 20 percent of any class of shares.

An Arizona corporation must file annual federal and state income tax returns.

In addition to the reports that must be filed with state and federal authorities, a corporation must annually provide shareholders with financial statements. Every corporation, regardless of its size or number of shareholders, is required to maintain appropriate accounting records, as well as minutes of meetings of its shareholders and board of directors. A corporation must also keep a record of its shareholders, with the names and addresses of all shareholders and the number and class of shares held by each. Under certain circumstances, shareholders have the right to inspect and copy the corporation's books and records.

## CONCLUSION

The primary benefit of forming a corporation is protection against the personal liability of the owners. A shareholder's risk is limited to the amount of capital invested in the corporation, unless there is abuse of the corporate form that justifies piercing the corporate veil. The disadvantages of the use of a corporation include the greater formalities that must be observed and, except when a Subchapter S election is used, the double taxation of business profits, once by taxing the corporation and a second time by taxing shareholders' income.

## General Partnerships

**P**ARTNERSHIPS are common forms of business ownership used by two or more persons to acquire investment property or to operate a business. The two kinds of partnerships under Arizona law are general partnerships and limited partnerships. Generally, the principal differences between a general partnership and a limited partnership are that each of the partners of a general partnership can incur liabilities on behalf of the partnership and each is personally liable for the payment of all partnership liabilities. The partners of a general partnership enjoy significant freedom under Arizona law to fix their rights and obligations by agreement as to most partnership matters.

## ORGANIZATIONAL FORMALITIES

A general partnership can be created with little formality. Under Arizona law, a general partnership is formed among two or more persons whenever they associate together to carry on a common business enterprise as co-owners for profit. Generally, there is no requirement to file any certificate or other organizational documents with any governmental agency. However, if the partners conduct the partnership business under a "fictitious name," one that does not consist of the individual names of all partners, a certificate showing the name and address of each partner must be filed in the county recorder's office of the county in which the partnership's place of business is located. In addition, a partnership may file a statement of partnership authority with the Arizona Secretary of State and, in some cases, the applicable County Recorder's office, which, in addition to providing information about the partnership and partners, states the authority, or limitations on the authority, of some or all of the members to enter into transactions on behalf of the partnership.

A partnership can be created without a written partnership agreement if the co-owners orally agree to form a partnership or, in certain cases, if they conduct their enterprise in a manner that demonstrates their intention to share profits and losses as partners. For this reason, a general partnership could inadvertently arise when two or more persons jointly acquire property and share income and expenses. Because a partnership relationship creates significant rights and obligations among co-owners, any arrangement involving the sharing of income and expenses should be carefully considered

to determine whether it creates a partnership. If so, a written partnership agreement should be prepared to clearly define the partners' respective rights and obligations, including such items as the sharing of profits and losses, the obligations to fund the ongoing business of the partnership, management decisions and transfer rights. In the absence of a written agreement, Arizona law will dictate the partners' rights and obligations in a manner that may or may not conform to the partners' expectations or desires.

### **CAPITALIZATION AND DEBT FINANCING**

Partners may contribute cash, property or services to the capital of a general partnership. Arizona law permits the partners' broad discretion to arrange their capital contributions in any way they choose. In most cases, the partners will describe in their partnership agreement the specific capital contributions required of each partner when the partnership is formed. The partnership agreement should also set forth the respective obligations of the partners to contribute additional capital if the business of the partnership requires. The partners may agree to make capital contributions in proportions different from their share of profits and losses or may agree to make additional contributions in proportions different from their initial contributions.

Arizona law permits a general partnership to borrow money or obtain credit from lenders in the name of the partnership. A general partnership may also borrow money from one or more of its partners. Each partner in a general partnership is personally liable to partnership creditors to repay partnership debts if the partnership's assets are insufficient. Consequently, a partnership's ability to borrow money or obtain credit will be influenced by each partner's individual financial condition and credit history, as well as by the partnership's financial condition. Because of each partner's financial responsibility for partnership debts, generally, the partners include a provision in their partnership agreement limiting the partnership's ability to borrow money without the consent of all, or a majority, of the partners.

As an alternative to obtaining its cash requirements from its existing partners or third-party lenders, the partnership may create and issue additional interests in the partnership to new partners who agree to contribute additional capital. Arizona law requires, except as otherwise provided in a partnership agreement, the consent of each existing partner before a new partner is admitted as a member of a general partnership, because the admission of an additional partner may alter the management control of the existing partners and dilute the value of their interests in the partnership's assets and profits.

### **MANAGEMENT AND CONTROL**

The partners of a general partnership are free to divide management authority and responsibilities among themselves in whatever manner they agree. If the partners fail to describe any specific

management arrangement in their partnership agreement, Arizona law provides that each partner will have an equal voice in all management decisions and that a majority vote of the partners is controlling as to ordinary partnership matters.

In many general partnerships, the partners modify the general rule that all partners have equal management rights. It is quite common, for instance, to give partners voting rights according to their respective contributions to the partnership or their percentage of shares of partnership profits. Partners may appoint a management committee for the purpose of approving all, or a specified list of, management decisions. The partners may also agree that one specific partner will be the “managing partner” with responsibility for conducting routine transactions within described limitations. One of the most important advantages of the partnership form of business is the wide range of freedom the partners have to devise internal management rules that reflect the needs of the enterprise and the individual partners.

Arizona law provides certain rules that cannot be modified by the partners in their partnership agreement. For example, no matter how the partners may agree to divide management responsibilities among themselves, except in very limited circumstances, third parties who are unaware of the partnership agreement are entitled to rely on the presumed authority of each partner to represent the partnership. Therefore, even if the partnership agreement deprives some of the partners of the right to participate in management, each of the partners is treated as an agent of the partnership for the purpose of carrying on ordinary partnership business. This means that each of the partners has the power to incur partnership debts and liabilities to third parties in the ordinary course of the partnership’s business that will obligate both the partnership and all individual partners. As noted above, one can mitigate this possibility by filing certain statements with the Secretary of State or applicable County Recorder stating limitations on the authority of some or all of the partners. Nonetheless, it is advisable to carefully evaluate the trustworthiness and reliability of all other partners before entering into a general partnership.

Partners owe a duty of loyalty and a duty of care to the partnership and each other. These duties must be performed consistent with the obligation of good faith and fair dealing.

### **PROFITS AND LOSSES**

Partners are free to allocate partnership profits and losses by agreement. If the partners do not specify in their partnership agreement how profits and losses are to be shared, Arizona law provides that profits and losses are shared equally among the partners. Partnership agreements often provide for unequal sharing of profits and losses to reflect differences in amounts or types of contributions made by the partners and, if one of the partners has contributed management or other services to

the partnership rather than cash or property, the “service” partner may be given a percentage share of profits greater than the proportion of any cash or property he or she contributed.

In cases in which one partner contributes services and another partner contributes cash, the partners often agree upon complex profit and loss sharing arrangements. One common arrangement is to allocate all or most of the profits to those partners who contribute cash until they receive a “targeted” return on their investment equal to an agreed-upon percentage per year. After the target is achieved, additional profits are then divided between the “service” partner and the other partners in equal shares or in some other agreed-upon proportion. The variety of possible arrangements is limitless.

The partnership agreement should describe when and how the partnership will make distributions of cash or other property to the partners. Frequently, the partners will desire to distribute cash flow from ordinary business operations in the same proportions that they share profits, but following a sale by the partnership of a capital asset, the partners will usually require that the partnership distribute the sale proceeds in proportion to the partners’ net capital contributions until capital is returned and that excess proceeds be distributed in proportion to the partners’ profit shares. A related issue is the need to decide whether proceeds must be distributed immediately or retained in the partnership to satisfy future requirements.

### **EXTENT OF OWNERS’ LIABILITY**

One of the principal disadvantages of a general partnership is that each of the partners is generally fully liable for the payment of all the partnership’s debts and liabilities. The partners’ liability is “joint and several.” Each partner alone can be sued by a partnership creditor for the full amount of an unpaid partnership liability, even though the partners may have agreed among themselves to share responsibility for the payment of partnership debts in specified portions.

Several steps can be taken to minimize the risk of unlimited liability of the individual partners. Under agreements with a third party, such as leases or loan agreements, the partners may be able to negotiate an agreed-upon limit to the liability of individual partners. A lender also may agree to limit the partners’ individual liability for all, or a portion, of a loan to the assets given as collateral by the partnership to secure the loan. With respect to non-contractual partnership liabilities, such as for a personal injury caused by the negligence of a partner, the partners may be able to protect themselves by obtaining liability insurance.

Further, Arizona law authorizes a general partnership to elect classification as a registered limited liability partnership. If a general partnership elects classification as a registered limited liability partnership, each partner is shielded from “vicarious” liability associated with the debts and obligations of the partnership, whether arising in contract, negligence or otherwise. The liability shield of a registered limited liability partnership does not, however, protect a partner from direct

liability on account of a partner's own actions, including wrongful acts, negligence or misconduct of the partner or the wrongful actions of others under the partner's direct supervision and control.

### **TRANSFERABILITY OF INTERESTS**

Under Arizona law, a partnership is viewed as a personal relationship of trust and confidence among the partners. Therefore, without a special agreement, no partner alone can transfer the partner's rights and duties as a partner to another person. If a partner desires the ability to transfer his or her interest in a partnership to a new partner, the partner should insist that the partnership agreement provide this right.

Arizona law does permit a partner to transfer the partner's economic rights. The transferable interest of a partner is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. No agreement of any other partners is necessary to transfer such economic rights unless the partnership agreement specifically restricts such transfers. However, because a person who acquires all or a part of a partner's economic rights generally cannot participate in the management of the partnership's business, it is usually difficult or impossible for a partner, without the agreement of the other partners, to sell economic rights for the full value of the partner's interest in the partnership.

### **CONTINUITY OF EXISTENCE**

A partner has the ability at any time to withdraw from the partnership, which generally will cause the dissolution of the partnership. In addition, the death, bankruptcy or termination of the existence of any partner may cause the dissolution of the partnership. In most cases, the partnership agreement can control what circumstances will cause the dissolution of the partnership. A partner who wrongfully dissociates from the partnership, including in breach of an express provision of the partnership agreement or before the expiration of a defined partnership term or the completion of a defined undertaking as a result of certain events, is liable to the partnership and to the other partners for damages caused by the dissociation, in addition to any other obligation of the partner to the partnership or to the other partners.

Arizona law requires the partnership to wind up its business and liquidate its assets upon any dissolution of the partnership, unless there is an agreement to the contrary. The partners often agree in advance to remain in the partnership for a fixed period or until a specific project is completed to avoid an undesirable and unplanned liquidation. If one of the partners should then withdraw, die, become bankrupt or be expelled prior to this time, Arizona law permits the other partners to continue the partnership business if their partnership agreement so provides. The partnership agreement usually provides a formula for valuing such partner's interest and requires one or more of the continuing partners to pay that value to the former partner. This payment can be required immediately in cash

or the partnership agreement may specify deferred payment terms. The partnership, or a dissociated partner, may also file a statement of dissociation to provide notice to third parties of the limitation on the dissociated partner's authority.

If the partnership business is wound up and liquidated after dissolution, Arizona law provides that liquidation proceeds must first be used to pay partnership debts and liabilities and the remainder distributed among the partners as the partners may agree or, if there is no agreement, in accordance with specified requirements.

### **TAX CONSIDERATIONS**

Typically, a general partnership is not treated as a separate entity taxable for purposes of either the U.S. or Arizona income tax codes. A general partnership is only required to file an annual informational tax return reflecting the partnership's income or loss for the year and each partner's share of the partnership's taxable income or loss. Each individual partner then includes his or her share of the partnership's taxable income or loss in computing taxable income on that partner's individual tax return. In effect, the partnership is treated for income tax purposes as a mere conduit that passes its income and expenses through to the partners. No income tax is imposed upon the partnership itself.

Each partner's share of partnership income or loss for income tax reporting purposes must conform to that partner's share of the economic profits or losses under the partnership agreement. In other words, if partners have agreed to share partnership profits and losses equally, they cannot report partnership income or expenses for tax purposes in different proportions. Furthermore, each partner must include his or her share of partnership taxable income in that partner's annual individual taxable income, even if the partnership does not distribute the income to the partners. For this reason, it is common for the partners to include in their partnership agreement a provision requiring that, in any year in which the partnership has taxable income, there will be a cash distribution sufficient to ensure that the individual partners will have enough funds to pay their tax liability arising out of the partnership.

Although a partnership is typically not treated as a separate entity for U.S. or Arizona tax purposes, there are circumstances in which a partnership may elect to be taxed as a corporation. In such case, the partnership and the partners are taxed in the same manner as corporations and corporate shareholders.

### **RECORD KEEPING REQUIREMENTS**

An Arizona general partnership must file annual federal and state informational tax returns that reflect the partnership's income or loss for the year and each partner's share of the partnership's taxable income or loss. Additionally, a general partnership must maintain correct and complete



books or records, which may be inspected by any partner. However, no reports of partnership activity are required to be filed with any state agency. If the partnership filed a statement of authority, and such statement is not canceled earlier, the statement is automatically canceled after five years and would need to be refilled.

## **CONCLUSION**

The primary benefit associated with use of a general partnership is the significant freedom afforded the partners to determine, by agreement, their respective rights and obligations relating to partnership matters, such as capital requirements, sharing of profits and losses and business management. Another benefit is the single level of income taxation resulting from the status of the partnership as a mere non-taxed conduit for tax purposes. The chief disadvantage is that each partner is subject to unlimited personal liability for partnership obligations unless the partnership elects classification as a registered limited liability partnership or takes other steps to insulate the partners from partnership liabilities. Another disadvantage is the considerable practical difficulty in the ability of partners to transfer their interests in the partnership.

## **Limited Partnerships**

**A** LIMITED partnership may be used by two or more persons or other forms of ownership to acquire investment property or to operate a business. The principal distinction between a limited partnership and a general partnership is that, although a limited partnership must have at least one general partner, a limited partnership is permitted to have one or more “limited partners” who are not personally liable for the partnership’s obligations unless they actively participate in management. As in a general partnership, Arizona law provides significant freedom to partners to fix, by agreement, their respective rights and obligations regarding most partnership matters.

## **ORGANIZATIONAL FORMALITIES**

A limited partnership is not created under Arizona law until partners have filed a “certificate of limited partnership” with the Arizona Secretary of State and have paid the requisite filing fee. If the partners conduct business prior to filing the required certificate of limited partnership, they run a substantial risk of having the entity treated as a general partnership with liability of all partners for all partnership obligations incurred prior to filing the certificate.

The certificate of limited partnership must disclose basic information about the limited partnership for public inspection, including, among other items:

- the name of the limited partnership, which may not be the same as, nor deceptively similar to, the name of any existing Arizona limited partnership, limited liability company, or corporation, nor any foreign limited partnership, limited liability company

or corporation authorized to transact business in the state. The name must include the words "limited partnership" or the initials "L.P." and, in most cases, must not include the name of any limited partner;

- the address of the partnership's office where the partners may inspect copies of the partnership agreement, financial statements and other partnership records;
- the name and address of an agent for service of legal process on the partnership, who may be an individual, an Arizona corporation or limited liability company, or a foreign corporation or limited liability company authorized to do business in Arizona;
- the name and business address of each general partner; and
- the latest date, if any, on which the partnership is to dissolve.

If the information in the certificate of limited partnership changes, the general partners are required to file an appropriate amendment with the Arizona Secretary of State. The partnership must amend the certificate within 30 days after the withdrawal of a general partner or the admission of a new general partner.

The partners in a limited partnership customarily enter into a written partnership agreement at the time the certificate of limited partnership is filed. The purpose of the partnership agreement is to describe the partners' financial responsibilities and economic rights in greater detail than in the certificate and to describe other responsibilities and rights (such as management rights) not covered in the certificate. As with general partnerships, if the partners do not define their rights and obligations in a written partnership agreement, Arizona law will supply any missing rights or obligations in a manner that may or may not be consistent with the partners' expectations.

The limited partners' interests in a limited partnership are generally considered securities under both U.S. and Arizona laws. Care must be taken to ensure that the issuance of the limited partnership interests complies with securities laws.

### **CAPITALIZATION AND DEBT FINANCING**

As in general partnerships, Arizona law permits the partners of a limited partnership broad discretion to determine among themselves how cash, other property or services will be contributed to the partnership by each partner at the time of formation or at any time thereafter.

A limited partnership is permitted under Arizona law to borrow money from its partners or from third parties. A limited partnership's ability to obtain debt financing may be based upon the financial condition of its general partners, who are individually liable under Arizona law for all partnership debts. The financial condition of a limited partner is not normally taken into account by a partnership lender, except to the extent that the lender is relying upon the limited partner's initial or future capital contribution commitment as a source of repayment of the debt. With respect to a lender's ability

to rely on a limited partner's future contributions, this can typically be accomplished by asking the limited partner to sign promissory notes payable to the partnership in the amounts of their future contributions. The promissory notes are then assigned, as collateral, to the lender to secure the loan to the partnership.

A limited partnership may also raise additional capital by creating and issuing additional partnership interests to new partners. Whether the new partner desires to become a general partner or a limited partner, the consent of all the existing partners is required unless the partnership agreement gives the partners authority to issue additional general or limited partnership interests. Because the issuance of additional interests to new partners almost always will dilute the profit shares of the existing partners, partnership agreements that give the general partners this authority usually impose conditions such as requiring a minimum capital contribution for any new limited partner or that any additional limited partner interests be offered first to the existing limited partners.

### **MANAGEMENT AND CONTROL**

Arizona law permits the partners of a limited partnership to divide management rights and responsibilities in any manner that they may agree upon, but a limited partner may become personally liable for partnership debts as a general partner if the limited partner participates in the control of the partnership's business. Arizona law permits limited partners to vote on certain specific management matters (for example, the sale of all of the partnership's assets) without risking personal liability as a general partner. Most partnership agreements restrict the management rights of limited partners to these specific matters.

If there are two or more general partners in a limited partnership, the partners may delegate management rights and responsibilities among the general partners as they choose. In the absence of a division of management rights in the partnership agreement, management decisions relating to the partnership's business are made by the general partners, each of whom has an equal voice in the management and conduct of the partnership business. Because limited partners may not be involved in the day-to-day management of the partnership's business, a limited partner, concerned that the general partners may not have taken the necessary steps to enforce a claim of the partnership against a third party, has a special right to bring a legal action (derivative action) against a third party if the general partners refuse to sue the third party. If the limited partner is successful in obtaining a judgment, or a settlement of the claim, the court may award the limited partner reimbursement for expenses and legal fees. The remainder of the recovery will belong to the partnership.

### **PROFITS AND LOSSES**

The partners in a limited partnership have significant freedom to divide partnership profits and losses and partnership distributions in any manner. If the partners do not allocate profits and losses in

their partnership agreement, Arizona law provides that they share profits and losses or distributions of cash or other property in the same proportions as their actual unreturned contributions to the partnership as stated in the partnership records required to be kept by the partnership.

Freedom to allocate profits, losses and distributions by agreement is one of the important advantages of limited (and general) partnerships under Arizona law. The different profit and loss sharing arrangements available to general partnerships are also available to limited partnerships. However, there are considerations that do not arise in general partnerships. The limited partnership agreement generally will, and generally should, provide that losses in excess of profits be allocated to the limited partners only up to their contributions to the partnership and that all other losses be allocated to the general partners. Also, if any distribution by the partnership causes the net worth of the partnership (the amount by which the value of the partnership's total assets exceeds its total liabilities) to be less than the total contribution of the partners as set forth in the partnership records, the partners who receive the distributions may be required to return the amount distributed if needed to pay partnership debts.

### **EXTENT OF OWNERS' LIABILITY**

The general partners of a limited partnership generally have the same "joint and several" liability for partnership debts as do general partners in a general partnership. However, the principal advantage of a limited partnership is that each limited partner's liability for partnership debts is limited, with exceptions, to the contribution that the limited partner has made or agreed to make to the partnership.

There are several exceptions to the limitation on the personal liability of a limited partner. The most notable applies when a limited partner participates in the control of the partnership's business. If a limited partner's management participation is substantially the same as a general partner, the limited partner will have joint and several liability for all partnership debts. If a limited partner participates in management but does not exercise substantially the same powers as a general partner, he or she will be liable only to partnership creditors who actually know of his or her management participation.

Several activities in which a limited partner may engage will not be considered participation in control under Arizona law. A limited partner may: (1) consult with and advise a general partner concerning management decisions; (2) be an employee or agent of a general partner or the limited partnership or be an officer, director or shareholder of a corporate general partner or a manager or member of a general partner that is a limited liability company; (3) act as a surety or guarantor for the limited partnership; and (4) request or attend a meeting of partners. A limited partner will also not be treated as participating in partnership control by reason of a right to vote on any of the following basic decisions:

- the sale, exchange, lease, mortgage, pledge or other transfer of all or substantially all of the partnership's assets;
- the partnership's incurrence of indebtedness other than in the ordinary course of its business;
- the dissolution and winding up of the partnership;
- a change in the nature of the partnership's business;
- the admission or removal of a general partner;
- the admission or removal of a limited partner;
- a transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners;
- an amendment to the partnership agreement or certificate of limited partnership; or
- other matters specifically provided for in the partnership agreement.

Another important exception to the general rule of limited liability of a limited partner is that a limited partner must repay excessive partnership distributions. Arizona law prohibits partnership distributions to partners if the value of the partnership's remaining assets is less than the aggregate partnership liabilities owing to third parties. If a limited partner receives a distribution of any part of the limited partner's contribution in violation of this prohibition or the partnership agreement, for six years thereafter, the limited partner may be required to repay the distribution to the partnership. Additionally, if a limited partner receives the return of any part of the limited partner's contribution from the partnership not in violation of this provision or the partnership agreement, the limited partner may be required during the following year to return the distribution, if necessary, to pay partnership debts incurred prior to the distribution.

Arizona law authorizes a limited partnership to elect classification as a registered limited liability partnership. If a general partnership elects classification as a registered limited liability partnership, each partner is shielded from "vicarious" liability associated with the debts and obligations of the partnership, whether arising in contract, negligence or otherwise. The liability shield of a registered limited liability partnership does not, however, protect a partner from direct liability due to the partner's own actions, including wrongful acts, negligence or misconduct of the partner or the wrongful actions of others under a partner's direct supervision and control.

To elect classification as a registered limited liability partnership, the partnership must file an application with the Arizona Secretary of State. Further, the name of the partnership must reflect the status of the partnership as a registered limited liability partnership. The partnership must file an annual report to retain status as a registered limited partnership.

## **TRANSFERABILITY OF INTERESTS**

A general partner of a limited partnership may sell or assign his or her interest in the partnership to another person and make that person a general partner only as provided in writing in the partnership agreement or, if not provided in the partnership agreement, then only with the consent of all other partners. A limited partner may substitute a buyer or assignee of his or her partnership interest as a new limited partner, if done in accordance with the provisions of the partnership agreement or, if not provided in the partnership agreement, then upon the consent of all other partners. Compliance with state and federal securities laws may be required in connection with any such transfer of rights.

If a general partner or limited partner desires merely to sell or assign the partner's economic rights to receive partnership distributions without providing the buyer or assignee any management or voting rights as a partner, Arizona law permits the transfer of these economic rights, unless the transfer is prohibited by the partnership agreement. In many cases, the limited partners will desire to restrict the assignment of a general partner's economic rights in order to maintain the general partner's incentive to manage the partnership's business. Also, the general partners may desire to restrict a limited partner's assignment of economic rights until the limited partner has made all of his or her agreed-upon capital contributions.

## **CONTINUITY OF INTEREST**

A limited partnership is dissolved as specified in the certificate of limited partnership or the partnership agreement, upon consent of all partners or at the time of a general partner's withdrawal if there is no remaining general partner unless all limited partners or the lesser number specified in the partnership agreement agree to continue the business and to appoint one or more general partners within a specified time period. However, generally events affecting a limited partner will not cause the dissolution of a limited partnership unless the partnership agreement provides otherwise. Without other agreements, if a limited partnership is dissolved, the partnership's business must be wound up and liquidated.

## **TAX CONSIDERATIONS**

The income tax treatment of a limited partnership and its partners is generally the same under the U.S. and Arizona tax codes as the treatment of general partnerships. A limited partnership typically is not required to pay income tax on its net income, but simply reports each partner's share of partnership income or loss to be included in the partner's individual income tax return. Like a general partnership, a limited partnership may elect to be taxed as a corporation. In such case, the partnership and the partners are treated in the same manner as a corporation and corporate shareholders, respectively.

## RECORD KEEPING REQUIREMENTS

An Arizona limited partnership must file annual federal and state informational tax returns that reflect the partnership's income or loss for the year and each partner's share of the partnership's taxable income or loss. A limited partnership must maintain correct and complete financial records that may be inspected by any limited partner. No annual activity reports need to be filed with any state agency. In addition, a limited partnership must maintain certain other records available to the partners, including a current list of names and addresses of partners, a copy of the certificate of limited partnership and any partnership agreements, copies of tax returns and any financial statements for the three most recent years and, unless contained in a written partnership agreement, a writing setting out the contributions made and required to be made by each partner, rights of the partners to receive, or of the general partner to make, distributions to parties that include a return of contributions, and any events that will cause the dissolution of the limited partnership.

## CONCLUSION

The principal benefit of using a limited partnership is the protection against the personal liability of the limited partners. A limited partner's risk associated with the partnership is generally limited to the amount contributed or required to be contributed to the limited partnership. Other benefits arising from use of a limited partnership include the significant freedom of the partners to allocate the sharing of profits and losses and the single level of taxation resulting from the status of the partnership as a mere non-taxed conduit for tax purposes. The primary shortcoming of a limited partnership is that, in contrast to a corporation, one or more of the owners (the general partners) will be subject to unlimited personal liability for the obligations of the partnership unless the partnership elects classification as a registered limited liability partnership.

## Limited Liability Companies

LIMITED liability companies have become an established form of business organization in Arizona. The limited liability company is intended to give flexibility to businesses in meeting their tax and business objectives.

As a general rule, a limited liability company combines some of the best characteristics of partnerships and corporations while eliminating some of their less desirable characteristics. The owners, or members, of a limited liability company, like shareholders of a corporation, are not generally liable for the debts of the business. Yet, like a partnership, double taxation is avoided because the profits of a limited liability company are not subject to income tax liability imposed upon the company. Furthermore, unlike limited partners in a limited partnership, members of a limited liability company may actively participate in management without becoming subject to unlimited personal liability.

The members of a limited liability company enjoy significant freedom under Arizona law to fix their rights and obligations by agreement as to most matters.

### **ORGANIZATIONAL FORMALITIES**

One or more persons may form a limited liability company by signing and filing articles of organization with the Arizona Corporation Commission (ACC). The person or persons need not be members of the limited liability company at the time of or after formation. If the members conduct business prior to filing the articles of organization, they run a substantial risk of having the limited liability company treated as a general partnership with liability of all members for all obligations incurred prior to filing the articles.

The articles of organization must disclose basic information about the limited liability company for public inspection, including, among other items:

- the name of the limited liability company. It must include the words “limited liability company” or “limited company” or the abbreviation “L.L.C.” or “LLC” or “L.C.” or “LC” and must not include the words “association,” “corporation” or “incorporated” nor an abbreviation of these words;
- the name and address of an agent for service of legal process on the limited liability company. This agent may be an individual resident of Arizona, an Arizona limited liability company or corporation, or a foreign limited liability company or corporation authorized to do business in Arizona;
- the address of the limited liability company’s known place of business in Arizona;
  - one of the following statements (as applicable):
    - management of the limited liability company is vested in a manager or managers;
    - or
    - management of the limited liability company is reserved to the members;
  - the name and address of either of the following (as applicable):
    - if management is vested in a manager or managers, each person who is a manager of the limited liability company and each member who owns a 20 percent or greater interest in the capital or profits of the company;
    - if management is reserved to the members, each person who is a member of the limited liability company; and
  - the latest date, if any, on which the limited liability company must dissolve.

A limited liability company’s articles of organization are amended by filing articles of amendment with the ACC. Generally, a limited liability company must amend its articles of organization if there



is a statement in the articles that was false when it was made or if facts described in the articles have changed, making the articles inaccurate in any respect. For example, an amendment is required if the membership changes and management has been reserved to the members. If management has not been reserved to the members, an amendment is required after any change in managers or in the members holding a 20 percent or greater interest in the capital or profits interest of the limited liability company. A limited liability company may also file a restatement of its articles of organization, if necessary. Articles of organization, articles of amendment or restated articles must also be published in a newspaper of general circulation or the ACC must input the information regarding the approval into the database described by § 10-130.

The members in a limited liability company customarily enter into an operating agreement at the time the articles of organization are filed. The purpose of the operating agreement is to describe the members' financial responsibilities, management rights and profit and distribution shares. As with general partnerships and limited partnerships, if the members do not define their rights and obligations in an operating agreement, Arizona law will supply any missing rights or obligations in a manner that may or may not be consistent with the members' expectations.

The members' interests in a limited liability company may be securities under both U.S. and Arizona laws. Care must be taken to ensure that the issuance of members' interests complies with securities laws to the extent that the members' interests are securities.

### **CAPITALIZATION AND DEBT FINANCING**

As in general partnerships and limited partnerships, Arizona law permits the members of a limited liability company broad discretion to determine among themselves how cash, other property or services will be contributed to the limited liability company by each member at the time of formation or at any time thereafter.

A limited liability company is permitted under Arizona law to borrow money from its members or from third parties. The financial condition of a member is not normally taken into account by a lender, except to the extent that the lender is relying upon the member's initial or future capital contribution commitment as a source of repayment of the debt. Members will sometimes be asked by a lender to the limited liability company to sign promissory notes payable to the limited liability company in the amounts of their future contributions. The promissory notes are then assigned as collateral to the lender to secure the loan to the limited liability company.

A limited liability company may also raise additional capital by creating and issuing additional interests in the limited liability company to new members. Unless the operating agreement provides otherwise, the consent of all members is required to issue new interests in the limited liability company. Because the issuance of additional interests to new members almost always will dilute the profit shares of

the existing members, operating agreements that give the limited liability company the authority to issue additional interests usually impose conditions, such as requiring a supermajority vote for any new member or that any additional interests be offered first to the existing members.

### **MANAGEMENT AND CONTROL**

Arizona law permits the members of a limited liability company to divide management rights and responsibilities among the members or to grant management rights and responsibilities to “managers” designated or elected by the members. Unlike a limited partner in a limited partnership, a member does not become personally liable for limited liability company debts if the member participates in the control of the limited liability company’s business. In the absence of an operating agreement to the contrary, Arizona law permits members to vote on certain specific management matters, such as the approval of a plan of merger or consolidation or the issuance of a new interest in the limited liability company.

If the members delegate management responsibilities to managers, the members will not be involved in the day-to-day management of the limited liability company’s business. If a member becomes concerned that the managers may not have taken the necessary steps to enforce a claim of the limited liability company against a third party, each member has a special right to bring a legal action (called a “derivative action”) to obtain a judgment in the name of the limited liability company against the third party if the managers refuse to sue the third party. If the member is successful in obtaining a judgment or a settlement of the claim, the court may award the member reimbursement for expenses and legal fees. The remainder of the recovery will belong to the limited liability company.

### **PROFITS AND LOSSES**

The members in a limited liability company have significant freedom to divide limited liability company profits and losses and limited liability company distributions in any manner they choose. If the members do not allocate distributions in their operating agreement, Arizona law provides that distributions will be shared by the members in proportion to their actual contributions to the limited liability company and, after all contributions have been returned, distributions will be shared equally by the members.

The members’ freedom to allocate profits, losses and distributions by agreement is one of the important advantages of limited liability companies under Arizona law. Different profit and loss sharing arrangements are also available to general partnerships and limited partnerships.

### **EXTENT OF OWNERS’ LIABILITY**

Any member, manager, employee, officer or agent of a limited liability company is not liable solely by reason of being a member, manager, employee, officer or agent, for the debts of the limited liability

company. Members of a limited liability company are only liable to the extent of their actual or agreed-upon capital contributions. This is different from the liability of general partners in a general partnership or of the general partners in a limited partnership who have “joint and several” liability for partnership obligations. It is also different from the liability of limited partners in a limited partnership. Each limited partner’s liability for partnership debts is generally limited to the contribution that the limited partner has made or agreed to make to the partnership. However, if a limited partner participates in the control of the partnership’s business, the limited partner may also become liable for all partnership debts.

### **TRANSFERABILITY OF INTERESTS**

Generally, a member cannot sell or assign his or her interest in a limited liability company to another person and make that person a member without the consent of all other members, unless all the members have previously agreed in their operating agreement that such consent is not necessary. As noted above, compliance with state and federal securities laws may be required in connection with any such transfer of rights.

Generally, if a member desires merely to sell or assign the member’s economic rights to receive limited liability company distributions without giving the buyer or assignee any management or voting rights as a member, Arizona law permits the transfer of these economic rights unless the transfer is prohibited by the members’ operating agreement.

### **CONTINUITY OF EXISTENCE**

A limited liability company is dissolved as provided for in the operating agreement or by the written consent of a majority of the members and by one or more members entitled to receive, upon dissolution and liquidation, assets valued at more than one-half the total value of the limited liability company’s assets distributed to members. The withdrawal of the last remaining member may also result in dissolution, unless all assignees admit at least one new member within 90 days or the members previously agreed in their operating agreement. Without other agreements among the members, if a limited liability company is dissolved, the limited liability company’s business must be wound up and liquidated. The ACC may involuntarily dissolve a limited liability company if, among other reasons, the company fails to amend its articles as required by law or if the company has failed to make a required publication.

After dissolution and prior to filing articles of termination or judicial or administrative termination, the limited liability company maintains its separate existence. However, during this period, the limited liability company may only carry on the business necessary to wind up and liquidate its business and affairs, including collecting assets, disposing of property that will not be distributed to members, discharging liabilities or distributing remaining property to the members according to their interests.

## **TAX CONSIDERATIONS**

The income tax treatment of a multi-member limited liability company and its members is generally the same under U.S. and Arizona tax codes as the treatment of limited partnerships. A multi-member limited liability company is not required to pay income tax on its net income, but simply reports each member's share of limited liability company income or loss to be included in the member's individual income tax return. Unless it elects to be taxed as a corporation, a single-member limited liability company is disregarded as an entity separate from its owner under the U.S. Tax Code and for Arizona income tax purposes. Accordingly, a single-member limited liability company does not file a separate income tax return. Like a limited partnership, a limited liability company is required to pay a withholding tax on behalf of a foreign member characterized as a nonresident alien for federal income tax purposes.

Similar to limited partnerships, a limited liability company may elect to be taxed as a corporation. In such case, the limited liability company and its members are treated in the same manner as a corporation and corporate shareholders.

## **RECORD KEEPING REQUIREMENTS**

An Arizona multi-member limited liability company must file annual federal and state informational tax returns that reflect the limited liability company's income or loss for the year and each member's share of the limited liability company's taxable income or loss. The company must maintain copies of a current list of the names and addresses of its members, the original articles of organization and all written operating agreements and amendments. A limited liability company must also maintain correct and complete financial records, which may be inspected by any member. No annual activity reports need to be filed with any state agency.

## **CONCLUSION**

The principal benefit available with use of a limited liability company is the protection against the personal liability of the members. A member's risk associated with the limited liability company is generally limited to the amount contributed, or required to be contributed, to the limited liability company. Limited liability companies also afford members significant freedom to structure member and/or manager rights and obligations according to the parties' wishes through an operating agreement, including the allocation of economic rights such as the sharing of profits, losses and distributions, as well as management powers and responsibilities. Members also benefit from the single level of taxation resulting from the treatment of the limited liability company as a non-taxable partnership for income tax purposes.





# REAL PROPERTY

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**A** COMMON investment in Arizona is ownership and development of real estate. Business operations in Arizona are often accompanied by the purchase or lease of local real estate. Foreign persons who contemplate investment or business activities that involve real estate may find Arizona attractive from a legal standpoint. Arizona has no “alien land laws” that restrict the acquisition or lease of real estate by foreign persons. Foreign persons have the same rights and opportunities as U.S. citizens to acquire or lease Arizona real estate.

## Acquisition of Arizona Real Property

In acquiring Arizona real estate, an investor usually acquires either outright ownership of the property (“fee simple” ownership) or a leasehold interest.

### PURCHASES

#### Purchase Agreements

The purchase of fee simple ownership of Arizona real estate is best accomplished through a written purchase agreement. An oral agreement to purchase or sell Arizona real estate generally is not enforceable. Arizona laws leave wide latitude to the parties to structure their transactions. As a result, a written purchase agreement in Arizona is often lengthy and detailed.

A purchase agreement will cover basic matters such as the purchase price of the property, the identity of the property, the timing of the transaction and the allocation between the potential buyer

and seller of ongoing income and expense, such as rents or utilities. Most real estate purchases also require investigation of the property by the potential buyer, a process that can involve substantial expenditures of time and money. Therefore, most written purchase agreements provide for a period of time during which the buyer may investigate the property for defects or problems.

Such matters as title, the physical condition and state of repair of any improvements to the property, soil and subsurface conditions, zoning and land use regulations, environmental matters, the availability of financing, the availability of water and other utilities, the financial history of the property and the economic feasibility of the particular investment are of concern to the buyer. The buyer's satisfaction as to such matters may be made an explicit condition of the buyer's obligation to purchase the property. The importance of such investigations and of the prospective buyer making a thorough analysis of all aspects of the transaction are critical in most transactions, especially if the seller is unwilling to make meaningful representations and warranties with respect to the property. Without appropriate seller representations and warranties, the buyer may be left without legal recourse against a creditworthy party for problems discovered after the property is purchased.

In Arizona, it is customary for a purchase agreement to provide for an "escrow," an arrangement in which an independent third party (such as a title insurance company) holds documents and money until the parties are prepared to complete the transaction. When the transfer of title and payment of the purchase price finally take place (called the "closing"), the escrow agent disburses the purchase money deposited by the buyer to the seller and records the deed to the property in the public records, thereby completing the purchase.

Often, the prospective buyer will be required to place money into escrow when the purchase agreement is signed. This "earnest money deposit" provides initial consideration for the transaction and demonstrates the prospective buyer's financial commitment to the transaction and intent to proceed in good faith with the transaction. Typically, the earnest money deposit is fully refundable to the buyer during the feasibility period. After the feasibility period, the earnest money ordinarily becomes non-refundable to the buyer, subject to seller's performance and the satisfaction of certain other contingencies agreed upon by the buyer and seller.

### **Letters of Intent**

Early in the course of negotiating a real estate transaction, a prospective buyer and seller may wish to memorialize the basic transaction terms in order to have a common framework for further negotiations toward a binding purchase agreement. A letter of intent or letter of understanding may be used for this purpose. A prospective buyer or seller should take care that such a letter does not constitute a binding agreement. The letter should clearly state that it is not intended to be binding, but only a basic outline of terms and conditions that the parties will discuss and negotiate further and that the parties will have no liability to each other if they fail to enter into a final contract.



## **Title Insurance**

The condition of title to property is a key consideration for prospective buyers. A purchase agreement will often require the seller to provide the buyer with a status report on the condition of title to the property, a preliminary title report or commitment for title insurance (known as a “title report”) issued by a company in the business of investigating and insuring title to real property. The title report will describe the current ownership of the property; will list any matters that may affect title to the property such as delinquent property taxes and assessments, covenants, conditions, restrictions, easements, liens, and any other encumbrances; and will identify the requirements that must be satisfied before the title company will insure title.

Both the title report and the copies of the “title exceptions” must be reviewed carefully by the prospective buyer during the investigation period to confirm marketable title and that the title exceptions will not interfere with the proposed use or development of the property. Often, it is necessary to obtain a survey of the property so that the property boundaries can be determined; easements, improvements, and encroachments can be located; and other physical characteristics of the property examined. Generally, the seller is obligated to remove deeds of trust, mortgages, judgment liens and other similar financial encumbrances affecting the property. The purchase agreement may also obligate the seller to cause other title exceptions to be removed from title or cause the title company to issue certain title insurance endorsements insuring over such title exceptions. The prospective buyer’s obligation to purchase the property should be conditioned upon review of a title report and upon receipt of a written commitment by a title insurance company to issue a title insurance policy at closing, ensuring the title to be in satisfactory condition approved by the buyer.

At the closing, or very shortly thereafter, the title insurance policy will be issued by the title insurance company to the owner. There are two forms of title insurance policies available to owners in Arizona: standard coverage and extended coverage. A number of policy modifications, called endorsements, also are available. Legal counsel should be consulted to determine appropriate policies and endorsements for specific transactions.

The premium for a title insurance policy is determined by the title company that issues the title policy, subject to state-regulated schedules. In Arizona, it is common for the seller to pay the premium cost of a standard owner’s policy of title insurance. Payment of the additional premium for any “extended coverage” policy, which provides additional protections such as ensuring the accuracy of boundary line locations, is as negotiated between buyer and seller.

## **Deeds**

Ownership of Arizona real estate is conveyed by delivery of the deed to the buyer. To be valid, a deed must be in writing, must adequately describe the property, must be signed by the seller and must be acknowledged before a notary public. There are additional requirements that apply to deeds to

or from trustees or to or from two or more individuals who give or take title in some form of co-ownership that will be discussed in more detail below.

Depending on the form of deed used to convey the property, a deed may or may not contain warranties concerning the condition of title. The common forms of deed in Arizona are a “general warranty deed”, “special warranty deed” and “quitclaim deed”. In a “general warranty deed”, the seller warrants title to the property against the acts of all persons whomsoever, including those of the seller and any of its predecessors in title. In a “special warranty deed”, the seller warrants title solely against the acts of the seller. Finally, in a quitclaim deed, the seller makes no warranties whatsoever concerning the ownership of or title to the property. A quitclaim deed merely transfers to the buyer all right, title and interest, if any, that the seller holds to the property. A special warranty deed is used in most commercial (arms-length) real estate transactions in Arizona.

A deed to Arizona real estate should be recorded promptly with the county recorder of the county in which the property is located. Failure to record a deed promptly may permit third parties, such as innocent purchasers or lien holders, to acquire rights superior to the rights of the buyer.

Subject to a limited number of statutory exemptions, Arizona law requires the buyer and seller to complete and execute an “affidavit of property value” in connection with a conveyance of property. The affidavit, which includes a number of details concerning the real estate transaction, must be filed with the county recorder at the same time that the deed is recorded. All information disclosed on the affidavit of property value is a matter of public record.

There is a small recording fee for both deeds and affidavits of property value. However, Arizona does not impose a documentary stamp tax or real estate transfer tax on real estate transactions.

### **Methods of Holding Title**

In acquiring Arizona real estate, attention must be given to the manner in which title to the real estate will be held. Arizona real estate may be owned by any natural person or legal entity or by combinations of persons and legal entities.

### **Individual Ownership**

Any natural person, regardless of age, nationality, religion or race, may own any Arizona real estate interest. Individual ownership may not be the most advisable method by which to acquire property, particularly if the individual is a foreign person. For example, on the death of an individual who owns real estate within the state, Arizona law may require a state probate proceeding to confirm the passage of title to an heir or legatee. Substantial time and expense may be incurred by the heirs of a foreign person in Arizona probate court proceedings.

### **Corporate Ownership**

Any foreign or domestic corporation may hold title to Arizona real estate. A foreign corporation should determine whether or not the corporation must qualify to do business in Arizona prior to the acquisition. If a foreign corporation merely purchases, holds and later sells an interest in undeveloped Arizona real estate in an isolated transaction, this alone would not require the foreign corporation to qualify to do business in the state. However, if the corporation's ownership of an interest in Arizona real property will involve substantial and continuous business activities, such as leasing of property or sales of lots, the foreign corporation should consider qualifying to do business in Arizona.

### **Partnership Ownership**

Foreign or domestic partnerships may also own Arizona real estate. Foreign general partnerships are required to file a certificate of "fictitious name" with the county recorder of each Arizona county in which the partnership will conduct business. This document sets forth the names of the partners as a matter of public record. Every foreign limited partnership must file an "application for registration" as a foreign limited partnership with the Arizona Secretary of State.

### **Trust and Estate Ownership**

Any legally existing trust or estate, whether foreign or domestic, may hold title to Arizona real estate.

### **Multiple Ownership**

Any interest in Arizona real estate may be owned by more than one person or entity. There are four forms of multiple ownership in Arizona real estate: community property, community property with right of survivorship, tenancy in common and joint tenancy with right of survivorship.

Unless the deed conveying title specifies to the contrary, all interests in Arizona real estate acquired by a husband or wife during their marriage are presumed to constitute "community property" of the husband and wife, regardless of where they reside, although spouses may own property individually ("separate property") as well. In community property ownership each spouse owns an undivided one-half interest. Both spouses must sign a deed in order to convey any interest in their community property to another person or entity. Generally, when property is acquired by gift or inheritance or with the separate funds of a spouse, the acquired property is the separate property of the acquiring spouse and the signature of that spouse alone on the deed is sufficient to transfer the property.

Husband and wife may also acquire title to real property as "community property with right of survivorship." This form of ownership retains all the essential characteristics of community property ownership, in that each spouse owns an undivided one-half interest and both spouses must sign a deed in order to convey any interest in their community property to another person or entity. Community property with right of survivorship eliminates some of the potential disadvantages associated with other forms of ownership. Unlike community property, which requires a probate proceeding upon the death of either spouse, with community property with right of survivorship, the deceased spouse's interest is automatically transferred to the surviving spouse without probate,

regardless of any provision to the contrary in the deceased spouse's will. Community property with right of survivorship can also provide a tax advantage upon the death of the first spouse if the sale of the property will result in significant gain, because both the deceased and surviving spouses' interest in the property receive a step-up in basis.

Any combination of natural persons or entities may acquire title to real property as "tenants in common." When title to real property is acquired by tenants in common, each tenant in common has a separate and distinct, proportionate and undivided interest in the property, with a separate interest that is freely transferable. The proportionate interest in the property of the different tenants in common may be equal or unequal. Unless fractional interests are specifically fixed in the instrument of conveyance, each tenant is presumed to own an equal share. Each tenant in common is entitled to the full use and enjoyment of the property, subject to the equal rights of use of the other cotenants. Except in the cases of conveyances to executors or trustees, or to husbands and wives, any conveyance of an interest in Arizona real estate to two or more persons or entities that fails to specify the form of ownership is presumed to create a tenancy in common.

Any combination of natural persons may acquire title to Arizona real estate as "joint tenants with right of survivorship." A joint tenancy with right of survivorship differs from a tenancy in common in one significant aspect. In the event of the death of an individual joint tenant, the deceased co-owner interest goes automatically to the survivor, joint tenant or, if more than one, is divided equally among the surviving joint tenants, without probate, regardless of any provision to the contrary in the deceased owner's will. In contrast, the interest of a co-owner under a tenancy in common can be transferred by a tenant in common while alive to any other person. On an individual tenant in common's death, the interest passes by will, if there is one, to the deceased's legatees. If there are none, it passes by intestate succession to the deceased's heirs.

### **Disclosure of Acquisition**

Although foreign persons have the same rights and opportunities as U.S. citizens or permanent residents to acquire Arizona real estate, U.S. law requires that certain investments in real estate by foreign persons be disclosed to the federal government. Generally, all information disclosed is confidential and access to the disclosed information is limited to officials and employees of governmental agencies. However, certain disclosure information required in connection with the ownership of agricultural land is available to the public.

## **LEASES**

### **In General**

A foreign investor may prefer to lease, rather than own, real estate. A lease of real estate is the exclusive right to possess and use real estate for a specified period of time in consideration for the payment of money as rent. The property owner under a lease is the "landlord" or "lessor." The party

acquiring the “leasehold” interest in the property is the “tenant” or “lessee.” The time period when the lease is in effect is the “term.” Although the lessor transfers the use and possession of the leased property to the lessee for the term of the lease, the lessor retains ownership of the property. Upon expiration of the term of the lease, the right to use and possess the property reverts to the lessor. Leases with a term over one year must be in writing to be enforceable.

A lease allocates the economic risks and expenses of property ownership, possession and operation between the lessor and lessee. For example, a lease generally specifies which of the parties will be responsible for the payment of taxes, assessments, utility charges, building maintenance and other costs; what type of insurance coverage each party must maintain; which of the parties is to bear the risk of loss if buildings, structures, improvements or personal property on the leased property are damaged or destroyed; and which of the parties is responsible for maintaining and repairing the property.

Various factors, including the proposed use of a particular property, determine the appropriate contents of a specific lease. Most leases of nonresidential property fall within one of the following categories: “ground leases,” “agricultural leases” or “commercial leases.”

### **Ground Leases**

A ground lease is often made by a landowner who wants to retain ownership of real property but to avoid an active role in its development. A ground lease entitles the lessee to use, develop and operate the leased property without actually owning the property. In turn, a ground lease generally obligates the lessee to assume most of the burdens and responsibilities associated with ownership of the property, including maintenance of the property and payment of real estate taxes. Most ground leases have a term of from 50 to 99 years.

### **Agricultural Leases**

A lease of agricultural land involves unique issues. A lessor under an agricultural lease may wish to impose restrictions against the use of pesticides, fertilizers or of other chemicals potentially hazardous to the environment. A lessor may also seek to limit the types of crops that may be grown on the property to qualify for governmental crop subsidies or to maintain an adequate soil nutrient level. A lessor may wish to reserve the right to terminate the agricultural lease if the opportunity to commercially develop the land arises. An agricultural lease should address which party is responsible for ensuring an adequate water supply is provided and maintained for the property and should address the respective parties’ responsibilities for growing and harvesting crops and entitlement to any profits from the sale of the crops. Investors acquiring large tracts of land for future development will often enter into agricultural leases with farm operators to preserve the “agricultural” status of the land for real estate tax purposes.

## **Commercial Leases**

The terms of commercial leases vary significantly, depending upon the type of property and improvements. A lessor under a shopping center lease often collects both a base rent and an additional rent equal to a percentage of the lessee's sales (percentage rent). A lessor under an office or industrial commercial lease generally does not collect percentage rent, but may be particularly concerned with other economic considerations. For example, if the lessor is paying for the utility costs, the lessor may seek to place specific limitations upon the types and quantities of electrical equipment that the lessee may operate on the property.

In many cases the lessor may contribute funds to modify, or may actually modify, the leased space in preparation for the tenant's occupation. The most extreme example of this type of lease is the "build to suit" lease in which an entire building is constructed by the lessor to lessee specifications and delivered to the lessee when completed. The cost of the construction usually is amortized over the term of the lease, including a return on investment for the lessor-developer. This arrangement can be particularly useful to a foreign business that requires a unique or unusual facility.

## **OTHER SIGNIFICANT OWNERSHIP INTERESTS**

Occasionally, investors may acquire real estate interests other than fee simple ownership or a leasehold. Many other types of real estate interests exist. The three most common are "easements," "mineral interests" and "water rights."

### **Easements**

An easement is an interest in real estate that grants to one person the right to use another person's land for a particular purpose. Typically, the right is non-exclusive. As examples, an easement may be given to a telephone company or power company to permit it to place its lines above or under property owned by another party or an easement may be provided to give a right of access over the property of an adjoining landowner. Easements should be in writing and should be recorded in the county recorder's office of the county in which the property is located to provide notice of the easement to third parties. An easement typically "runs with the land," meaning that the easement continues to encumber the property "burdened" by the easement, even if the property is conveyed to another owner.

### **Mineral Interests**

Mineral interests may be purchased or leased apart from surface rights to real estate. Both the federal and the state governments often "reserve" the mineral rights to many parcels of real estate. These mineral rights may be separately acquired or leased from the U.S. government or from the State of Arizona. Mineral rights reserved by the U.S. government may be acquired through filing mining claims or through purchase applications filed with the U.S. Bureau of Land Management. Mineral rights reserved by the State of Arizona may be acquired by mining claims, exploration permits and

leases issued by the Arizona Department of Mines and Mineral Resources. Mineral rights owned by private parties may be purchased or leased in the same manner as other interests in real estate.

### **Water Rights**

Water rights present special considerations. In some cases, water rights are attached to land (“appurtenant”) and cannot be transferred except in connection with a transfer of the land. In other cases, water rights are personal property rights not connected with any particular land and can be transferred independently. Water rights in Arizona are the subject of complex statutory regulation, explained further in the chapter “Water Rights.”

### **State Land**

Privately owned Arizona real estate presents many attractive investment opportunities. In addition, a significant amount of the land in Arizona, including land in prime urban areas, is owned by the State of Arizona and is available for purchase or lease. Fee simple ownership of land may be acquired from the state by purchase or by an exchange of private land for the state land. Special conditions govern the acquisition of state land, whether by direct purchase or by exchange. For instance, state land cannot be sold or exchanged for less than its appraised value and state land, in most cases, must be sold to the highest bidder at an advertised public auction.

Land owned by the State of Arizona may be leased for agricultural, grazing or commercial purposes. The term of an agricultural or grazing lease is limited to not more than 10 years without a public auction, but a lessee of state land has a preferred right to renew an existing agricultural or grazing lease for up to an additional 10 years. A commercial lease of state land may be for up to 99 years, but a commercial lease for a term of over 10 years is subject to competitive bidding at public auction. An application to acquire or lease state land must be made on forms provided by the Arizona State Land Department. An application fee is required and public notice requirements must be satisfied.

## **THE ROLE OF PROFESSIONALS AND CONSULTANTS**

Real estate brokers match a buyer with a seller of real property. Normally, brokers are employed by the seller to locate an interested buyer, but it is not uncommon for a foreign investor to retain a broker for assistance in locating suitable real estate for purchase. The broker or salesperson, in some cases, may be asked only to identify likely prospects for sale or lease. In other cases, the broker or salesperson may be authorized to negotiate purchase and sale contracts and leases. In still others, the broker or salesperson may be empowered to sign documents on behalf of an owner.

A broker usually receives a commission for services. In a sale, the commission is usually paid by the seller upon the closing of the sale, based on a percentage of the purchase price. In a lease, the commission is commonly paid by the lessor at the time of execution of the lease or at the time the tenant occupies the leased space. The amount of a lease commission is determined by various

formulas. A common formula is a percentage of the rent to be paid over a period of years. Another is a specified amount multiplied by the amount of space leased to the tenant.

A written brokerage agreement is usually signed by the party engaging the broker and by the broker. Brokerage agreements can be exclusive, giving a single broker the exclusive right to deal on behalf of an owner. Brokerage agreements can provide that brokers are entitled to a commission only if the transaction is consummated. Unless the agreement expressly says otherwise, a broker will be entitled to a commission on a sale if the broker has procured a ready, willing and able buyer, even if the sale fails to close. In most cases, brokerage agreements must be in writing to be enforceable. Brokerage agreements generally specify the responsibilities of the broker, the amount of the commission to which a broker will be entitled, the conditions that must be satisfied for a broker to earn the commission, the time when the commission will be paid and the duration or term of the brokerage agreement.

Subject to very limited exceptions, it is unlawful to engage in real estate brokerage activities without a license. It is also unlawful to compensate an unlicensed person for brokerage services. If a party to a real estate transaction, or the party's agent, is a licensed broker or salesperson, this must be disclosed to the other party.



# CONVENTIONAL FINANCING

DAVE SPRENTALL

**C**onventional financing is financing provided by banks, commercial finance companies, savings and loan associations, insurance companies, pension funds and other non-governmental lenders. Conventional financing is typically either commercial financing or real estate financing. The proceeds from commercial financing are customarily used to provide working capital for business, inventory or equity financing or to finance a transaction such as the acquisition of a business. The proceeds from real estate financing are commonly used to finance acquisition of real estate or to provide funds for improvements to real estate. This chapter examines general concepts, the documentation of financing and loan transactions and the securing of loans by encumbrances, security interests and guaranties. Financing of real property transactions is also briefly considered in the “Real Property” section. A special kind of financing is treated in the section “Tax-Exempt Financing.”

## In General

### PARTIES

The principal parties to a loan transaction are the lender and the borrower. There may be more than one of each. In a commercial loan, the lender is typically a bank or commercial finance company. In a real estate construction loan, it is a bank or a savings and loan association. In other real estate loans, such as acquisition loans or permanent loans issued following completion of construction,

the lender is usually a bank, a savings and loan association, an insurance company or a pension fund.

A lender may require assurances of repayment as security for the borrower's obligations under the loan, such as a mortgage or deed of trust. The owner of the property given as security may be someone other than the borrower, in which case the owner of the property will also become a party to the transaction as the pledgor. A lender may also require a guarantor who will agree to repay the loan in the event the borrower defaults on its obligations.

### **DURATION OF LOAN**

A loan is either a "term" loan or a "demand" loan. A term loan is a loan for a specified period. The borrower under a term loan may be required to make periodic payments of loan principal and interest throughout the term or may be permitted to make a single payment of the entire loan balance at the end of the term. The borrower of a demand loan is required to repay the loan within a short period following the lender's demand for repayment, which may be made at any time.

Most loans by conventional lenders are term loans. Most commercial loans and real estate construction loans have terms of between one and five years. Other real estate loans, such as "permanent financing," have terms of up to 30 years.

### **INTEREST**

Conventional loans, like other loans, require payment of interest by the borrower. The two most common methods for charging interest are the "flat rate" and the "variable rate." Under a flat rate, the borrower pays the same rate of interest on the unpaid principal throughout the term. Under a variable rate, the rate of interest is determined at various intervals throughout the term by reference to an objective rate standard, such as the London Interbank Offered Rate or other "cost of funds" index, or to the "base" or "prime" rate of interest charged by the lender or by a designated institution. As the objective rate standard changes, the interest rate on a variable rate loan changes. Thus, an interest rate equal to the "prime rate of interest charged by the lender plus one percent" results in a periodically adjusted rising or falling interest rate that always exceeds by one percentage point the prime rate of interest charged by the lender.

Additionally, Arizona does not have a general usury statute, unlike many other states. Thus, in most circumstances, the interest rate can be any rate the parties agree to in writing. There are certain varieties of loans that do have set interest rate maximums.

### **BASIC LOAN DOCUMENTATION**

Most loans are evidenced by a promissory note, which may be supplemented by a credit agreement and other documents between the borrower and lender.

## **Promissory Note**

A promissory note sets forth the promise or obligation of the borrower to repay the principal amount of the loan plus interest, with provisions concerning the rate and computation of interest. The promissory note also sets forth the dates when payments of principal and interest come due.

The promissory note and any credit agreement will also state “events of default.” On the occurrence of an event of default, the lender typically has the right to demand immediate payment of the entire balance of the loan prior to the due date. The lender may have the right to sell in foreclosure any property securing the loan and may require any guarantor to make payment. Common events of default are failure to make a payment of interest or principal when due, failure to perform some other promise of the borrower and discovery of a misrepresentation made by the borrower in obtaining the loan.

## **Credit Agreement**

A credit agreement provides the basic terms of the loan and typically includes representations and warranties by the borrower that are relied upon by the lender, such as warranties of the accuracy of the borrower’s financial condition as set forth in financial statements delivered to the lender. The borrower, if not an individual, will be required to represent that it is duly organized and existing under applicable law and that the borrowing has been duly authorized pursuant to its formation documents.

A credit agreement also customarily includes various covenants, which are requirements with which the borrower must comply until the loan is paid in full. An example is a covenant that the borrower will provide financial information at periodic intervals. A credit agreement may contain both affirmative and negative covenants. Negative covenants restrict a borrower’s activities; for example, they may provide that the borrower will not engage in any other financing transactions until the loan is paid in full, that the borrower’s net worth will not fall below a stated amount or that the borrower’s ratio of debt to equity will not exceed given limits.

A credit agreement commonly specifies events of default, any one of which will authorize the lender to demand payment of the loan, foreclose against security or take other enforcement action. A credit agreement will usually include specific procedures and conditions for any installment funding or future advances.

## **LOAN SECURITY**

A lender may require security for repayment of the loan. Security may be real property, personal property or both. Documentation used to evidence real property security differs from the documentation used when personal property is security. Also, the laws governing the two types of security differ.

### **Real Property Security**

Raw land, buildings, improvements to land and the right to collect rent under leases may serve as security for a loan. The real property may be owned by the borrower or by another person or entity that pledges its interest in the property. Under Arizona's community property law, for a valid encumbrance upon community real property, both the husband and wife must sign the encumbrance document.

Mortgages and deeds of trust are used to encumber real property to secure loans. Under either a mortgage or a deed of trust, the owner of the property has the right to possess and use the property while the loan is not in default. Included in any mortgage or deed of trust are representations and warranties by the property owner, such as warranties of ownership and of authority, to encumber the property as security. Covenants are also commonly included, such as that the property will be maintained in good repair, that all applicable insurance will be kept in force, that real estate taxes will be paid when due and that the property will not be sold or further encumbered.

Arizona law allows both mortgages and deeds of trust to encumber fixtures by incorporating or adding a "financing statement" that is filed and recorded. Fixtures are improvements attached to the real estate described in the mortgage or deed of trust.

The mortgage or deed of trust will identify events of default in addition to the events of default specified in the promissory note or credit agreement. The mortgage or deed of trust will describe the actions the lender may take after default, including the right to take possession of the real property, to take action to protect or realize upon the security and to sell the real property through foreclosure or forfeiture proceedings.

The principal difference between a mortgage and a deed of trust is the remedy available to the lender. Under a mortgage, in the event of a default, the lender may accelerate the entire unpaid balance of the loan and may foreclose the mortgage. Foreclosure of a mortgage requires bringing suit for the unpaid amount of the loan and foreclosing against the security. Once judgment is obtained, the lender must request the court to direct the sheriff to sell the real property and use the sale proceeds to pay the loan. This process may take several months, even longer if the borrower contests foreclosure. If the property is sold at a foreclosure sale, the borrower can redeem the property within six months after sale or within one month after sale if the property has been abandoned and is not farmland. Redemption is made by paying the sheriff the price paid by the purchaser at the foreclosure sale, plus the amount of taxes and assessments paid by the purchaser, plus a redemption charge of 8 percent of the sale price.

Under a defaulted deed of trust, the lender has the option to foreclose by suit, as under a mortgage or to hold a trustee's sale. A trustee's sale is a private sale without suit. The sale is held by a trustee named in the deed of trust, often a title company. The sale may be held on a day noticed, which must be at least 90 days after the trustee gives notice of the sale. A trustee's sale thus can be held more

quickly than a mortgage foreclosure sale. After a trustee's sale, the borrower has no right to redeem the property. The borrower can reinstate the loan and prevent the trustee's sale at any time prior to the sale by paying the lender only the amount in default (not the entire unpaid balance) together with statutory costs.

The lender may purchase the real property at a foreclosure sale or at a trustee's sale and may credit the unpaid amount of the loan as part of the total payment. Arizona law limits the amount of the "deficiency" that may be collected from the borrower or any guarantor after either a mortgage foreclosure or a trustee's sale under a deed of trust. The recoverable deficiency is the amount, if any, by which the debt exceeds the higher of the sale price at either the foreclosure sale or the trustee's sale or the fair market value of the property on the date of the sale. The lender has 90 days after a trustee's sale to commence a deficiency action. However, if the security for the loan is real property of 2 1/2 acres or less and used as a single one-or two-family residence, in most cases the lender is not entitled to collect any deficiency after either a mortgage foreclosure sale or a deed of trust trustee's sale.

Arizona limits who may be a trustee of a deed of trust. A trustee of a deed of trust must be a person or entity that is specifically listed in the statute as eligible to hold the position. Banks, real estate brokers, title companies and attorneys are examples of qualified trustees.

### **Personal Property Security**

Besides real property, personal property can also secure a loan. Personal property often furnished as security includes notes, accounts receivable, deposit accounts, securities, equipment, inventory and contract rights. The property may be owned by the borrower or by another person or entity that pledges a security interest to the lender. Arizona has adopted revised Article 9 of the Uniform Commercial Code, which governs most instances where a person or entity pledges personal property collateral as security, with the exception of cars, boats, aircraft and certain other collateral that may be governed by a different regulatory scheme. In the case of equipment, inventory or accounts receivable, the lender generally allows the party furnishing the property to possess and use the property as long as the loan is not in default. If the personal property is "documentary" personal property such as promissory notes, stocks or bonds, the lender usually must take actual possession of the property and hold it in pledge until the loan is repaid. If the collateral is a deposit account, the lender will usually need to obtain control over the account by having the bank holding the account acknowledge that it will follow the lender's instructions with respect to the account. The Uniform Commercial Code sets forth mandatory but flexible foreclosure procedures to ensure that adequate notice is given and that the foreclosure sale is conducted in a "commercially reasonable" manner.

The person or entity pledging the property generally enters into a security agreement granting the lender rights in the collateral in order for the lender to hold an effective security interest. Personal

property security agreements generally contain provisions that are similar to those found in a deed of trust or mortgage, such as representations, that the pledgor owns the personal property and is authorized to provide it as security, a covenant to maintain the property in good condition and, if the personal property consists of contract rights, a covenant not to amend, modify or terminate the contract rights without the approval of the lender. In all cases, the security agreement will contain promises not to sell the personal property or to grant other security interests in the personal property without the lender's approval.

The security agreement will also state events of default and the actions the lender may take if an event of default occurs, including the right to sell the personal property security and to use the proceeds of the sale to pay the loan.

### **RECORDING AND FILING**

Mortgages, deeds of trust, security agreements and pledge agreements are between a lender and the person furnishing the security. They give the lender rights in the property that are enforceable against the party owning the security. To protect its rights in the security against claims by third parties, including other lenders, judgment creditors and bankruptcy trustees, the lender must take additional action. In the case of real property, the lender must record the mortgage or deed of trust with the county recorder of the Arizona county in which the real property is located. Recording is the filing of the document with the recorder, where it becomes public record and notice to the world, as a matter of law, of the existence of the mortgage or deed of trust.

Generally, in the case of personal property, the lender must file a "UCC-1 financing statement" with the appropriate filing office of the state where the debtor is located. The Uniform Commercial Code provides tests for determining the debtor's location, which, in the case of an entity formed pursuant to the laws of a state (such as a corporation or limited liability company), would be the state of the entity's formation.

Arizona has very strict margin and typeset requirements for recording documents. If the document does not comply with the requirements, it will not be recorded. As mentioned, as to certain documentary personal property, the lender must actually take possession of the property in pledge in order to protect a lender against claims by third parties against the security.

### **LOAN GUARANTIES**

A guaranty is an agreement made by a person, other than the borrower, that the loan will be paid or that other actions, to be performed by the borrower, will be performed. Guaranties are taken when the borrower's credit or security is considered weak or inadequate. For example, in a loan to a small or closely held corporation, the lender will often require guaranties from the shareholders of the

corporation. A guaranty may be unlimited, or it may be limited to a specific amount or percentage, or to a single or limited number of transactions, or to obligations incurred within a given period of time.

The obligation of the guarantor comes due upon the borrower's default. If the guaranty so provides, the lender may proceed independently against the guarantor, without first attempting to collect from the borrower or to recover against other security. In Arizona, a married individual executing a guaranty cannot bind the community property of the marital estate without the other spouse's joinder in the guaranty.





# TAX-EXEMPT FINANCING

BY JULIE QUIGLEY

**F**INANCING for private projects may be available through the issuance and sale of tax-exempt bonds by certain governmental units. The principal benefit is lower-cost financing. Because most purchasers of tax-exempt bonds do not pay federal or state income taxes on the interest received, interest rates on such bonds are typically below the rates generally prevailing in the marketplace. The benefit is passed on to private borrowers in the form of lower interest loans by the governmental unit. Although borrowers in tax-exempt financing transactions may have higher origination costs than with conventional financing, lower interest costs throughout the term of the loan usually produce substantial overall savings.

Tax-exempt financing for private projects in Arizona takes one of two forms: financing provided by the sale of private activity bonds and financing provided by the sale of community facilities district bonds or public improvement district bonds.

## Private Activity Bonds

### IN GENERAL

The sale of private activity bonds (PABs), once referred to as “industrial development bonds,” is designed to provide both for-profit and not-for-profit entities with an attractive means of borrowing money at low cost for investment in Arizona projects. In Arizona, all counties, all major cities and many smaller cities and towns have established industrial development authorities with the ability

to issue PABs on behalf of private borrowers. Sales of PABs are governed by both federal and state laws.

### **QUALIFYING PROJECTS**

For business purposes in Arizona, PABs are generally used to provide financing for three types of projects: the acquisition or construction of “manufacturing facilities,” the acquisition or construction of “qualified residential rental projects” and the acquisition or construction of “facilities for not-for-profit corporations.”

### **MANUFACTURING FACILITIES**

A manufacturing facility can be acquired or constructed with financing provided through the sale of PABs. A manufacturing facility is any facility used in the manufacture or production of tangible personal property. Limited on-site office space and warehousing space can be included in a manufacturing facility if it is functionally related and subordinate to day-to-day manufacturing operations.

Several restrictions under federal law affect the amount that can be used to finance the acquisition or construction of specific manufacturing facilities. Interest on tax-exempt bonds issued to finance a manufacturing facility will become taxable if the aggregate amount of the borrower’s capital expenditures (including the expenditures made with bonds proceeds, in the local jurisdiction in which the facility is located during the period beginning three years before the issuance of the bonds and ending three years after the issuance of the bonds) exceeds \$20 million. A borrower cannot be the recipient of PABs financing for a manufacturing facility if the aggregate of the financing proceeds, plus other outstanding PABs financings of the borrower for acquisition or construction of facilities elsewhere in the United States, exceeds \$40 million.

### **QUALIFIED RESIDENTIAL RENTAL PROJECTS**

A “qualified residential rental project” can be acquired or constructed with proceeds from the sale of PABs. A qualified residential rental project is a building or buildings with self-contained residential units that are offered for rent to the general non-transient public. Federal law conditions the receipt of PABs financing for the acquisition or construction of qualified residential rental projects on the agreement by the borrower to reserve a percentage of the rental units for rental to individuals or families whose income is less than a set percentage of the median gross income in the jurisdiction.

### **FACILITIES FOR NOT-FOR-PROFIT CORPORATIONS**

A corporation or partnership that has been determined to be a not-for-profit entity for federal tax purposes, pursuant to Section 501(c)(3) of the Internal Revenue Code, may finance the construction or acquisition of a headquarters building, health care facilities (hospitals, nursing homes and related

equipment) or other facilities designed to achieve its charitable purposes. In general, such financings are not subject to the same restrictions and volume limitations as other PABs.

### **PROCEDURE**

An application for PABs financing must be prepared and submitted to the Industrial Development Authority (IDA) with jurisdiction over the area in which the financed project is or will be located. The IDA will consider the application and may, in its discretion, either grant or decline to grant preliminary approval. This approval is important because project costs and commitments paid or incurred prior to preliminary approval generally may not be reimbursed or paid from the proceeds of PABs financing. Therefore, prospective borrowers may want to avoid significant financial undertakings with respect to any project until preliminary approval is secured.

Once preliminary approval is obtained, a for-profit applicant must apply to the Arizona Department of Commerce for an allocation of the state's volume limit on PABs financing. Because the state's volume limit is generally allocated on a first-come, first-served basis within the relevant project areas, it is advisable to file applications for allocations on January 1 or as early as possible in the year to improve the chances of securing an allocation.

Following agreement for the sale of the PABs and the terms of the related financing, and prior to their sale, an application must be made to the IDA for final approval. The final approval is generally preceded by a public hearing, notice of which must be published in a local newspaper. The hearing gives local residents an opportunity to express their opinions. If final IDA approval is obtained, the matter is then presented for ratification by the governing body that organized the IDA, either the board of supervisors of the county or the mayor and council of the city or town. If approved, the financing is thereafter closed.

Once the financing is closed, the issuer of the PABs is responsible for filing Form 8038 with the Internal Revenue Service. The bondholder is then eligible to exclude from gross income the interest on any qualified state or local bond when filing federal and state income tax returns.

### **COMMUNITY FACILITIES AND PUBLIC IMPROVEMENT DISTRICT BONDS**

Arizona law authorizes the owners of real property in an area to petition the city for the organization of a "community facilities district." Similarly, the owners of real property in incorporated or unincorporated areas can petition the city or county, as applicable, for the formation of a "public improvement district." Either type of district is permitted to issue tax-exempt bonds to finance a variety of public improvements intended to benefit the district and ultimately to be owned by the district. Projects for construction of streets and sewers are typical. These districts are also often

used in Arizona to finance a portion of the costs of large residential or commercial development projects, such as master-planned communities and industrial parks.

# IMMIGRATION

REBECCA A. WINTERSCHIEDT

**F**OREIGN persons conducting business operations in Arizona may seek an extended stay in the state for themselves or for other foreign persons they seek to employ in Arizona. Admission of foreign persons into the United States is governed exclusively by the U.S. immigration laws. Individual states, such as Arizona, have no immigration authority to grant visas.

Generally, a foreign person can be admitted into the United States under one of two broad categories—immigrant or nonimmigrant. Immigrant status is an appropriate goal for persons seeking to live permanently in the United States. Individuals with immigrant status can pursue virtually any investment or business objective. Obtaining permanent residency status as an immigrant is commonly referred to as obtaining a “green card.”

The number of foreign persons who can obtain immigrant status in any year is limited and there are preferences that favor relatives of U.S. citizens or individuals who possess unique skills that are difficult to find among U.S. workers. It is also possible to apply for immigrant status through the EB-5 program that currently requires an investment of \$1 Million (or \$500,000 in a high unemployment area) in a new commercial enterprise or troubled business. An EB-5 investor must be able to demonstrate the investment created 10 new jobs.

The majority of foreign persons who enter the United States do so through nonimmigrant visas. A nonimmigrant visa allows a foreign person to reside temporarily in the United States for a given period of time and, depending upon the particular visa classification, to engage in specific permitted activities.

## **Type B-1 (Business Visitor) Visa**

The B-1 “Business Visitor” visa is designed for foreign persons whose presence in the United States will be limited to a few months to conduct business. Activities associated with business include international trade or commerce. The foreign person, however, may not conduct work for hire, accrue most profits in the United States, perform services that are part of the United States labor market or actively manage an investment or business while in the United States. The normal rules for B-1 activities have been revised for Mexican and Canadian businesspersons under terms of the North American Free Trade Agreement (NAFTA). Under NAFTA, Mexican and Canadian businesspersons have more liberal terms of entry with regard to some B-1 activities than do nationals of other countries.

### **REQUIREMENTS FOR A B-1 VISA**

Among the general requirements for the issuance and maintenance of a B-1 visa are:

- the foreign person must intend to depart the United States at the expiration of the term of the visa;
- the foreign person must possess sufficient financial resources to travel to and depart from the United States; and
- the foreign person must maintain a foreign residence throughout the person’s stay in the United States.

### **PROCEDURE FOR OBTAINING A B-1 VISA**

#### **In General**

An application for a B-1 visa is made at a U.S. consulate abroad. An applicant is not required to file any paperwork with the U.S. Citizenship and Immigration Services (CIS), the agency that administers the immigration laws.

### **UNITED STATES VISA WAIVER PROGRAM**

The United States Visa Waiver Program (VWP) is an expedited method for nationals of certain countries to visit the United States for up to 90 days to engage in activities permitted under a B-1 visa. If a foreign national is from a country that is on the approved visa waiver list, the foreign national can apply for the visa waiver online and avoid having to apply for a B-1 visitation visa.

## **Type E (Treaty Trader/Investor) Visa**

The E “Treaty Trader” or “Treaty Investor” visa category is intended for foreign persons seeking entry into the United States to oversee or work in an enterprise engaged in substantial trade with the United States or to engage in activities relating to a substantial investment in the United States. Separate requirements govern the issuance of E-1 and E-2 visas.

## **BASIC REQUIREMENTS FOR AN E-1 (TREATY TRADER) VISA**

The following basic requirements must be satisfied to obtain an E-1 visa:

- a treaty containing treaty-trader provisions must exist between the United States and the country in which the foreign person has citizenship; a current list of countries with which the United States has outstanding treaties with such provisions can be found in the Visa Bulletin of the U.S. Department of State, Bureau of Consular Affairs;
- at least 50 percent of the sponsoring U.S. company must be owned by nationals of the treaty country;
- the E-1 applicant must have the same nationality as the treaty company;
- the foreign person or the person's employer must be engaged in ongoing "trade," which, for this purpose, is the exchange, purchase or sale of goods, services or technology;
- the trade engaged in by the foreign person or the person's employer must be "substantial." At present, no minimum dollar amount is used in determining whether a specific amount of trade is substantial. Instead, the evaluation is made on the basis of such factors as the quantity of transactions and the volume, nature and duration of the trade;
- the trade must be "principally" between the United States and the treaty country; and
- the employee or principal must serve the company in a specified capacity: either managerial or involving "essential skills."

## **BASIC REQUIREMENTS FOR AN E-2 (TREATY INVESTOR) VISA**

The following basic requirements must be satisfied to obtain an E-2 visa:

- a treaty containing treaty-investor provisions must exist between the United States and the country in which the foreign person has citizenship and at least 50 percent of the sponsoring U.S. employer must be owned by nationals of the treaty country;
- the E-2 applicant must have the same nationality as the treaty company;
- the foreign person or the person's employer must be engaged in an "active" investment in the United States;
- the investment of the foreign person or the person's employer must be "substantial;" an investment is substantial if the investor personally has at-risk sufficient funds to establish or develop the enterprise;
- the business invested in by the foreign person or the person's employer must either employ U.S. workers or be capable of creating job opportunities for U.S. workers; and
- the foreign person must fulfill an essential role in the enterprise.

## **PROCEDURE FOR OBTAINING AN E VISA**

An application for an E visa is usually made at a U.S. consulate abroad. It is also possible to apply for an E visa through CIS when the person is already in this country in some other nonimmigrant category.

### **Type H-1 B (Distinguished Merit and Ability) Visa**

The H-1 B “Distinguished Merit and Ability” visa is used by companies to temporarily employ foreign persons who qualify as persons in “specialty occupations.” An H-1 B visa is usually granted for periods of up to three years. When need is demonstrated, an extension of up to an additional three years, for a total maximum stay of six years, is possible. Note that there are a limited number of H-1B visas each fiscal year and recently the government has conducted a lottery for these visas.

#### **BASIC REQUIREMENTS FOR AN H-1 B VISA**

The following two basic requirements must be satisfied to obtain an H-1 B visa:

- the foreign person must be engaged in a “specialty occupation.” Specialty occupations are defined as those requiring theoretical and practical application of a body of highly specialized knowledge or attainment of a bachelor’s or higher degree in a specific field; and
- the position to be filled in the United States must be of sufficient complexity that it requires a person with specialized knowledge.

#### **PROCEDURE FOR OBTAINING AN H-1 B VISA**

An employer seeking to employ a foreign person in a specialty occupation in Arizona must file form I-129 and its H supplement. The form must be accompanied by documentation demonstrating the applicant’s qualifications for the H-1 B visa and proof of filing a Labor Condition Attestation.

### **Type L-1 (Intra-Company Transferee) Visa**

The L-1 “Intra-Company Transferee” visa enables companies with operations abroad to transfer corporate executives and managers, or persons with specialized knowledge, temporarily to the United States to assist in local operations. The L-1 visa has no annual quota, and the beneficiary may remain in the United States for a period of five to seven years.

#### **REQUIREMENTS FOR AN L-1 VISA**

The following requirements must be satisfied to obtain an L-1 visa:



- foreign person to be transferred to the United States must have been employed abroad in an executive or managerial capacity or in a capacity involving “specialized knowledge” on a full-time basis for at least one of the last three years preceding the visa application; specialized knowledge refers to particular knowledge of the employer’s product, service and equipment and to their application in international markets;
- the U.S. company that will employ the recipient of the L-1 visa must be the same company for whom the employee has worked abroad, or is a parent, subsidiary or affiliate of that company;
- both the U.S. company and its parent, subsidiary or affiliate abroad, must be engaged in active business operations throughout the period the employee remains in the United States; the mere presence of an agent or office either in the United States or abroad is not sufficient; and
- an export license must be obtained when controlled technology is involved.

### **PROCEDURE FOR OBTAINING AN L-1 VISA**

An employer seeking to obtain an L-1 visa must file form I-129 and its L supplement with the CIS. Canadians may file for an L-1 visa at the border. The form should include supporting documentation demonstrating the applicant’s qualifications for the L-1 visa. If the U.S. operation is a start-up, the employer must provide extensive additional information, including evidence that a physical location for the operation has been secured, evidence of preliminary contracts demonstrating that the new operation has customers and evidence that the foreign employer or affiliate has invested sufficient funds to pay the wages of the transferred employees.

### **Other Visas**

A number of other non-immigrant visas may be available in connection with entry into the United States by foreign persons contemplating investment, business, religious or training activities. Information regarding these additional visa classifications can be obtained by contacting CIS, a U.S. consulate abroad or legal counsel with experience in the field of immigration law. Under certain circumstances a foreign national can immediately file for an immigrant visa.

### **The Legal Arizona Workers Act**

The Legal Arizona Workers Act is one of the toughest employer sanction laws in the United States. It covers any employer that (1) transacts business in Arizona; (2) has a license issued by an Arizona agency; and (3) employs one or more individuals who perform employment services in Arizona. Violation of the law carries severe penalties. If a company is found to have knowingly employed unauthorized workers, the employer must terminate the worker, sign an affidavit that it will not

knowingly or intentionally hire unauthorized workers and file quarterly reports for a three-year probationary period. A court may also suspend the employer's business license for not more than 10 business days. The "intentional" hiring of an unauthorized worker extends the probation period from three years to five years and requires mandatory suspension of the employer's business license for at least 10 days.

# ANTITRUST

COLIN P. AHLER

**U**NITED States antitrust laws have evolved in recent decades to reflect real world economics and become more favorable to business. The principal antitrust laws are the federal Sherman and Clayton Acts. The Arizona Legislature has enacted the state's own Arizona Antitrust Act that shares many features of the federal law. Antitrust violations include illegal agreements among competitors (horizontal restraints), illegal agreements between manufacturers and dealers (vertical restraints) and attempts to monopolize. Certain agreements are always (per se) illegal; others are tested by the "rule of reason" as to whether they unreasonably restrain trade. Penalties for antitrust violations can be severe.

## Background

The Sherman and Clayton Acts were enacted in the late 1800s, during a period of public concern about the aggregation of economic power. Interpretation of that legislation for the first 70 years reflected this concern. Beginning in the 1970s, there was a sea change with respect to how courts and government enforcement agencies interpret the antitrust laws. More recent interpretations of the antitrust laws have focused, as a result of the "Chicago School" of economics, on economic or allocative efficiency rather than the mere aggregation of economic power. The Chicago School argues that only those trade practices that harm consumer welfare through reductions of output or supracompetitive pricing should be prohibited. The practical result is that the antitrust laws are increasingly favorable toward business and the unrestricted operation of the free market. Many restrictive former antitrust rules have been abandoned.

The “Post-Chicago School” of economics has recently emerged as an alternative approach to antitrust interpretation. The practical result, however, is that some decisions have been characterized as “antibusiness.”

Enforcement of federal antitrust laws is the responsibility of the United States Department of Justice and the Federal Trade Commission. The Arizona Attorney General is responsible for enforcing the Arizona Antitrust Act. Private plaintiffs can also bring civil suits under both federal and state antitrust laws. Violations of the federal Sherman Act can also give rise to criminal penalties, including jail time. Criminal prosecutions typically involve per se violations, such as price fixing, bid rigging or market allocation schemes.

Penalties for civil violations of the antitrust laws can be significant. Large monetary fines can be imposed under federal and state law and criminal sanctions under federal law. In civil suits, private parties may recover three times the actual damages suffered (“treble damages”), plus attorneys’ fees.

## **Horizontal Restraints—Agreements Among Competitors**

### **IN GENERAL**

Not all agreements among competitors (horizontal agreements) are illegal under the antitrust laws. The law prohibits only those agreements that “unreasonably” restrain trade within the meaning of Section 1 of the Sherman Act or its Arizona counterpart.

Some horizontal agreements are so plainly anticompetitive, however, that no proof of their unreasonableness is necessary. These are per se illegal. No inquiry is made as to the precise harm a per se illegal agreement may cause and no business justification is a defense.

The legality of other horizontal agreements is analyzed under the “rule of reason” to determine whether, on balance, the agreement constitutes an unreasonable restraint of trade. Under the rule of reason, all relevant circumstances are weighed, both the positive effects (procompetitive benefits) and negative effects (anticompetitive effects) on competition. The intent or motive of the parties in entering into the horizontal agreement can also be a relevant consideration when the rule of reason standard applies. As a practical matter, the burden of establishing the anticompetitive effects (e.g., the potential to raise prices above competitive levels) is typically impossible to meet. Consequently, most agreements that are subject to the rule of reason analysis are legal.

## **HORIZONTAL AGREEMENTS AFFECTING PRICE**

Agreements among competitors that affect price present the greatest risks. Section 1 of the Sherman Act prohibits not only agreements among competitors that directly raise prices, but also combinations formed for the purpose and with the effect of raising, depressing, fixing, pegging or stabilizing prices. An agreement between competitors setting minimum or maximum prices is illegal per se. Agreements among competitors that indirectly affect price, such as agreements to restrict price advertising or to prohibit premiums or discounts, are also illegal per se.

## **TERRITORIAL DIVISIONS AND CUSTOMER ALLOCATIONS**

It is illegal for competitors to divide markets among themselves by agreeing not to compete with each other in certain geographical areas or not to compete for certain customers. Such agreements between competitors to divide markets, whether by territorial division or customer allocation, are illegal per se.

## **BID RIGGING**

Agreements among competitors to coordinate the outcome of a competitive bidding process for the award of a contract (“bid rigging”) are illegal per se.

## **NO POACHING AGREEMENTS**

A no poaching agreement is one between two different employers not to hire or solicit each other’s employees. No poaching agreements are considered “naked” if they are not reasonably necessary to a legitimate business collaboration between the employers, such as a joint venture or a merger. Naked no-poaching agreements are illegal per se and can give rise to civil or criminal liability.

## **COVENANTS NOT TO COMPETE**

A covenant is often included in an agreement for sale of a business that prohibits the seller from later competing with the purchaser of the business in a particular area for a particular time. Even though most agreements among competitors not to compete in certain geographical areas are illegal per se, a covenant not to compete that is an element of a sale of a business is evaluated under the “rule of reason.” The covenant not to compete in the context of the sale of a business is regarded as part of a larger agreement that has a legitimate objective as its principal goal, and the public interest in facilitating a transfer of a business is deemed to justify the rule of reason approach. If the covenant is not unreasonably broad in geographical scope and is not unreasonably long in duration, the covenant is legal. Indeed, in Arizona, a properly structured covenant not to compete in terms of reasonable time and geographic scope will likely be legal.

## **GROUP BOYCOTTS**

A group boycott is an agreement among competitors to refuse to deal with another competitor or to refuse to deal with a supplier or customer. The objectives of such an agreement can be to force another party out of business or to compel the acceptance of some condition. A group boycott undertaken by a group of competitors with market power, which has the intent or effect of driving another competitor out of business, generally is illegal per se. Other group boycotts are tested under the rule of reason.

## **JOINT VENTURES**

A joint venture is a partnership formed for a particular purpose, such as to perform research and development, or to produce and market a new product. The legality of joint ventures among competitors is usually determined under the rule of reason.

Many factors are considered under a rule of reason analysis to determine whether the anticompetitive effects of a joint venture are outweighed by competition-enhancing features. Among them are the size of the joint venturers, their share of their respective markets, the contributions of each party to the venture, the reasonableness of their relationship to the purposes of the venture and the likelihood that one or all of the parties would undertake a similar project in the absence of the joint venture. Other factors include the scope and duration of the venture, the nature of the functions transferred by the members of the joint venture to the joint venture itself, the efficiencies created through the formation and function of the joint venture, whether a pattern of joint ventures has emerged in the particular industry and whether the joint venture builds new productive capacity or utilizes existing capacity.

The principal factor is the magnitude of the venture. An “over-inclusive” venture is of concern because it reduces the number of potentially competing parties. Nevertheless, an extremely large venture may be justified only if a venture of that size could successfully achieve the objectives of the venture.

Joint venture status does not insulate otherwise impermissible behavior. Price fixing, illegal group boycotts and territorial or customer allocations are illegal per se even though engaged in by a joint venture.

## **TRADE ASSOCIATIONS**

Although participation in a trade association is usually considered pro-competitive or competitively neutral, an association may not be used to facilitate otherwise illegal horizontal agreements. Such an agreement may arise, for example, if competitors enact rules for the association that have the effect of unreasonably restraining competition, such as rules prohibiting members from soliciting another member’s clients or employees. Another primary concern is the potential for information sharing by

competitors. When competitors disclose confidential business information at a trade association meeting, such as information on current or future pricing, this may provide strong evidence of a price fixing conspiracy. By comparison, the collection of historical data by an independent third party (such as the trade association itself), which is then disseminated to members of the association in an aggregated format, is usually permissible.

## **VERTICAL AGREEMENTS-RESTRAINTS BETWEEN MANUFACTURERS AND DISTRIBUTORS OR RETAILERS**

Manufacturers or other producers may seek to enter into agreements with distributors and retailers of their products (vertical agreements). Generally speaking, vertical agreements are analyzed under the rule of reason and are generally regarded as legal. Under federal law, a plaintiff can only maintain an antitrust action against a vertical participant that has directly sold the goods or services to the plaintiff. Arizona courts have adopted a different approach and gives standing to sue to so-called “indirect purchasers.”

### **EXCLUSIVE DEALING ARRANGEMENTS**

An agreement by two businesses to deal exclusively with one another is a common form of vertical agreement, one that often arises in a distributorship arrangement because an exclusive distributorship typically provides a distributor with the right to serve as the exclusive outlet for a manufacturer. Agreements of this kind are judged under the rule of reason. Such exclusivity provisions are generally upheld as not violating the antitrust laws, as long as they do not restrain an undue share of either the manufacturer’s or the distributor’s market or are one year or shorter in duration.

### **TERRITORIAL AND CUSTOMER RESTRICTIONS**

Territorial and customer restrictions may be sought by a manufacturer. For example, a manufacturer may limit a dealer’s sale of the manufacturer’s product to a particular geographical area and time, prohibit other dealers from selling the manufacturer’s product in the same area or restrict sales by dealers to certain customers. In contrast to horizontal agreements among competitors involving territorial divisions and customer allocations that are illegal per se, vertical agreements of this kind between manufacturers and distributors are tested under the rule of reason. The justification is that although vertical agreements limit competition among dealers in the same brand, they may enhance competition among dealers of different brands. Current antitrust scholarship views nearly all vertical territorial and customer restrictions as procompetitive or competitively neutral and therefore legal under the rule of reason.

## **RESALE PRICE MAINTENANCE**

A vertical agreement fixing the minimum prices at which a manufacturer's products can be resold by wholesalers and retailers ("resale price maintenance") are judged under the rule of reason. These agreements can attract more scrutiny, however, if they are adopted by competing manufacturers, if a retailer provides the impetus for the arrangement, or if either party to the agreement has dominant market power. On the other hand, courts recognize that resale price maintenance agreements can result in pro-competitive benefits, such as incentivizing resellers to provide customer-friendly services and preventing discount resellers from "free riding" on those services, allowing manufacturers to maintain a premium reputation, and facilitating market entry for new brands.

Generally, a manufacturer can terminate a distributor that is discounting more than the manufacturer wishes, although antitrust counseling should be obtained before any actions directed at termination are commenced. Like minimum vertical price fixing, maximum vertical price fixing is also subject to the rule of reason test.

## **Monopolization and Attempts to Monopolize**

### **MONOPOLIZATION DEFINED**

Section 2 of the federal Sherman Act and the Arizona Antitrust Act prohibit monopolization and attempted monopolization.

Monopolization is the possession of "monopoly power," plus some conduct that demonstrates intent to exercise or maintain the monopoly power. Monopoly power refers to the power to control prices, which exists if a business can establish appreciably higher prices than those charged by competitors for equivalent goods without a substantial loss of business to competitors.

A business that does not have monopoly power can nevertheless be liable for attempted monopolization if it has sufficient market power such that there is a "dangerous probability" that the business will succeed in attaining monopoly power. Attempted monopolization requires a specific intent to monopolize.

Proof of monopolization, or of attempt to monopolize, is a two-step process. First, it must be demonstrated that the alleged offender has monopoly power in the relevant market or a dangerous probability of attaining market power. Second, there must be proof of some type of monopolistic conduct showing a willful intent to maintain or acquire that power, respectively. This second element allows courts to distinguish monopolies that are considered legal and legitimate, such as those that arise from superior technology, business acumen or historic accident.



## **DETERMINATION OF RELEVANT MARKET**

The first step in a Section 2 Sherman Act case is to determine the relevant market in which the alleged monopoly power exists. The relevant market is the area of effective competition in which the alleged monopolist operates. This market has two separate dimensions: the products included in the market and the geographic area covered.

### **Relevant Product Market**

The relevant products in the market include all goods or services that are reasonably interchangeable with the products that the alleged offender produces. Some of the factors that courts consider in determining whether products are “reasonably interchangeable,” and therefore in the same market, are whether the products have the same or similar characteristics or uses, whether the products are sold to similar customers and whether the products are distributed and sold by the same kinds of distributors or dealers. Products do not have to be identical to be in the same product market, but they must meaningfully compete with each other. In other words, assuming a hypothetical monopolist in products A and B, the question is whether if, in response to that monopolist raising the prices of A and B, a “significant but nontransitory amount,” usually 5 percent to 10 percent, the monopolist loses enough sales to product C to make the price increase unprofitable. If so, product C is in the same relevant product market as products A and B.

### **Relevant Geographic Market**

The relevant geographic market is the geographic area in which the sellers of a relevant product or service operate, the area in which the alleged monopolist faces competition from suppliers of competing products and to which purchasers can practically turn for such products or services. In essence, one applies the same hypothetical monopolist “test” to sellers in the broader geographic market as is done with the relevant product market. The relevant geographic area can be as large as the entire world or as small as a city neighborhood.

## **PROOF OF MARKET MONOPOLY POWER**

Once the relevant market is determined, the next inquiry is whether the alleged offender actually has market power in the relevant market. One way to demonstrate market power is direct proof of the alleged offender’s actual control over prices by charging supracompetitive prices. But direct evidence is often lacking. In the absence of direct proof, the courts focus on two other considerations: market share statistics and barriers to entry.

Market share statistics are often used to determine market power. Market share statistics show the percentage of the market that the alleged monopolist controls. If the market share is sufficiently

large (e.g., 50 percent or more), a court will generally conclude that the alleged offender has market power.

Barriers to entry are also critical. It is often said that even a 100 percent monopolist cannot exercise market power in the absence of entry barriers. Barriers to entry are obstacles that a new business would face if it tried to enter the same market. Barriers to entry may exist when significant capital would be necessary to fund the new business or when the new business would require specialized training or technology.

### **PROOF OF MONOPOLY CONDUCT**

An alleged offender's monopoly power, by itself, does not constitute unlawful monopolization. The monopoly power must be coupled with conduct that is harmful or will result in harm to consumers. This conduct is referred to as anticompetitive conduct. The courts have not fully defined what constitutes anticompetitive conduct, but two of the more common types are "predatory pricing" of products and "refusals to deal." The focus is harm to consumers and not harm to competitors, although harm to consumers can result from harm to competitors.

### **Predatory Pricing**

Predatory pricing (i.e., pricing below some measure of costs) occurs when a firm prices its products so low that the intended effect is to discipline or eliminate competition and thereby allow the firm to charge higher prices at a later time. The obvious problem is to distinguish prices that constitute legitimate competitive behavior from prices that are predatory. The courts do not want to discourage low prices if the result is more competition. Courts are skeptical of predatory pricing claims and usually will not uphold them unless it is clearly shown that the alleged offender can both eliminate competition and preclude others from reentering the market once the offender is able to charge monopoly rents and recoup any profit loss during the period of predatory pricing.

### **Refusals to Deal**

It is often difficult to distinguish between legitimate business practices designed to increase market share and practices that are exclusionary or predatory, especially regarding refusals to deal with competitors. Many believe that a business has an absolute right to choose the parties with whom it deals, but this is not always true. Historically, a monopolist's refusal to deal with a business or a competitor is predatory and illegal if the refusal is intended to eliminate competition. Recently, however, the U.S. Supreme Court has announced some movement away from this principle, suggesting that even a monopolist can refuse to deal with competitors. (On the other hand, the European Union has made it clear that it will view a refusal to deal by a monopolist as illegal.)

## **Price Discrimination Under the Robinson-Patman Act**

The Robinson-Patman Act prohibits a seller engaged in commerce from discriminating in price between two or more buyers in the sale of goods. A violation of the Robinson-Patman Act requires that there be at least two sales, one of which is interstate in character and that there be actual discrimination in sales of goods. In other words, there must be at least two sales to different customers at different prices of goods of similar grade and quality. A sale, plus only an offer to sell at a higher price, does not constitute illegal price discrimination. In addition, the Robinson-Patman Act has no application to services or leases. The Robinson-Patman Act also makes it unlawful for a buyer knowingly to induce or receive a discriminatory price, but, in such case, a buyer cannot be found liable unless the seller is also liable.

The Robinson-Patman Act is riddled with exceptions and defenses. Advanced antitrust counseling can often allow a company to implement a desired discount, although not always in the precise form the company initially desires.

### **EXCEPTIONS**

The prohibition against price discrimination in the Robinson-Patman Act does not prohibit “functional discounts,” which are price reductions granted by sellers to purchasers based on the position of the purchaser in the distribution chain. An example is a favorable price charged by a manufacturer to a wholesaler, which is less than the price the manufacturer would charge a retailer or a consumer, provided that the functional discount offered to the one wholesaler is available to all other wholesalers.

There is also an exemption from the Robinson-Patman Act for “delivered pricing” that reflects the costs of transportation. A manufacturer that quotes one price for products available at the factory may quote a higher delivered price for products delivered elsewhere. Although some delivered pricing has been found illegal as nothing more than a subterfuge to diminish price competition, a legitimate delivered pricing structure does not violate the Robinson-Patman Act.

### **DEFENSES**

There are also a number of defenses to a claim of price discrimination. Where a seller acts “in good faith to meet an equally low price of a competitor,” there is no illegal price discrimination. It also is not a Robinson-Patman Act violation if the price differential is made in response to changing conditions affecting the market or marketability of the product. This defense permits, for example, price cuts on obsolete or seasonal goods. Another defense authorizes price differentials attributable to differences in the cost of manufacture or sale, such as a quantity discount attributable to lower costs achieved by economics of scale.

## Mergers

Section 7 of the federal Clayton Act and Arizona's antitrust laws prohibit a merger if the effect of the merger may be to lessen competition. A merger may be by way of consolidation, stock acquisition or asset acquisition. Mergers are typically challenged by the federal enforcement agencies: the Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission. The key question is whether the proposed transaction will result in increased market concentration in a manner that allows for the exercise of market power.

As in monopolization cases, the starting point of merger analysis is to define the appropriate product and geographic markets. Market definition often plays a major role in merger litigation. If the product or geographical market is narrowly defined, the competitive impact of the merger will be more pronounced than in a broader market. Generally, a market is determined by the "interchangeability" of use. Thus, for example, if customers can readily turn to other products or to other geographic areas, those products and geographic areas are within the relevant market. After the relevant market is defined, the proposed transaction's effect on overall concentration of the market is evaluated. If the market has low-market concentration, meaning many (i.e., more than five rather equally matched competitors), the merger likely will pose no antitrust concerns. If four or fewer will have roughly 40 percent or more market share, the enforcement agencies will give the transaction greater scrutiny. If so, the first thing that the enforcement agencies will evaluate will be whether there exists the potential for entry by either additional capacity by current players or by new capacity from entirely new entrants and whether that new entry could defeat the exercise of market power (i.e., make any "significant but nontransitory" price increase unprofitable). If not, the enforcement agencies will evaluate whether, either by coordinated effect or by unilateral effect, the proposed merger will have anticompetitive effects. The above analysis is quite stringent and very few mergers are successfully challenged.

### **Compliance with The Hart-Scott-Rodino Antitrust Improvements Act**

The Hart-Scott-Rodino Antitrust Improvements Act requires notice to the Department of Justice and the Federal Trade Commission at least 30 days before certain mergers that have a value that meets or exceeds a specified threshold can be consummated. This threshold adjusts on an annual basis; as of 2018, the threshold is \$84.4 million. After receipt of the prescribed premerger notification, the Department of Justice or Federal Trade Commission may request additional information. This is called a second request. Second requests are often quite onerous and frequently cause the parties to abandon their proposed transaction. If additional information is requested, the merger cannot be consummated until 30 days after the Commission's receipt of all of the additional information. There is no similar notice requirement under Arizona's antitrust laws.

# EMPLOYMENT

JOSHUA R. WOODARD

**E**MPLOYERS in the United States historically have had significant discretion in employment matters including hiring, discharge and working conditions. Over the last several decades, the workplace has become increasingly regulated and the discretion of employers has been limited by federal and state legislation. Arizona employers have been impacted by this legislation, and it is important for employers to be aware of recent changes.

## GENERAL REGULATION OF EMPLOYMENT

The following provides a brief overview of some of the regulations impacting Arizona employers.

## CIVIL RIGHTS LAWS

### FEDERAL LEGISLATION

#### **Title VII of the U.S. Civil Rights Act of 1964, as amended in 1991 (Title VII)**

Title VII prohibits discrimination in employment on the basis of race, color, religion, sex, or national origin. The prohibition applies to all elements of the employer-employee relationship, including hiring, firing, wages, promotion and transfer. Title VII applies to every employer that has 15 or more employees engaged in any business affecting interstate commerce.

Title VII is enforced by the federal Equal Employment Opportunity Commission (EEOC). Employees or job applicants can file charges of discrimination with the EEOC. The EEOC itself may also file charges

against an employer on behalf of employees or job applicants. Following an investigation and attempts at resolution, the EEOC, employees, or job applicants may file a suit against the employer. Remedies available include compelled employment, reinstatement, back pay, compensatory damages, punitive damages and equitable relief and attorneys' fees. Employees are entitled to a jury trial.

### **Age Discrimination in Employment Act (ADEA)**

The ADEA protects individuals who are at least 40 years of age from employer discrimination based on age with respect to hiring, firing, wages, promotions, transfers and other terms, conditions or privileges of employment. The ADEA applies to any employer that has 20 or more employees engaged in business affecting interstate commerce. An exception permits age discrimination when age is a "bona fide occupational qualification" reasonably necessary to the normal operation of the employer's business. Selection of a younger employee over an older one is permitted if reasonably based on factors other than age.

Age discrimination claims must be filed with the EEOC. Thereafter, the EEOC, employees, or job applicants can file suit against the employer. Remedies available include compelled employment, reinstatement, back pay awards, liquidated damages and attorneys' fees.

### **The Rehabilitation Act**

The Rehabilitation Act of 1973, as amended, prohibits discrimination against qualified individuals with disabilities and requires certain employers to take affirmative steps to provide employment opportunities to qualified individuals with disabilities.

Employers subject to the Rehabilitation Act include federal contractors, subcontractors, and recipients of federal financial assistance. The standards for determining employment discrimination under the Rehabilitation Act are the same as those used in Title I of the ADA. The U.S. Department of Labor enforces the Rehabilitation Act. Violations can result in the cancellation of existing contracts with the U.S. government and disqualification from future contracts.

### **Americans with Disabilities Act of 1990 (ADA)**

The ADA prohibits discrimination against "qualified individuals with disabilities." The prohibition extends to hiring, firing, wages, promotions, transfers and all other terms, conditions or privileges of employment. A "qualified individual with a disability" is one who meets the definition of a "qualified handicapped person" under the Rehabilitation Act. The ADA applies to an employer engaged in a business affecting interstate commerce that has 15 or more employees. The ADA is enforced by the EEOC. Rights of action and remedies under the ADA are similar to the remedies under Title VII described above.

The ADA was amended in 2008 by the Amendments Act and is now known as the ADAAA. One of the central purposes of the Amendments Act is to expand the definition of disability, which Congress

criticized as having been too narrowly construed by the Supreme Court. The practical effect of the Amendments Act and interpreting regulations is that more individuals will qualify as disabled and will be entitled to reasonable accommodations at the workplace. Moreover, the broad coverage of the Amendments Act increases the number of employees protected under the ADA, thereby increasing the likelihood of litigation if companies are not complying with the statutory requirements.

The main point for companies to keep in mind is that the primary focus of the ADAAA is on whether discrimination occurred – not whether an individual is disabled. The practical effect is that an employer should, in almost all instances, initiate the interactive process with the employee to identify and implement appropriate reasonable accommodations once the employer becomes aware of the need for accommodation, as the majority of employees will be able to establish an actual disability or record of a disability. Moreover, the regulations reiterate that an individualized assessment is required to determine whether an impairment substantially limits a major life activity. Accordingly, it is now even more important that human resources representatives sit down with employees and discuss why they may be struggling at work and determine if a reasonable accommodation might help them to perform the essential functions of their position, assuming the employee is disabled. The employer need not provide the accommodation the employee requests or prefers – the employer need only provide an accommodation that is effective. Companies may want to ensure that all efforts to provide reasonable accommodations and that all conversations regarding accommodations held with the employees are documented in writing and maintained with their employees' confidential medical files.

### **Equal Pay Act (Pay Act)**

The Pay Act prohibits discrimination in employee wages on the basis of sex. It requires employers to pay equal wages for work at a single site of employment requiring equal skill, effort and responsibility, regardless of sex. Differences in wage rates are permissible if attributable to operation of a seniority system, a merit system, a system that measures earnings by the quantity or quality of production or any other system based on factors other than sex. The Pay Act applies to any employer with two or more employees. The Pay Act is administered by the EEOC. Either the EEOC or the employee may file a lawsuit to enforce the provisions of the Pay Act. Remedies include back pay awards, damages and attorneys' fees.

### **Section 1981 of the Civil Rights Act of 1870 (Section 1981)**

Section 1981 prohibits discrimination based on race or membership in an ethnic group. Any employer (regardless of size) engaged in business affecting interstate commerce is subject to Section 1981. Unlike Title VII, a job applicant or employee is not required to file a charge with the EEOC before suing the employer for a violation of the statute. Significantly, courts have found that Section 1981 applies to at-will employees. Remedies under Section 1981 include requiring employment, back pay, compensatory damages, punitive damages and attorneys' fees.

## **Genetic Information Nondiscrimination Act (GINA)**

The Genetic Information Nondiscrimination Act of 2008 (GINA) prohibits genetic discrimination in two areas—employment and health insurance. Title II of GINA applies to employers, labor organizations, and joint labor-management committees and generally prohibits employment discrimination based on the genetic information of an employee or the employee’s family members.

GINA makes it unlawful for an employer to fail or refuse to hire, or to discharge, an employee, or otherwise discriminate against an employee with respect to compensation, terms, conditions, or privileges of employment because of the employee’s genetic information.

GINA also makes it unlawful for an employer to request, require, or purchase genetic information with respect to an employee or an employee’s family member, with six limited exceptions. Regardless of whether an exception applies, GINA makes clear that genetic information, once acquired, may not be used to discriminate against an individual with respect to employment or benefits or disclosed in violation of GINA’s confidentiality requirements. If an employer acquires genetic information, such information must be treated and maintained as part of the employee’s confidential medical records. Such information must be maintained on separate forms and in separate medical files and must be treated as a confidential medical record. This is consistent with the requirements under the Americans with Disabilities Act (ADA) regarding the maintenance and treatment of medical information.

The preceding overview covers only a few of the most fundamental components of GINA’s new regulations and is not an exhaustive list of all obligations. Employers would be wise to carefully review the regulations, which may be obtained through the EEOC website.

## **STATE LEGISLATION**

### **Arizona Civil Rights Act (Arizona Act)**

The Arizona Act mirrors the federal civil rights laws and applies to Arizona employers with 15 or more employees. A claimant simultaneously may pursue identical claims under Title VII of the federal Civil Rights Act of 1964 and the Arizona Act. The Arizona Act’s prohibition against sexual harassment applies to Arizona employers with one or more employees. The Arizona Act is administered by the Civil Rights Division of the office of the Arizona Attorney General.

## **LOCAL LEGISLATION**

Certain local municipalities (such as Flagstaff, Phoenix, Sedona, Tempe, and Tucson, for example) prohibit employers from discriminating against employees on the basis of employees’ sexual orientation and gender identity.



# WAGE AND HOUR LAWS

## FEDERAL LEGISLATION

### **Fair Labor Standards Act (FLSA)**

The FLSA establishes minimum wage, overtime pay, record keeping and child labor standards affecting full-time and part-time workers in the private sector and in the federal, state and local government. Virtually all employers are subject to the FLSA. Under the FLSA, employers must pay employees not less than the prescribed minimum wage. The federal minimum wage is currently \$7.25 per hour. Generally, employers and employees may not make agreements to pay and receive less than the FLSA standard, or less than Arizona's minimum wage which currently is higher than the federal minimum wage.

Under the overtime provisions of the FLSA, most employees must be paid one and one-half (1.5) times their regular rate of pay for all hours worked in excess of 40 hours per week. There are exceptions to the overtime standards for certain employees, including executive, administrative, professional, certain computer personnel, outside sales employees and certain highly compensated employees.

The FLSA is administered and enforced by the Wage-Hour Division of the U.S. Department of Labor. The Labor Department may bring an action against an employer to compel compliance with the FLSA, or employees can sue for unpaid wages, liquidated damages, injunctive relief and attorneys' fees.

### **Davis-Bacon Act**

The Davis-Bacon Act requires employers that contract with the federal government to pay their employees a special minimum wage (i.e., the "prevailing wage" rate for corresponding classes of employees employed on projects of a similar character in the area in which the contracted work is to be performed). The Davis-Bacon Act is enforced by the Labor Department. Failure to pay the required "prevailing wage" can result in termination of the underlying contract and back pay obligations. If the contract is canceled and the work is completed by another contractor, the employer may be liable for any excess costs incurred by the government.

### **Walsh-Healy Act**

The Walsh-Healy Act mandates a special "prevailing minimum" wage, which must be paid to employees of employers that supply goods or materials to the U.S. government. Enforcement and sanctions are similar to those applicable under the Davis-Bacon Act.

### **Family and Medical Leave Act of 1993 (FMLA)**

The FMLA applies to employees who have been employed at least 12 months and have worked for at least 1,250 hours in the previous 12 months for an employer employing at least 50 people (either at one location or separate worksites within a 75-mile radius). Eligible employees are entitled to 12

weeks of unpaid leave during a 12-month period: (1) to care for a newly born or adopted child, (2) due to the employee's serious health condition, (3) to care for a spouse, child, or parent with a serious health condition, (4) when a qualifying exigency arising out of the fact that the employee's spouse, son, daughter, or parent is a covered military member on active duty, or has been notified of an impending call or order to active duty, in support of a contingency operation exists, or (5) to care for a covered service member with a serious injury or illness if the employee is the spouse, son, daughter, parent or next of kin of the service member. When FMLA leave expires, the employee is entitled to be restored to the same or equivalent position with equivalent pay, benefits and other conditions of employment. The employer must continue the existing health insurance coverage during the leave, but may have the right to recover the premiums if the employee fails to return to work.

Covered military members only include individuals in the Reserves or retired members of the regular Armed Forces or Reserves. The following categories constitute a qualifying exigency: short-notice deployment, military events and related activities, childcare and school activities, financial and legal arrangements, counseling, rest and recuperation, post-deployment activities and additional activities that are agreed to by the employer and employee.

For leave due to the care of a covered service member, eligible employees are entitled to 26 work weeks of leave in a single 12-month period. This leave may be taken to care for a current member of the Armed Forces, including a member of the National Guard or Reserves, who has a serious injury or illness incurred in the line of active duty for which he or she is undergoing medical treatment, recuperation, or therapy, or is otherwise in outpatient status or on the temporary disability retired list. Additionally, an employee may have multiple family members who qualify as the next of kin and they may take FMLA leave either consecutively or simultaneously.

The FMLA authorizes the Wage and Hour Division of the U.S. Department of Labor to investigate and resolve complaints. Employees may also file suit to enforce their rights under the law without filing an agency complaint. Employers who violate the FMLA or discriminate against employees exercising their rights under it are liable for lost compensation, compensatory damages, liquidated damages and attorneys' fees.

## **STATE LEGISLATION**

In 2018, Arizona imposed a minimum wage requirement of \$10.50 an hour. Arizona minimum wage will increase to \$11.00 an hour on January 1, 2019, and to \$12.00 an hour in January 2020. The minimum wage then will increase annually in 2021, and thereafter, based on the cost of living. Otherwise, Arizona laws relating to wages and hours generally follow the federal laws governing these issues. In addition, an employer in Arizona is required to designate at least two days each month as fixed pay days, not more than 16 days apart. Discharged employees must be paid all wages due within seven working days of the date of discharge or by the end of the next regular pay

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period, whichever is sooner. Employees who quit must be paid in the usual manner all wages due by the regular pay day for the pay period during which the termination occurred. Violations can result in employer liability of three times the amount of wages due.

Employers are required to allow an employee or an employee's designated representative the opportunity to inspect and copy the employee's payroll records.

## **SAFETY LAWS**

### **FEDERAL LEGISLATION**

#### **The Occupational Safety and Health Act (OSHA)**

OSHA imposes a duty on employers to provide employees with a safe and healthful place to work. OSHA requires all employers to furnish employees with a workplace free from recognized hazards causing, or likely to cause, death, serious physical harm or illness. OSHA is administered by the U.S. Labor Department, which, from time to time, issues mandatory safety standards. The Labor Department is authorized to conduct inspections of the workplace to determine compliance with these standards. Violations of OSHA can result in civil and criminal penalties. OSHA has jurisdiction over employers on federally-controlled lands and properties in Arizona as well as most Native American lands.

#### **Mine Safety and Health Act (MSHA)**

MSHA prescribes standards governing working conditions of employees employed in mining operations. Sanctions for violations of MSHA are similar to the sanctions imposed under OSHA.

### **STATE LEGISLATION**

#### **Arizona Occupational Safety and Health Act (Arizona OSHA)**

Although OSHA is a federal law enforced by the U.S. Labor Department (see above), Arizona OSHA provides that an individual state may assume responsibility for safety and health within its jurisdiction, provided that the state has a federally approved Arizona OSHA plan. Arizona has assumed responsibility for workplace safety in the state in accordance with the federal OSHA standards.

## **OTHER SIGNIFICANT LAWS**

### **FEDERAL LEGISLATION**

#### **Uniformed Services Employment and Reemployment Rights Act (USERRA)**

USERRA requires employers to grant employees unpaid time off to fulfill temporary military obligations and also requires employers to rehire individuals who leave work to serve full time in the U.S. Uniformed Services for up to five years. The Act also prohibits discrimination against individuals

who apply for, perform or have performed in a uniformed service. In addition to re-employment, covered employees have seniority rights, pension rights and the right to continued health insurance coverage. Unlike other laws, USERRA alters the at-will employment standard for veterans returning to the workplace. The law imposes a just cause standard on an employer who seeks to discipline or discharge a veteran who has resumed his or her employment, but the length of time that the just cause standard applies varies on the length of service of the veteran.

Except in certain circumstances, employees must notify their employer in advance of the need for military leave and also must reapply for employment after their service. The time limits for reapplication vary depending on the length of service. Damages recoverable for violation of USERRA include re-employment, lost wages and benefits, liquidated or double damages for a “willful” violation and attorneys’ fees.

### **Worker Adjustment Retraining and Notification Act of 1988 (WARN)**

WARN requires employers of 100 or more full time employees to provide a 60-day advance notice to impacted employees and to local and state officials before implementing a plant closing or a mass layoff. A “plant closing” is a shutdown of facilities at a single site that results in a loss of jobs for 50 or more employees for at least 30 days. A “mass layoff” is a reduction in the work force of 50 or more workers at a single site, provided that the reduction affects at least one-third of the total work force. A reduction in the work force of 500 or more at a single site is a mass layoff, regardless of the percentage of the work force affected. An employer is not obligated to provide advance notice of a mass layoff if the work force reductions will last for less than six months. In some instances, layoffs that occur within 90 days of each other will be considered as one layoff for meeting the WARN threshold.

There are three recognized exceptions to providing the full 60 days’ notice to impacted employees. These include the following:

- 1) The “faltering company” exception. This is available when a company is actively seeking capital or business and reasonably believes that advance notice would preclude its ability to obtain such capital or business, and this new capital or business would allow the employer to avoid or postpone a shutdown for a reasonable period;
- 2) The “unforeseeable business circumstance” exception. This is available when the closing or mass layoff is caused by business circumstances that were not reasonably foreseeable at the time the 60-day notice was required. An example would be the unexpected cancellation of a major order; and
- 3) The “natural disaster” exception. This applies when the closing or layoff is the direct result of a natural disaster such as a flood, earthquake, etc. In such a case, notice may be given after the event.

Employers who violate the notice requirements of WARN are liable to each unnotified employee for back pay and benefits for a period of up to 60 days. Employers who violate the notice requirements may also be fined by local governmental units.

### **Employee Polygraph Act of 1988 (Polygraph Act)**

The Polygraph Act prohibits employers from using polygraphs, “lie detectors” or similar devices to screen job applicants or current employees. The Act prohibits an employer from taking any adverse employment action based on the results of a polygraph test or based on an employee’s refusal to submit to such a test. The Polygraph Act applies to any employer engaged in interstate commerce but certain government employers are exempt. Employers may be fined up to \$10,000 for each violation. Employees or prospective employees have the right to sue for damages, including reinstatement, back pay, benefits and attorneys’ fees.

### **Immigration Reform and Control Act of 1986 (Immigration Act)**

The Immigration Act prohibits employers from employing aliens who are not authorized to work in the United States. To be authorized to work, an alien must be a permanent resident, hold a non-immigrant work visa or possess other authorization from the government. The Immigration Act requires employers to verify the right of each employee to work in the United States and to obtain documents verifying their identity. Virtually all employers are subject to the Immigration Act. Violations of the Immigration Act are punishable by civil and criminal penalties. See also the “Immigration” chapter.

### **Drug-Free Workplace Act (Drug Act)**

The Drug Act requires federal contractors and grantees to implement anti-drug programs. Employers are required to provide information to employees regarding the dangers of drug abuse in the workplace. If an employee is convicted under a criminal drug law for a violation that occurs at the workplace, the employer must notify U.S. authorities. The employer must also impose sanctions against the convicted employee or require the employee to satisfactorily complete a drug abuse or rehabilitation program. The Drug Act does not require drug testing of employees. Employers covered by the Drug Act are those that hold contracts with the U.S. government in excess of \$100,000 and recipients of federal financial assistance. Violations of the Drug Act may result in the termination of existing federal contracts and disqualification from future contracts.

## **STATE LEGISLATION**

### **Workers’ Compensation Act**

As do most states, Arizona has workers’ compensation insurance laws. The law requires employers to maintain insurance that provides specified benefits to employees for job-related accidents causing injury. The cost of the insurance is paid by employers through payment of premiums into a state fund or to a private insurance carrier. Some employers qualify to be self-insured. Employers are required to document and report workplace accidents resulting in injuries.

### **Arizona Economic Security Act (AESAs)**

AESA provides for the payment of benefits for specified periods to individuals who become unemployed through no fault of their own. The cost of the benefits is provided by employers who are required to make periodic contributions to a state unemployment insurance fund.

### **Arizona Drug Testing of Employees Act (Drug Testing Act)**

While the Drug Testing Act neither requires nor prohibits employee drug screening, it grants legal protection to employers who conduct drug or alcohol impairment tests that conform to the requirements of the Act. Compliance protects the employer from liability for actions taken in good faith relating to positive test results, failure to test or detect a specific drug, or condition, or the elimination of a prevention or testing program.

To comply with the Drug Testing Act, the employer must publish and distribute a written statement to employees describing the drug and alcohol testing policy. The Act contains specific requirements and each policy must describe which employees are subject to testing, under what circumstances, the substances for which the employee is tested, the methods and procedures of testing and the consequences of positive test results or of failure to participate. The employer also must pay for employee testing, compensate the employee for his or her time, ensure that it is done in a reasonable and sanitary area, keep all communications relating to the testing confidential and provide employees with the opportunity, in a confidential setting, to explain a positive test.

### **1996 Arizona Employment Protection Act**

This Act strengthens the employment-at-will doctrine, allowing employers or employees to terminate the employment relationship at any time for any reason unless there is a written contract to the contrary. To overcome the presumption that the employment relationship is at-will, the contract must be signed by both the employee and the employer or be set forth in an employee handbook that identifies itself as a contract or be signed by the party to be charged. Under this law, implied contracts are not enforceable.

The Act also eliminates “wrongful termination” suits based on public policy. Before this law, courts allowed lawsuits alleging that a termination was “morally wrong,” even if it did not violate a specific law. Now these claims are not allowed. The employee’s wrongful termination claim must be based on the employer’s breach of an employment contract described above; violation of a specific Arizona statute or the state constitution or retaliation for the employee’s refusal to violate Arizona law, good faith disclosure that the employer has violated Arizona law, or exercise of workers’ compensation rights.

The Act limits remedies in some areas. If the statute provides for a specific remedy, a successful plaintiff may receive no more than that remedy. An employee may not base a claim on the statute to obtain a greater award than the one contained in the statute itself, such as damages for emotional

distress, humiliation or punitive damages in a discrimination action. Such damages, however, can be awarded in a proper case. The Act also shortens the statute of limitations for wrongful termination. To pursue a claim, the employee must file suit within one year of termination.

### **Arizona Medical Marijuana Act (AMMA)**

Arizona voters passed the AMMA in 2010. AMMA provides expansive workplace protections to registered employees who are users of medical marijuana. The most significant of AMMA's provisions impacting employers are found in A.R.S. § 36-2813. Those provisions prohibit employees who use medical marijuana from being discriminated against in hiring, termination or imposing any term or condition of employment or otherwise penalize a person based upon either: (1) the employee's status as a registered cardholder under AMMA; or (2) the registered cardholder/employee's positive drug test for marijuana components or metabolites, unless the employee used, possessed or was impaired by marijuana on the employer's premises or during the hours of employment.

Regardless of the situation, if an employee is protected under AMMA, employers should use care in reviewing all the facts and issues before taking any employment action to avoid allegations of discrimination, harassment, or retaliation.

### **Arizona Fair Wages and Healthy Families Act**

Effective July 1, 2017, all Arizona employers are required to provide employees with paid sick leave to use for enumerated paid sick leave purposes as set forth in the Arizona Fair Wages and Healthy Families Act. Employers with less than 15 employees are required to provide no less than 24 hours of paid sick leave per 12-month period, and employers with 15 or more employees are required to provide no less than 40 hours of paid sick leave per 12-month period. Employers may provide a lump sum of the required paid sick leave hours or require employees to accrue one hour of paid sick leave for every 30 hours worked. Employers are required to provide certain information on or attached to each employee's pay stub, or make such information readily available to each employee, including the amount of paid sick time available for use during the 12-month period, the amount of paid sick time used to date in the 12-month period and the amount of pay the employee has been paid for use of paid sick time during the 12-month period. Depending upon whether employers provide paid sick time in a lump sum at the beginning of the 12-month period ("frontload") or allow employees to accrue one hour of paid sick time for every 30 hours worked, there may be a requirement to allow employees to roll-over accrued but unused paid sick time into the next 12-month period. Notwithstanding any roll-over, however, employees are still entitled to earn the full amount of paid sick time for the new 12-month period even though employees may cap paid sick time use to 24 or 40 hours (depending upon the size of the employer). In other words, there may be occasions where employees accrue a greater bank of paid sick time than they may be allowed to use during the year. For paid sick time use of three or more consecutive work days, employers may require "reasonable documentation" from the employee showing the paid sick time was used for a covered reason. Employers are not required

to pay-out accrued but unused paid sick time upon termination of employment but are required to reinstate accrued but unused paid sick time if the employee is rehired within 9 months. Given the nuances of Arizona Fair Wages and Healthy Families Act, employers may want to seek counsel regarding its many requirements.

## **Other Matters**

### **ARBITRATION**

Many employers are requiring employees to enter into arbitration agreements as a condition of employment or issuing mandatory arbitration policies. These agreements or policies typically require employees to arbitrate any claims arising in the course of employment or termination or employment. Both employers and employees often prefer arbitration to litigation because of its lower cost and quicker resolution of claims. Courts also view arbitration agreements favorably. For example, courts have sent various employment-related claims, including employment discrimination lawsuits based on Title VII, the ADEA, and the ADA, to arbitration when an enforceable arbitration agreement required it. Indeed, the United States Supreme Court recently ruled that such agreements may contain enforceable class action waivers, precluding employees from pursuing class action lawsuits against their employers or former employers. To increase the likelihood of court enforcement, arbitration agreements should contain numerous provisions ensuring both procedural and substantive fairness to employees.

### **RESTRICTIVE COVENANTS**

Arizona recognizes employers' rights to impose non-disclosure, non-solicitation, and non-compete requirements on employees, provided that such restrictions protect legitimate business interests and are reasonable in scope and duration. Overbroad restrictions are not enforceable, and courts have the authority to strike unreasonable restrictive covenants. What is considered reasonable is determined on a case-by-case basis and depends upon a variety of factors including the employer's industry, the employer's business, how the employer treats confidential information, the employee's position, the actual duties of the employee, and a variety of other applicable factors. Arizona courts are allowed to "blue pencil" restrictive covenants to eliminate (but not revise) unreasonable restrictions.

### **INDEPENDENT CONTRACTORS**

By entering into a declaration of independent business status, Arizona companies can create a rebuttable presumption under state law that the relationship between a contractor and the company is, in fact, an independent contractor relationship rather than an employment relationship. The declaration of independent business status must include six components and the parties must



comply with such matters in the relationship. This declaration is optional but can be helpful in the event the classification of workers as independent contractors is challenged under state law.

For purposes of workers' compensation coverage, Arizona law also provides that a rebuttable presumption of independent contractor status exists where there is a written agreement between an independent contractor and an employer that expressly states that the independent contractor is not eligible for workers' compensation benefits.

### **CONSTRUCTIVE DISCHARGE**

Employers who post (in a conspicuous place where notices to employees are customarily posted or by including substantially similar language in an employment handbook or policy manual) a constructive discharge notice that includes the statutorily-required language can require employees in certain situations to complain about objectively difficult or unpleasant working conditions and provide at least fifteen days' notice of the intent to resign before filing any constructive discharge claim. Such fifteen-day period allows employers time to cure such working conditions and minimize the risks of constructive discharge claims.

### **BRING YOUR GUN TO WORK**

Arizona employers may prohibit employees from bringing firearms into work. In certain situations, however, Arizona's employers are not permitted to have a policy that prohibits employees from lawfully transporting or lawfully storing any firearm that is (i) in the employee's locked and privately-owned motor vehicle or in a locked compartment on the employee's privately-owned motorcycle, and (ii) not visible from the outside of the motor vehicle or motorcycle. Such would not apply if the possession of the firearm is prohibited by federal or state law, the motor vehicle is owned or leased by the employer, if the employer has a fence, barrier, or limits access to the parking facility, and other circumstances.

### **UNIONIZATION OF EMPLOYEES**

The unionization of employees can affect an employer's discretion in employment matters. Briefly examined below are how a union is recognized, the effect of union recognition and the impact on unionization of Arizona's right-to-work law. Also discussed is the impact when a business is sold upon collective bargaining with unions and upon existing union collective bargaining agreements.

### **UNION RECOGNITION**

Unions generally obtain recognition through one of two means: voluntary recognition by the employer or an election under the supervision of the National Labor Relations Board (NLRB). In a voluntary

recognition, an employer generally agrees to a “card check” – a review of signed union authorization cards – by an impartial third party to verify that a majority of employees wish to be union represented.

Once a union has achieved recognition, the employer is required to “collectively bargain” with representatives of the union as to wages, hours and other terms and conditions of employment. The employer must bargain with representatives of the union, which then exclusively represent all employees in the bargaining unit. After union recognition, an employer cannot negotiate with any individual employees within the unit, including those opposed to the union.

### **IMPACT OF RIGHT-TO-WORK LAWS**

In some states, employees may be required to join a union or pay dues to a union, either to obtain employment or to retain their positions, once the union and the employer have signed a collective bargaining agreement, which provides for such requirement. This requirement is referred to as “Union Security.” The National Labor Relations Act, however, permits individual states to prohibit such Union Security requirements. States that prohibit such requirements are referred to as “Right to Work” states. Arizona is a Right to Work state. No employee in Arizona may be required to join a union or to pay dues to a union as a condition of employment.

### **EFFECT OF UNION OR BARGAINING AGREEMENT UPON SUCCESSOR EMPLOYER**

The question of union representation often is involved in the context of the sale of a business. If employees of the business are represented by a union, the issue may arise of whether the successor employer must bargain collectively with the union or whether it must abide by the terms of an existing collective bargaining agreement made between the union and the seller.

Generally, if a company acquires the assets of a business, the purchasing company is neither bound by the seller’s union contract nor required to bargain collectively with an existing union, unless there is “substantial continuity” of work force between the successor employer and the predecessor employer. Whether substantial continuity exists depends on a number of factors, the most important of which is whether a majority of the employees of the successor employer were employed by the predecessor employer. Even if a duty to bargain is found, a successor employer is not obligated to comply with the terms of an existing collective bargaining agreement, unless the successor employer expressly or implicitly adopts the agreement or if the successor employer is the “alter ego,” essentially the same party, as the predecessor employer.

# EMPLOYEE BENEFITS

NANCY K. CAMPBELL AND MARVIN S. ("BUCKY") SWIFT, JR.

**A**LTHOUGH wages are primary compensation for services, various non-cash benefits are usually an integral part of total compensation. Salaried and hourly employees, often called "rank-and-file employees," are generally the recipients of basic benefits, including medical and retirement. "Management employees" (executive personnel) commonly receive basic benefits supplemented by such items as deferred compensation, stock options, restricted stock and other stock-based arrangements. Benefit payments, characteristically established by benefits "plans," are governed principally by federal laws.

## Regulation of Employee Benefits

Employee benefits are subject to significant regulation under U.S. law. The Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (the Code) are the principal federal statutes. State laws that purport to regulate benefit plans generally are superseded (preempted) by federal law.

### ERISA

ERISA is a comprehensive regulatory scheme. Under ERISA, employers must meet reporting and disclosure requirements, including annual reports to the U.S. Department of Labor, the agency that administers the regulatory scheme. ERISA also imposes minimum standards on certain types of plans to assure that basic benefits are provided to rank-and-file employees, rather than being

confined to management employees. In addition, ERISA imposes standards for the administration of employee benefit plans.

ERISA can be enforced through proceedings brought by the Department of Labor, employees, beneficiaries of employees or plan fiduciaries, such as a plan administrator or a plan trustee. The Department of Labor in some cases can impose fines for violations of ERISA.

### **THE INTERNAL REVENUE CODE**

The Code's impact on employee benefit plans is primarily through requirements imposed as a condition of obtaining favorable tax treatment. Failure to satisfy the Code's requirements can result in loss of employer tax deductions for plan contributions made by the employer or of employer deductions for costs of plan benefits paid by the employer. Violations of the Code can also result in the loss of favorable tax treatment for employees as to receipt of benefits from a plan and the taxation of an otherwise tax-exempt trust. For example, for public companies in the United States, compensation in excess of \$1 million for the company's most highly compensated executives is generally not deductible.

### **IMPACT OF STATE LAW**

ERISA generally preempts state laws that relate to employee benefit plans. However, state insurance laws, as they apply to insured plans, are expressly exempted from preemption under ERISA. Accordingly, insured employee welfare benefit plans (but not self-insured plans) are subject to state laws regulating insurance, including laws requiring that specific benefits be provided by medical plans.

## **Specific Benefit Arrangements**

A variety of benefit arrangements may be provided by employers to employees. Among the most common arrangements are medical plans, qualified retirement plans, nonqualified plans, stock-based compensation arrangements and performance unit plans.

### **MEDICAL PLANS**

Adequate medical coverage is an important consideration for workers. The availability of employer-provided medical benefits can be an important part of employee compensation. Medical coverage can be provided by an employer in several ways, including through insured (including HMOs) and self-insured plans, health flexible spending accounts, and health savings accounts. Under the Code, certain medical plans must not discriminate in favor of highly compensated employees.

The following federal laws also impose requirements on group health plans: ERISA, the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), the Family and Medical Leave Act of 1993, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Americans with Disabilities Act, the Age Discrimination in Employment Act, Title VII of the Civil Rights Act, the Pregnancy Discrimination Act, the Health Insurance Portability and Accountability Act (HIPAA) as amended by the Health Information Technology for Economic and Clinical Health Act, the Mental Health Parity Act of 1996, the Mental Health Parity and Addiction Equity Act of 2008, the Newborns' and Mothers' Health Protection Act of 1996, the Women's Health and Cancer Rights Act of 1998, and the Genetic Information Nondiscrimination Act of 2008.

The Patient Protection and Affordable Care Act was signed into law on March 23, 2010 and was followed shortly thereafter by the Health Care and Education Reconciliation Act of 2010 (collectively the Affordable Care Act). The Affordable Care Act has significant implications for employer group health plans. For example, most medical plans must provide coverage for children to age 26, eliminate pre-existing condition exclusions, eliminate annual and lifetime limits on essential health benefits and prohibit the retroactive rescission of coverage. Non-grandfathered plans (those not in effect on March 23, 2010 and plans to which significant changes have been made since that date) are subject to additional requirements.

Historically, employers have had discretion in deciding whether to offer medical coverage to their employees. Starting in 2015, this changed due to the shared responsibility provisions of Code Section 4980H, which is part of the Affordable Care Act. Section 4980H applies to large employers with at least 50 full-time employees or a combination of full-time and part-time employees that is equivalent to 50 full-time employees. Under Code Section 4980H, large employers are subject to a penalty if they either: (1) fail to offer minimum essential coverage to 95 percent of their full-time employees (and their dependents); or (2) offer employer-sponsored coverage to 95 percent of their full-time employees (and their dependents), but the coverage is either not "affordable" or does not provide "minimum value." The penalties are assessed only if at least one of the large employer's full-time employees receives a premium tax credit for purchasing individual coverage through a Health Insurance Marketplace. "Full-time employees" for this purpose generally means employees who work an average of at least 30 hours per week.

The Affordable Care Act withstood two trips to the U.S. Supreme Court during President Barak Obama's tenure. On January 20, 2017, his first day in office, President Donald Trump signed an executive order indicating his intention to dismantle the Affordable Care Act. In addition, the tax penalty associated with the individual mandate was repealed by the Tax Cuts and Jobs Act effective for months after December 31, 2018. The repeal of the individual mandate penalty is the basis of a lawsuit filed in early 2018 in the U.S. District Court for the Northern District of Texas, which may

result in some or all of the Affordable Care Act being declared unconstitutional. The future of the Affordable Care Act remains to be seen.

The Department of Health and Human Services enacted the HIPAA “privacy rules,” which generally became effective on April 14, 2003. The privacy rules prohibit “covered entities” (which include employer-provided medical plans) from using or disclosing an individual’s “protected health information” for purposes other than the provision of health care and certain other limited purposes. The HIPAA privacy rules require medical plans to adopt policies and procedures designed to safeguard against the improper use or disclosure of protected health information.

Medical benefits usually are provided to employees and their dependents only during employment. Pursuant to COBRA, however, an employer who employs 20 or more employees, and who maintains a group medical plan, must allow certain former employees and their dependents to continue plan coverage, at the employee’s expense, for a minimum of 18 months. Collective bargaining agreements often require longer continued health coverage for former employees.

## **QUALIFIED RETIREMENT PLANS**

Retirement benefits can be provided through a wide range of qualified plans. A retirement plan is a “qualified plan” if it satisfies detailed Code requirements. A number of favorable tax consequences result from status as a qualified plan. An employer is entitled to a current deduction for contributions made to such a plan. Employees are not taxed on their plan benefits until benefits are actually received. The trust established under a qualified plan to receive contributions is not taxed on its earnings, which permits tax-free compounding of interest. Here are five of the most common types of qualified retirement plans:

### **Profit-Sharing Plans**

Under a profit-sharing plan, employer contributions can be contingent on the employer’s profits. More likely, the employer is permitted to make contributions in its discretion, whether or not the employer makes a profit. Contributions made by an employer are allocated to individual accounts established for eligible employees. Upon retirement or other termination of employment, an employee is entitled to benefits based upon the employee’s account balance.

### **Section 401(k) Plans**

A 401(k) plan is a profit-sharing or stock bonus plan under which employees make pre-tax contributions that are not taxed until the employee takes a distribution from the plan. Plans may allow employees to make after-tax Roth contributions, which are included in taxable income when made. Roth contributions and earnings are not taxed when distributed if they are part of a “qualified distribution.” Employee contributions, whether pre-tax or after-tax, may be matched by tax-deductible contributions from the employer.

## **Stock Bonus Plans**

A stock bonus plan is similar to a profit-sharing plan, except that the benefits are generally distributed in stock of the employer. Under certain stock bonus plans, employees are authorized to exercise voting rights with respect to shares allocated to their accounts.

## **Leveraged Employee Stock Ownership Plans (ESOP)**

A leveraged ESOP is a specific type of stock bonus plan under which the plan borrows funds to invest primarily in the employer's stock. Employees who participate in a leveraged ESOP have the right, in certain cases, to vote the shares allocated to their accounts.

## **Defined Benefit Pension Plan**

Under a defined benefit pension plan, an employee is promised a fixed pension at retirement, the amount being determined by the employee's salary, years of employment or both. The employer is required annually to contribute an amount actuarially sufficient to fund pension benefits.

## **NONQUALIFIED PLANS**

Nonqualified plans play an important role as a tax and retirement planning device for executives. The principal attraction of nonqualified plans is that they are not subject to many of the onerous requirements of ERISA and the Code. Such plans can provide benefits to executives without providing corresponding benefits to rank-and-file employees. Two of the most common forms of nonqualified plans are excess benefit plans and deferred compensation plans.

### **Excess Benefit Plans**

An excess benefit plan provides an executive with a supplemental pension equal to the difference between the pension that the executive would have received under the employer's qualified retirement plan if there were no limitation on benefits imposed by the Code and the limited pension that the executive will actually receive under the qualified plan.

### **Deferred Compensation Plans**

A deferred compensation plan permits covered executives to avoid current income tax by deferring current compensation for a specified period or until retirement. Interest on the deferred amounts during the deferral period may be credited to the executive as an additional benefit. To avoid adverse tax consequences to covered executives and to avoid ERISA regulation, nonqualified deferred compensation plans are neither funded nor secured. Executives generally have no greater right to payment than do other unsecured creditors. Although there are ways in which the employer's promise can be somewhat secured, there is no way to give executives priority over their employer's other creditors without an adverse tax result.

## **STOCK-BASED ARRANGEMENTS**

The theory underlying stock-based arrangements is that the executive who has the right to acquire the employer's stock or to receive compensation based upon the performance of the stock, will have an incentive to work more diligently for the company's success. Among the most common forms of stock-based arrangements are stock options, restricted stock and stock appreciation rights.

### **Stock Options**

A stock option is a right granted by an employer to an employee that permits the employee to purchase shares of the stock of the employer at a fixed price within a specified period of time. The option permits the employee to share in the appreciation in the stock of the employer while avoiding the risk of depreciation in value. Stock options are of two kinds: incentive stock options and nonqualified stock options.

### **Incentive Stock Options**

Incentive stock options (ISOs) are creations of the Code and must satisfy the Code's requirements. One requirement is that the exercise price of the option (the amount payable by the employee to acquire the stock) cannot be less than the fair market value of the underlying stock on the date of the grant of the ISO. Also, an ISO must be exercised within 10 years after the date of grant.

The principal benefit of an ISO is the tax treatment available to an employee. An employee is not taxed either at the time of the grant of an ISO or at the time of the exercise of the ISO, unless the employee is subject to the special alternative minimum tax. If the stock acquired upon exercise of an ISO is not sold or disposed of until after a mandated holding period (two years from grant and one year from exercise), any gain to the employee from the sale is capital gain. No deduction is available to an employer in connection with an ISO unless the employee sells the ISO stock before the holding period.

### **Nonqualified Stock Options**

A nonqualified stock option (NQSO) is any option that does not qualify as an ISO. Unlike ISOs, NQSOs are not required to meet specific requirements. As a result of state and federal tax and securities laws, however, NQSOs tend to have common features. Typical NQSOs permit the employee to purchase stock at a fixed price for a specified period of time at a price equal to the fair market value on the date of grant. Most NQSOs cannot be exercised until a specified period has expired and most expire upon termination of employment, with the exception of death, retirement or disability.

The employee's tax treatment under an NQSO generally is not as favorable as under an ISO. Although the employee generally is not taxed upon grant of an NQSO, the employee will realize taxable ordinary income at the time of exercise of the option equal to the difference between the fair market value of the stock at exercise and the exercise price. The exercise price paid by the employee, plus the income recognized by the employee, is the employee's "basis" in the stock in the event of a subsequent sale.



Any amount realized on a subsequent sale that is in excess of the employee's basis is taxable at capital gain rates.

Although no deduction is available to an employer that issues an ISO, an employer that issues an NQSO is entitled to a deduction upon the employee's exercise of an NQSO equal to the amount of income includable by the employee.

### **Restricted Stock**

Restricted stock is stock of the employer issued to an employee for the performance of services. Restricted stock is subject to restrictions on the employee's stock ownership rights. For example, the employee's ownership of some or all of the shares may be made contingent on continued employment by the employer for a specified period. Restricted stock is often issued to an employee without cost to the employee or at a significant discount.

An employee is not subject to tax on restricted stock until the stock restrictions lapse. When the stock restrictions lapse, the employee realizes ordinary income in an amount equal to the excess of the fair market value of the stock, as of the date the restrictions lapse, over the amount, if any, paid for the stock. Any appreciation in the stock that occurs after the restrictions lapse generally is eligible for capital gains treatment upon a subsequent sale.

An employee can elect to be taxed immediately upon the receipt of the restricted stock by filing a special notice with the IRS within 30 days of the stock grant. In such case, the employee realizes ordinary income equal to the excess of the fair market value of the stock on the date of receipt over the amount, if any, paid for the stock. Any appreciation in the stock occurring after the date of receipt is then eligible for capital gains treatment.

### **Stock Appreciation Rights**

A stock appreciation right (SAR) is a right to be paid an amount equal to the difference between the value of a share of an employer's stock on the date the SAR is granted and the value of that share on the date the SAR is exercised. SARs are sometimes granted in conjunction with stock options and often require that the underlying option be exercised as a condition for the exercise of the SAR. Payments under SARs can be made in cash or in employer stock. The tax treatment of SARs is generally the same as the tax treatment of NQSOs.

## **PERFORMANCE UNIT PLANS**

Awards under performance unit plans are usually contingent upon the attainment of corporate performance goals within a specified period of time, such as a specified increase in the market share of the employer or improvement in the performance of the employer relative to a group of competitors.

Participation in a performance unit plan generally is limited to senior executives in a position to have a direct impact upon the employer's success. Eligible employees are awarded a specified number of units valued at a designated dollar amount. The period for measuring performance usually ranges from three to five years. If the goals of the plan are achieved, the employee receives the difference between the value of the unit on the date that it was awarded to the employee and the value of the unit at the end of the performance period. Payment is usually made in cash. An employee granted a performance unit is generally not subject to tax until amounts are actually paid out under the plan.

# INTELLECTUAL PROPERTY

DWIGHT KIM AND CHARLES F. HAUFF JR.

**B**USINESSES often own valuable intangible assets referred to as “intellectual property.” These assets may consist of trade secrets, trademarks and patentable or copyrightable technology. Federal and state laws provide protection to owners of intellectual property in various circumstances. The following chart summarizes the protections of trade secrets, trademarks, patent and copyrights.

**Chart: Summary of Intellectual Property**

	<b>Protectable Subject Matter</b>	<b>Available Protections</b>
<b>Trade Secrets</b>	Virtually any information, including ideas	Right to prevent disclosure or use of information
<b>Trademarks</b>	Words, names, symbols or devices	Right to prevent others from using same or similar marks to identify merchandise
<b>Patents</b>	Machines, processes or compositions of matter; ornamental designs of manufactured goods	Right to exclude all others from making, using, importing, offering to sell or selling patented invention
<b>Copyrights</b>	Literary works, musical works, artistic works and computer software	Right to prevent others from reproducing copyrighted work; exclusive right to distribute copyrighted work

<b>Eligibility for Protection</b>	<b>Commencement of Protection</b>	<b>Duration of Protection</b>
Information must not be known or must not be readily ascertainable by other persons; information must also be the object of reasonable efforts under the circumstances to maintain its confidentiality	On creation	Until legitimate and proper discovery by another
Use of the mark to adequately distinguish one's goods or services; registration may provide enhanced protectability	On use of the trademark	So long as properly used as a trademark
Novelty, nonobviousness and utility	When granted by the U.S. government	20 years from filing date of patent application; with respect to design patents, 15 years from date granted
Tangible form of expression and originality	On creation	Life of the author plus 75 years as respect to works made for hire; 95 years from publication or 120 years from creation, whichever expires first

### **IN GENERAL**

One who invents or discovers a new machine, composition, or process and is the first to file for patent protection may be able to obtain a U.S. patent, which provides the patent owner with the exclusive right for a specified time to prevent others from making, using, importing, offering to sell or selling in the United States the patented invention. A patent provides the holder with a limited monopoly on the use of the patented invention. A valid patent forecloses use of the patented invention by any other party, even if another party independently conceives the identical invention (with certain exceptions for prior commercial use).

A utility patent, which generally covers the functional aspects of a machine, process, or composition of matter, is enforceable beginning at the grant of the patent and ending 20 years (plus more time for certain delays) after the filing date of the regular patent application. A design patent, which covers the ornamental aspects of the design or appearance of an article of manufacture, is enforceable for 15 years from the issue date of the patent. A provisional patent application, which is filed before a regular patent application, establishes a priority filing date and provides up to 12 months to further

develop the invention without filing a regular patent application. During the life of the patent, anyone who makes, uses, imports or sells the patented invention in the United States without authority from the patent holder is considered to “infringe” the patent and may be liable for damages.

The America Invents Act (AIA), signed into law on September 16, 2011, represents the most substantial change to the U.S. patent system in over fifty years. In addition to changing the U.S. patent system from a “first-to-invent” system to “first-inventor-to-file” system, the AIA effected numerous other changes to the U.S. patent laws, some significant, others subtle. Several notable changes to the patent laws provided by enactment of the AIA are highlighted below.

### **EFFECT OF FOREIGN PATENTS**

Patent protection can also be obtained in a large number of foreign jurisdictions. A foreign patent generally is not enforceable in the United States. Furthermore, an invention that is the subject of a foreign patent cannot be the subject of a U.S. patent unless an application for a U.S. patent is filed within one year following issuance of the foreign patent. Accordingly, an inventor who holds a foreign patent but fails to apply for a U.S. patent within one year from the date of the issuance of a foreign patent, usually will have no recourse against others who use the invention in the United States. Likewise, an inventor or patentee interested in obtaining patent protection outside of the United States must take timely proper steps to file an international patent application (under the Patent Cooperation Treaty) or individual national patent applications to secure patent rights in foreign countries that may represent important commercial markets.

### **REQUIREMENTS FOR PATENTABILITY**

Three requirements govern patentability in the United States of a particular invention. First, an invention must be “novel.” An invention is novel if it has not previously been known or used by others in the United States, nor patented nor described elsewhere. Second, the invention must be “nonobvious.” An invention is nonobvious if it could not have been conceived by a person with ordinary skill in the field to which the invention pertains. Third, the invention must have “utility.” An invention has utility if it is useful and is capable of performing the function claimed by the patent.

To determine novelty and, hence, patentability of an invention, it is often useful to search the records of the U.S. Patent and Trademark Office (USPTO). There, one may examine all U.S. patents, many foreign patents and a large number of technical publications. A patent search customarily is performed by a patent attorney or by an individual with similar technical training, sometimes referred to as a patent agent. A patent attorney or patent agent may be asked to render an opinion regarding the patentability of a particular invention. An inventor can then make an informed decision as to whether to proceed to incur the cost of an actual patent application. Publicly available internet resources such as the Google Patents website also provide increasingly useful resources for identifying U.S. and foreign

patents and applications, and inventors and companies currently have a far greater degree of access to technical and patent literature of value to an assessment of the competitive and patent landscape than in years past.

### **PATENT APPLICATION PROCESS**

A U.S. patent application must be filed with the USPTO. A complete patent application includes five elements. First, the application must include the “specification,” a description of what the invention is and what it does. The specification can be filed in a foreign language provided that an English translation, verified by a certified translator, is filed within a prescribed period. Second, the application must include at least one claim. The claims of a patent define the scope of protection afforded by the patent. Third, the application must include drawings, if essential to an understanding of the invention. Fourth, the application must include an oath or declaration, which certifies that the inventor believes himself or herself to be the first and original inventor. Finally, the appropriate fee must be included. Only the first three elements are required to be submitted to receive a filing date. The fee and oath/declaration may be submitted later, within a prescribed time limit.

After a proper application is filed, the application is assigned to an examiner with knowledge of the particular subject matter. The examiner makes a thorough review of the application and the status of existing concepts in the relevant area to determine whether the invention meets the requirements of patentability. The examiner interacts with the applicant and the applicant’s representatives in a process referred to as “patent prosecution.” During this process, the parties communicate regarding the patentability of the invention, and the scope of the patent claims is frequently modified to ensure that any patent rights conferred in a patent grant are appropriately tailored, taking into account all pre-existing technology. The patent prosecution process typically takes approximately 18 months to three years.

The patent prosecution process may not lead to grant of a patent. Rejection of a patent application by the examiner may be appealed to the Patent Trials and Appeals Board (PTAB). Decisions of the PTAB may be appealed to the federal courts.

Provisional patent application requirements are less stringent than those for a regular patent application. The oath or declaration of the inventor and claims are not required and the application is held for the 12-month period without examination. A provisional patent application can be filed to establish a patent application filing date for a non-provisional application subject to examination in the patent prosecution process described above.

## **POST-GRANT REVIEW PROCEEDINGS**

The AIA introduced notable changes to post-grant procedures for challenging the validity of issued patents, including a post-grant review procedure and an inter partes review procedure. These Patent Office litigation procedures provide alternatives to civil procedures that may be litigated in district court in the context of patent infringement and validity disputes, with the Patent Office procedures offering certain strategic advantages including lower burdens of proof and shorter time frames as compared to district court litigation. The post-grant review proceedings have become a popular avenue to test the validity of patent claims outside of civil litigation.

Post-grant review (PGR) is a trial proceeding conducted at the PTAB to review the patentability of one or more claims in a patent. A PGR process begins when a third party files a petition challenging the validity of one or more of the claims in a patent within nine months of the grant of the challenged patent. The petitioner can challenge claims on bases of novelty, obviousness, statutory subject matter, written description, enablement, or definiteness. The patent owner may file a preliminary response to the petition. A PGR will be instituted by the PTAB upon a showing that it is more likely than not that at least one claim challenged is unpatentable. If the proceeding is not dismissed by the PTAB, a final determination by the Board regarding validity of the challenged claims(s) will be issued within 12-18 months.

The inter partes review (IPR) process replaces inter partes reexamination and becomes available after the nine month time period following patent grant has elapsed and begins similarly to a PGR. The standard for instituting an IPR, however, requires that the party requesting IPR show that there is a reasonable likelihood that the requester will prevail on at least one claim. In addition, the bases of invalidity that may be asserted are more limited as compared to a PGR and include only novelty or obviousness challenges based on patents or printed publications. An IPR is decided within 12-18 months of instituting the review.

A special category of review for Covered Business Method (CBM) patents was also provided for in the AIA. This process is available for challenges to the validity of patents with claims to systems or methods for the practice, administration, or management of a financial product or service that does not include a “technological invention.” The rules governing Covered Business Method review share some similarities with those for PGR and IPR, but include several aspects unique to this category of review proceeding. For example, only a party charged with infringement of a CBM patent may initiate a CBM challenge and a CBM challenge can only be filed after nine months from issuance.

Ex parte reexamination continues to remain available under the AIA as a mechanism for third parties to challenge the validity of a patent. An ex parte reexamination procedure may be requested at any time for a granted patent and is initiated by filing a request for reexamination of the patent in light of submitted prior art patents or publications. The requester must establish that a substantial

new question of patentability is presented. Unlike PGR and IPR, if instituted, ex parte reexamination involves only the patent owner and the Patent Office, and the requester may remain anonymous.

### **MARKINGS**

After a patent application has been filed, the product made in accordance with the invention may be marked with the legend “patent pending” or “patent applied for.” After a patent is issued, products may be marked “patent” or “pat.” together with the U.S. patent number or an internet address listing patent numbers associated with the products, the latter marking approach newly added to the patent laws by the AIA and referred to as “virtual marking.” Marking is not required, but it may be necessary to prove marking in order to recover damages in an infringement action.

### **RIGHTS TO PATENTED INVENTIONS**

Disputes sometimes arise between employers and employees over the rights to inventions made by employees during the course of employment. Accordingly, employers often require employees to execute formal agreements under which each signing employee agrees that all rights to any invention made by the employee during the term of employment will belong to the employer.

### **CHANGES TO PATENT LAW UNDER THE AMERICA INVENTS ACT**

The AIA has had an immediate impact on patent litigation both nationally and in Arizona as many litigation-related provisions were effective on the date of enactment. For example, individuals can no longer bring actions for statutory damages based on products that are mismarked as covered by a patent; instead, the federal government can bring an action for statutory damages or private parties can bring an action for compensatory damages based on “competitive injury.” Failure to disclose “best mode” is no longer a basis to invalidate a patent. Joinder and consolidation requirements are stricter, preventing patentees from filing a single lawsuit against many different defendants, whose only connection is that they are all accused of infringing the same patent. The failure of an infringer to obtain the advice of counsel or present such advice to the court or jury “may not be used to prove that the accused infringer willfully infringed the patent or that the infringer intended to induce infringement of the patent.”

Patent prosecution before the USPTO is also heavily affected by the AIA. For example, a dispute between individuals filing for the same invention is no longer decided in favor of the first person to invent but is now dependent on the first person to file a patent application or the first person to publically disclose a technology followed by filing a patent application within one year. Similarly, the UPSTO no longer provides a means to determine questions regarding the first party to invent; instead the USPTO provides a means of determining if a patent applicant derived an invention from another patent applicant, now referred to as a derivation proceeding. The assignee of a patent may now file for the patent. The scope of materials that may be cited as “prior art” is expanded to include more



foreign references as well as prior public uses or sales anywhere in the world. In addition, under the AIA, patent owners can now request the USPTO to perform supplemental examination of a patent to “consider, reconsider or correct information believed to be relevant to the patent,” allowing patent owners an opportunity to address certain issues otherwise missed in the original prosecution of the patent.

Practically, implementation of the IPR post-grant procedure described above may represent one of the more significant economic impacts of the AIA, with the high rate of challenged claims invalidated leading some analysts to suggest that patent valuations have decreased to a tune of hundreds of billions of dollars. Other changes that practitioners feared would have negative impacts, such as the expanded universe of information available as potential prior art, have not produced significant practical effects in patent prosecution. Businesses and prospective patentees should remain aware that the AIA change from a first-to-invent to a first-inventor-to-file patent system heightens the need for inventors and companies to implement effective mechanisms for identifying inventions and determining whether to file for patent protection without excessive delay to minimize any risk of competitors filing in the Patent Office first.

## **CHANGES TO PATENT LAW UNDER RECENT COURT DECISIONS**

### **Patentable Subject Matter Eligibility**

The Supreme Court has been actively considering patent law cases in the last few years, and recent decisions by the Court have produced considerable uncertainty with respect to the patentability of inventions in the fields of business methods, software, and diagnostic methods. The cases in question have generally involved the Court’s consideration of the so called judicial exceptions to patentable subject matter, which include abstract ideas, laws of nature, and natural phenomena. In particular, the Court’s 2014 decision in *Alice Corp. v. CLS Bank* regarding the subject matter eligibility of a software system and method has resulted in a substantial decrease in the allowance rate of software and business method patent applications and an increase in the success rate of challenges of the validity of issued patents in those areas. The impact of the Alice decision extends into other technology areas such as diagnostic methods, an area that has itself received attention from the Court with the decision in *Mayo Collaborative Services v. Prometheus Laboratories, Inc.* (2012). The USPTO has periodically published subject matter eligibility guidance setting forth and clarifying the analytical framework by which the Patent Office examines claims in patent applications in light of the Court’s decisions in Alice and Mayo, among other cases. However, subject matter eligibility questions continue to be hotly contested in the lower courts, and continued refinement of the rules set forth in Alice and Mayo in future appellate cases is likely. Thus, businesses and their counsel should be aware of the unsettled nature of the patent laws with respect to certain areas of technology and the associated business risks and costs. Despite the uncertainty posed by the impacts of evolving case law, it remains possible to obtain patent protection for software, business

method, and diagnostics technologies, and businesses should seek the guidance of experienced patent counsel to formulate strategies for navigating the changing patent laws and pursue patent protection for their technologies.

### **Fee-Shifting and Non-Practicing Entities**

Patent holders that do not operate a business leveraging the technology of their patents but seek to enforce their patent rights against accused infringers, referred to as “non-practicing entities” (NPEs) or the more colorful term “patent trolls,” have become a frequent subject of headlines and legislative reform initiatives. At a federal level, certain provisions included in the AIA were designed to raise obstacles to NPE litigation (e.g., 35 U.S.C. § 299, which limit the ability of an NPE to join large numbers of accused infringers in a single patent infringement suit), and there is some evidence that the post-grant review procedures introduced by the AIA are also being used to challenge patents owned by NPEs. In addition to various legislative tools that may be used to combat NPEs, the Supreme Court issued a pair of decisions in 2014, *Octane Fitness LLC v. Icon Health & Fitness Inc.* and *Highmark Inc. v. Allcare Health Management System Inc.*, that interpreted the attorney-fee shifting provision of 35 U.S.C. § 285 in a manner that has discouraged lawsuits by NPEs. Those decisions provide lower courts with more latitude for determining that a case is “exceptional” and subject to an award of attorneys’ fees to the prevailing party in cases in which patent litigation is brought or conducted in an abusive manner. In addition, several states have passed anti-troll legislation, with states’ Attorneys General bringing legal action against companies that threaten small businesses and nonprofits with patent infringement suits. The State of Arizona may implement similar legislation that would likewise enable the Office of the Arizona Attorney General to bring suit against NPEs asserting patent infringement in bad faith.

## **Trademarks**

### **IN GENERAL**

A mark is often used by a business to identify its merchandise or services and to distinguish them from those supplied by others. A mark can be a word, name, number, slogan, symbol, device or combination.

A trademark should not be confused with a trade name. Although the same designation may function as both a trademark and a trade name, a trade name refers to a business title or the name of a business; a trademark is used to identify the source of goods or services.

### **SELECTION OF TRADEMARK**

A company should carefully consider the trademark selected for its merchandise. The level of protection against infringement of a trademark varies with the “strength” or “uniqueness” of the

trademark. “Generic” marks are entitled to no protection at all. “Descriptive” marks are the weakest and least protectable. A descriptive trademark is a name that describes some characteristic, function or quality of the goods. “Arbitrary” and “fanciful” marks are the strongest types of marks. An “arbitrary” mark consists of a word or symbol that is in common usage in the language, but is arbitrarily applied to the goods or services in question in such a way that is not descriptive or suggestive. A “fanciful” mark is a coined name that has no dictionary definition.

Evaluation should also include consideration of the likelihood of success in obtaining federal and state registrations of the trademark. For example, a trademark that is “merely descriptive” cannot be registered under either federal or Arizona law.

Selection of a trademark should be accompanied by a trademark search to determine whether someone else has already adopted or used a mark that is the same or similar to the one desired in one or more relevant areas of commerce. Publications provide lists of existing trademarks, including both registered and unregistered marks, and there are businesses that specialize in trademark searches. Actual and potential trademark conflicts should generally be avoided, lest the business become involved in an expensive infringement lawsuit. Of even greater concern is the potential loss of the right to use a mark after considerable expenditure in advertising goods or services bearing the mark.

### **ADVANTAGES OF TRADEMARK REGISTRATION**

Under the trademark laws of the United States and Arizona, the principal method of establishing rights in a trademark is actual use of the trademark. “Registration” of a trademark is not legally required but can provide certain advantages.

Federal registration of a trademark is presumptive evidence of the ownership of the trademark and of the registrant’s exclusive right to use of the mark in interstate commerce, strengthening the registrant’s ability to prevail in an infringement action. After five years of continued use of the mark following federal registration, the registrant’s exclusive right to use the trademark becomes virtually conclusive. Federal registration may assist in preventing the importation into the United States of foreign goods that bear an infringing trademark. There are also other, less tangible advantages of registration, such as the implication of government approval of the trademark.

State registration provides some advantages, but not as extensive as federal registration. State registration is usually advisable, particularly in situations in which a business’ sales will occur only in Arizona.

## **FEDERAL REGISTRATION APPLICATION PROCESS**

Federal trademark registration requires that a trademark application be filed with the USPTO. The application must identify the mark and the goods with which the mark is used or is proposed to be used and must be accompanied by payment of the requisite fee. After the application is filed, it is reviewed by an examiner who evaluates, among other matters, the substantive ability of the mark to serve as a valid mark and the possibility of confusion with existing marks. If the examiner rejects the application, the examiner's decision can be appealed to the Trademark Trial and Appeal Board. An adverse decision by that body can be appealed to federal court.

If the application is approved, the mark is published in an official publication of the USPTO. Opponents of the registration have 30 days after publication, or such additional time as may be granted, to challenge the registration. If no opposition is raised, or if the opponent's claims are rejected, an applicant whose mark is already in use receives a "certificate of registration." An applicant whose trademark is proposed before use receives for future use a "notice of allowance." An applicant who receives a notice of allowance must, within six months of the receipt of the notice, furnish evidence of the actual use of the trademark. The applicant is then entitled to a certificate of registration. Failure to furnish evidence of the actual use of the mark within the time allowed results in rejection of the application.

## **POST-CERTIFICATE FEDERAL PROCEDURES**

A certificate of trademark registration, issued by the USPTO, remains in effect for 10 years. Registration expires at the end of six years unless the registrant furnishes evidence of continued use of the trademark. The initial 10-year term of a certificate of registration can be renewed for an additional 10-year term by furnishing evidence of continued use of the mark and paying a fee during the one-year period immediately preceding the end of the 10-year period.

After at least five years of continuous use of a trademark following the receipt of a certificate of registration, a registrant can seek to have the status of the trademark elevated from "presumptive" evidence of the registrant's exclusive right to use of the trademark to virtually conclusive evidence of an exclusive right. To do so, the registrant must furnish the USPTO with evidence of continuous use of the trademark for at least five years. Additionally, there must not be any outstanding lawsuit or claim that challenges the registrant's rights to use the mark.

## **STATE REGISTRATION APPLICATION PROCESS**

Arizona trademark registration law requires that a trademark application be filed with the Arizona Secretary of State. The application must identify the mark and the goods or services with which the mark is used and must be accompanied by the requisite fee. In contrast to registration of a mark under federal law, the mark must actually be in use before an Arizona registration application can be

filed. If the trademark application is approved, the applicant receives a certificate of registration. A certificate of registration has an initial 10-year term and can be renewed indefinitely for successive 10-year terms.

### **MARKINGS**

Before receipt of a certificate of registration, the designation “TM” can be used in association with the trademark. After a federal certificate of registration has been obtained, merchandise can be marked “Reg. U.S. Pat. & Tm. Off.” or “Registered in U.S. Patent and Trademark Office,” or with an encircled “R” or some similar designation to reflect that the trademark has been federally registered. Marking is not required, but proof of marking may be necessary to recover damages in an infringement action.

### **TRADE NAMES**

Arizona provides separate registration of trade names with the Arizona Secretary of State. The application is simple. The registration remains in effect for five years and may be renewed for successive five-year terms. The Secretary of State will not register any trade name if it might mislead the public or is not readily distinguishable from names, titles or designations previously registered and still in effect, or if it is the same as, or deceptively similar to, an existing corporate name or one that has been reserved. However, there is no requirement that a trade name be registered by the Secretary of State, nor is there currently any routine process for purging the Secretary of State records of trade names or trademarks that are no longer in use. For these reasons, prospective trade name or trademark registrants should not rely only on Secretary of State records in selecting and adopting a trade name or trademark.

## **Copyrights**

### **IN GENERAL**

Copyright law provides the author of a copyrightable work (or such person’s employer in the case of a “work made for hire”) with exclusive rights to use, distribute, modify and display the work. Generally, works are entitled to copyright protection for the life of the author plus 75 years. As to works made for hire, however, copyright protection is for the shorter of 95 years after publication or 120 years after creation. Anyone who, without authority, exercises the rights reserved exclusively to the copyright owner is considered to infringe the copyright and may be liable for damages.

### **COPYRIGHTABLE WORKS**

Works of authorship that qualify for copyright protection include literary works, musical works, dramatic works, pantomimes and choreographic works, pictorial, graphic and sculptural works, motion pictures and other audiovisual works, sound recordings and architectural works. The Computer

Software Copyright Act of 1980 expressly made computer software eligible for copyright protection. The precise scope of copyright protection for computer software has not yet been fully defined. Constantly developing technology is likely to present many new issues, presently unforeseen.

All works eligible for copyright protection must meet two specific requirements. First, the work must be fixed in some tangible form; there must be a physical embodiment of the work so that the work can be reproduced or otherwise communicated. Second, the work must be the result of original and independent authorship. The concept of originality does not require that the work entail novelty or ingenuity, concepts of importance to patentability.

### **ADVANTAGES OF COPYRIGHT REGISTRATION**

Copyright protection automatically attaches to a work the moment that the work is created. "Registration" of the work with the U.S. Copyright Office, however, provides advantages. A certificate of registration is prima facie evidence of the validity of the copyright, provided registration occurs not later than five years after first publication. With respect to works whose country of origin is the United States, registration is a prerequisite to an action for infringement. With respect to all works, regardless of the country of origin, certain damages and attorneys' fees relating to the period prior to registration cannot be recovered in an infringement action. Registration also is a useful means of providing actual notice of copyright to those who search the copyright records.

### **COPYRIGHT REGISTRATION APPLICATION PROCESS**

In order to obtain registration of copyright, an application for registration must be filed with the U.S. Copyright Office. The application must be made on the specific form prescribed by the Register of Copyrights and must include the name and address of the copyright claimant, the name and nationality of the author, the title of the work, the year in which creation of the work was completed and the date and location of the first publication. In the case of a work made for hire, a statement to that effect must be included. If the copyright claimant is not the author, a brief statement regarding how the claimant obtained ownership of the copyright must be included. An application must be accompanied by the requisite fee and a copy of the work must be submitted.

### **COPYRIGHT NOTICE**

Until 1989, all publicly distributed copies of works protected by copyright and published by the authority of the copyright owner were required to bear a notice of copyright. A copyright notice is no longer mandatory, but a copyright notice is still advantageous. For example, the defense of "innocent infringement" generally is unavailable to an alleged infringer if a copyright notice is used.

If a copyright notice is used, the notice should be located in such a manner to sufficiently demonstrate the copyright claim. The notice should consist of three elements: first, should be the symbol of an

encircled “C,” or the word “copyright,” or the abbreviation “copr.”; second, should be the year of first publication; and third, should be the name of the copyright owner.

### **WORKS MADE FOR HIRE**

In a “work made for hire” the employer is presumed to be the author. Authorship is significant because a copyright initially vests in the author. The parties can rebut the presumption of employer authorship by an express written agreement to the contrary.

The term “work made for hire” applies to any work created by an employee in the course and scope of employment. On occasion, there is dispute as to whether a work created by an employee arose from the employment, and application of the “work made for hire” definition may not be straightforward. Employers often require execution of a formal employment agreement under which the employee expressly agrees that all copyright rights will belong to the employer. A similar agreement is also advisable in connection with the engagement of an independent contractor to perform copyrightable services for a business, since particular criteria must be met in order for a work created by an independent contractor to be a work made for hire.

### **COPYRIGHT PROTECTION FOR FOREIGN AUTHORS**

Copyright protection is available under U.S. law for foreign authors until the copyrightable work is published. If the work has been published, the availability of continued U.S. copyright protection is dependent upon the location of the publication and the nationality or domicile of the author. Copyright protection continues in the United States subsequent to publication if publication by the foreign author occurs in the United States or occurs in a country that is a treaty party. A treaty party is a country or intergovernmental organization, other than the United States, that is a party to an international agreement. If the work is first published by a foreign author outside the United States, continued copyright protection in the United States is available only if the foreign author is either a domiciliary of the United States or a national or domiciliary of a country that is a party to a copyright treaty to which the United States is also a party. A person is generally a domiciliary of the country in which the person resides with the intention to remain permanently.

## **Trade Secrets**

### **IN GENERAL**

Manufacturing businesses and other businesses may possess commercially sensitive information. The ability to benefit from such information and yet keep the information secret from competitors is a common business objective. Substantial protections are available if the information can legally be considered a “trade secret.”

## **REQUIREMENTS OF A TRADE SECRET**

Among items of information characterized as trade secrets have been manufacturing processes, product specifications, employee training manuals, computer programs, databases, marketing plans, financial statements and customer lists.

There are two requirements for business information to qualify as a trade secret. One essential qualification is that the information must not be generally known or readily ascertainable by proper means by other persons. The other is that reasonable efforts must be made to maintain the secrecy of the information. The holder of the trade secret must take affirmative steps to safeguard confidentiality. There are no specific actions that must be taken, but these steps should be considered:

- advise employees through an employee manual or other writing of the employer's policy regarding protection of trade secrets;
- require employees who have access to trade secrets to sign confidentiality agreements;
- physically separate trade secret information from other information;
- install locks on gates and doors leading to areas where trade secrets are housed;
- label trade secret documents clearly with a proprietary notice and instruct employees as to the significance of the notice; and
- restrict access by use of password codes to access computer systems used to store trade secrets.

## **UNIFORM TRADE SECRETS ACT**

Arizona and 47 other states have adopted the Uniform Trade Secrets Act (the UTSA) or based their respective laws on the UTSA. Under the UTSA, a person who obtains a trade secret through improper means such as theft, bribery, misrepresentation or espionage, or a person who obtains a trade secret from another, if such person has reason to know that the trade secret was obtained by improper means, can be enjoined or sued for substantial damages. Legal action may be taken under the UTSA against competitors, employees, suppliers, partners and virtually any other person or entity who seeks to disclose or use another's trade secret improperly. However, New York and Massachusetts have not yet adopted the UTSA, and interpretation and implementation can vary from state to state.

## **DEFEND TRADE SECRETS ACT**

On May 11, 2016, the Defend Trade Secrets Act (DTSA) was enacted. The DTSA created a federal, private, civil cause of action for trade secret misappropriation. Previously, only state law causes of action for trade secret misappropriation were available. The DTSA does not preempt state law, meaning an action for trade secret misappropriation may be brought at state court or federal court.

The DTSA's definition of a trade secret is relatively broad, including "all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans,



compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if— (A) the owner thereof has taken reasonable measures to keep such information secret; and (B) the information derives independent economic value” from not being generally known.

The DTSA defines misappropriation as “(A) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or (B) disclosure or use of a trade secret of another without express or implied consent” by a person who used improper means to acquire the trade secret or had reason to know that the trade secret was acquired using improper means.

In order to bring an action under the DTSA, the plaintiff must allege (1) that the plaintiff owned a trade secret; (2) that the defendant acquired, disclosed, or used that trade secret through improper means; and (3) that the defendant” actions harmed the plaintiff.

A finding of trade secret misappropriation under the DTSA allows for various remedies, including an injunction, damages, and in extraordinary circumstances, civil seizure. Civil seizure is reserved for situations where the seizure of property is “necessary to prevent the propagation or dissemination of the trade secret that is the subject of the action.”

The DTSA does not automatically provide a presumption of irreparable harm, and it must be proven by the plaintiff in order to receive preliminary injunctive relief against the defendant. The DTSA also prohibits injunctions that prevent a person from entering into an employment relationship, although conditions may be placed on the employment.

Attorneys’ fees and punitive damages are available under the DTSA. In DTSA actions, however, an employer may only recover these damages if the employer provided notice to its employees of the whistleblower immunity provisions of the DTSA, described below. The notice of the whistleblower immunity provisions of the DTSA may be satisfied by (1) incorporating the whistleblower immunity provisions in the contract or agreement itself, or (2) including in the contract or agreement a cross-reference to the employer’s policy containing the whistleblower immunity provisions.

The DTSA provides whistleblower immunity for employees who disclose a trade secret that is made in confidence to an attorney or federal, state, or local governmental official “solely for the purpose of reporting or investigating a suspected violation of law,” or in a filing in a lawsuit made under seal. The whistleblower immunity protects the employee from any criminal or civil liability under any federal or state trade secret law.



# ENVIRONMENTAL

CHRISTOPHER P. COLYER AND FARRIS J. GILLMAN

**A**rizona is widely recognized as having an efficient and workable balance between environmental and developmental goals. The state is home to both stunning natural wonders like the Grand Canyon, as well as major business endeavors, including copper mines that are among the largest in the world and the largest nuclear generating station in the country. Arizona and its state environmental agency work closely with businesses to foster growth while minimizing impacts to the environment.

As with any state, some environmental concerns are more prominent than others. Given the state's arid climate, water protection is a key concern. Likewise, its large expanses of undeveloped desert land produce substantial amounts of dust, leading to more significant regulatory oversight of the state's air quality. There are localized concerns within the state as well. Large portions of the state are comprised of state and national parks and tribal lands, which hold their own regulatory challenges. Fortunately, the state government of Arizona has demonstrated a continuing commitment to managing these environmental issues while still fostering economic growth.

This chapter provides a broad overview of the environmental regulation of air, water, hazardous materials, endangered and native species, and renewable energy within Arizona. Most of these areas implicate multiple layers of legal regimes. There are four primary sources of environmental regulation in Arizona:

- federal law, as regulated by the U.S. Environmental Protection Agency (EPA);
- state law, as regulated by the Arizona Department of Environmental Quality (ADEQ);

- tribal law, as regulated by various Native American communities located within the state; and
- local law, as regulated by the state’s municipalities and counties.

The purview of each is discussed below with respect to the major areas of environmental regulation found in the state.

## **Air Pollution Control**

Air quality is a major area of concern in Arizona, largely due to the state’s geography and climate. Any business operating within the state should be aware of the requirements arising under the federal Clean Air Act (CAA), particularly as they pertain to dust control, ozone, and greenhouse gases. The CAA is designed to “protect and enhance the nation’s air resources so as to promote the public health and welfare and the productive capacity of the population.”

Like many federal environmental statutes, the CAA operates under a system of cooperative federalism. Both EPA and ADEQ—and in some circumstances various Arizona counties—play a role in implementing the law. ADEQ is charged with the primary responsibility for administering the state’s air quality programs. ADEQ is also tasked with determining the quantity and nature of emissions of air contaminants, the economic effect of remedial measures on the various areas of the state and the effect on human health and danger to property from air contaminants.

ADEQ has delegated its authority to some of the counties within Arizona—Maricopa County, Pima County, and Pinal County—to administer and enforce the CAA with respect to certain air quality standards. County air quality regulation is vested in the County Board of Supervisors and in the “control officers” who are designated officials in each county. The County Board of Supervisors adopts regulations proposed and administered by the control officer and the control officer’s staff. For tribal air permit programs, however, EPA Region 9 is responsible for conducting the functions that the county or state otherwise would perform.

The CAA establishes National Ambient Air Quality Standards (NAAQS) for “criteria pollutants” to protect public health and public welfare. These criteria pollutants include particulates, carbon monoxide, ozone, nitrogen dioxide, lead, and sulfur dioxide. Arizona—or in some instances Maricopa County, Pima County, and Pinal County—must submit State Implementation Plans (SIPs) that set forth rules and regulations within the state or county to achieve compliance with the air quality standards promulgated for each criteria pollutant. EPA also sets minimum air quality levels for other “hazardous pollutants” such as asbestos, mercury and other air toxics.

The State’s most populous county, Maricopa County, is classified as a nonattainment area for both PM-10 particulates (i.e., dust) and ozone (O3). The state’s second most populous county,

Pima County, has been classified as a nonattainment area for PM-10 particulates. In light of their significant history of noncompliance, both counties employ a comprehensive set of regulations to manage and control air emissions. Although these regulations are intended to foster economic growth, businesses entering these counties should be mindful of potential permit requirements.

### **AIR PERMITS**

The CAA requires certain sources of emissions to obtain air permits from either EPA, ADEQ, or the County. The permit process often requires that an applicant submit a detailed compliance plan and provide notice to the public. Public hearings may also be held if requested by the public.

The type of permit—and any emission limitations requirements—will differ depending on the type of emissions source, the quantity and type of emissions, and its location. Sources generally will be subject to more stringent permit requirements if located within a region that does not meet a NAAQS requirement for a pollutant (referred to as a nonattainment area). For example, in attainment areas, a permit is required before a business can construct or modify a facility with the potential to emit 100 or more tons per year of a regulated pollutant. The owner or operator must also provide for control of the emissions through the “best available control technology” and demonstrate that facility operation will not result in “significant deterioration” of air quality. By contrast, in nonattainment areas, a permit may be conditioned upon the installation of pollution control equipment that results in the “lowest achievable emissions rate.” Moreover, new major sources in nonattainment areas typically must also obtain an emissions offset through the creation or purchase of emissions reduction credits.

## **Water Pollution Control**

Water quality in Arizona is regulated under federal, state, and local laws.<sup>1</sup> Primary regulation is through a permitting program intended to limit discharges of pollutants. Generally, water pollution control in Arizona falls into two categories: surface waters (such as water in streams, rivers, lakes, ponds and springs) and subsurface groundwater.

### **SURFACE WATER**

Surface water quality is generally regulated through two permitting processes under two sections of the Clean Water Act: Section 402 and Section 404. The 402 permits (more commonly known as AZPDES permits) are required for discharges into a “water of the United States” (WOTUS) and a 404 permit is required for dredging or filling a WOTUS.

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<sup>1</sup> Please note that this section addresses water quality standards. Water rights will be discussed at length in the following chapter.

The standard for what water qualifies as “a water of the United States” is somewhat amorphous, but includes navigable waters and any water with a significant nexus to such waters. Under the Obama administration, EPA proposed a much broader definition for WOTUS that would increase the number of water bodies subject to regulation, but the Trump administration has withdrawn this effort.

Groundwater historically has not been considered a WOTUS. However, recently the Ninth Circuit Court of Appeals—which encompasses Arizona—held that a discharge into groundwater that was “fairly traceable” to the ocean constituted a discharge into a WOTUS. Although this decision could be overturned on appeal or limited by the U.S. Supreme Court, businesses should be mindful of its impacts if they anticipate their operations will cause discharges to groundwater.

### **Permits to Discharge into Surface Waters**

An AZPDES permit must be obtained from ADEQ before any facility can discharge regulated pollutants into surface waters of the United States. An application for an AZPDES permit must demonstrate that regulated pollutants in the discharges will not exceed specific standards. In addition, AZPDES permits are required for most construction sites and certain industrial sites to address pollution caused by stormwater runoff.

### **Dredge and Fill Permits**

Section 404 of the Clean Water Act prohibits the deposit of dredge or fill materials into the waters of the United States and adjacent wetlands without a dredge and fill permit. The Army Corps of Engineers administers this program for most of the country, including Arizona. Arizona is currently pursuing the authority to issue these permits, and if successful will be only the second state to do so. Issuance of a dredge and fill permit is conditioned upon state certification that the applicant’s discharge will not contravene existing water quality standards.

Certain activities may be exempt from dredge and fill permit requirements. Exempt activities include normal farming, ranching, or silviculture activities. Additionally, certain activities may be eligible for certain streamlined permits, referred to as Nationwide permits, which allow businesses to avoid a prolonged permit approval process.

### **Industrial Pretreatment Regulation**

Publicly owned sewage treatment systems that ultimately discharge effluents into surface waters and industrial facilities that discharge into surface waters or into publicly owned sewage treatment systems are regulated under the Clean Water Act. Such facilities must comply with specific EPA pretreatment standards and, under certain conditions, must obtain facility-specific discharge permits. These standards are intended to limit discharges of regulated pollutants into surface waters and to protect the systems and their operators from dangerous pollutants, such as corrosive materials. Such systems may also be regulated under county or municipal ordinances.

## **GROUNDWATER**

All underground strata in the state that yield usable quantities of potable water are characterized as “aquifers.” ADEQ imposes strict standards to preserve the drinking quality of groundwater from aquifers. Any discharge into an aquifer that would violate these standards is prohibited.

### **Aquifer Protection Permit Program**

Arizona’s Aquifer Protection Permit (APP) program is designed to reduce and, where practicable, eliminate the discharge of pollutants to the state’s aquifers or groundwater. Subject to certain exemptions, any person that discharges pollutants that have a reasonable probability of reaching groundwater must obtain an APP from ADEQ. The term “discharge” is broadly defined for purposes of aquifer protection as the “addition of a pollutant from a facility either directly to an aquifer or to the land surface or the vadose zone in such a manner that there is a reasonable probability that the pollutant will reach an aquifer.” The APP program provides for two types of permits: general and individual. As the name suggests, individual permits are tailored for a specific facility, and thus are more expensive and have more extensive application requirements. By contrast, general permits are “one size fits all” type permits designed to provide coverage for similarly-situated facilities with common discharges.

Procuring an APP—particularly an individual permit—can often be a difficult, expensive and time-consuming effort. In recent years though, ADEQ has worked to drastically reduce permit approval times in an effort to better support the regulated community.

## **Hazardous Waste**

Under the Resource Conservation and Recovery Act (RCRA), EPA has established standards for the protection of the environment and human health from materials specifically identified as “hazardous waste.” The comprehensive regulatory program adopted by EPA regulates waste materials from generation through final disposal. ADEQ administers and enforces the state hazardous waste program, although Arizona largely incorporates RCRA standards into its regulatory scheme. Regulations address three broad aspects: generation, transportation and treatment, and storage or disposal.

### **GENERATION OF HAZARDOUS WASTE**

A facility that generates hazardous waste must advise ADEQ on an annual basis of the level of its generating activities and must comply with specific recordkeeping, handling, and disposal requirements. Depending on the quantity of hazardous waste generated per year, a site may need to register with ADEQ and obtain an EPA Hazardous Waste Identification Number. Before transporting or offering hazardous waste for transportation to an offsite location, the facility also must comply with packaging, labeling, and marking requirements.

## **TRANSPORTATION OF HAZARDOUS WASTE**

Transporters of hazardous waste must comply with reporting and recordkeeping requirements. Among other requirements, a transporter of hazardous waste in Arizona must obtain a special license from the Department of Transportation before moving such materials.

## **TREATMENT, STORAGE AND DISPOSAL OF HAZARDOUS WASTE**

A facility that treats, stores, or disposes of hazardous waste is subject to extensive regulations. Strict requirements govern the design, construction, maintenance, operation, and closure of such a facility in order to minimize the possibility of fire, explosion, or unplanned releases of hazardous wastes that could threaten the environment or human health. Among other requirements, treatment, storage, and disposal facility personnel must be trained to respond effectively to emergencies. Closure of such facilities must take place in accordance with an approved plan that minimizes the need for further maintenance and the possibility of post-closure escape of hazardous waste. Specific requirements are determined on a facility-by-facility basis.

# **Employee Hazard Communication**

## **OSHA REQUIREMENTS**

The Occupational Safety and Health Administration (OSHA) imposes a duty on employers to provide employees with a safe and healthy place to work, free from recognized hazards causing or likely to cause death or serious physical harm. The U.S. Labor Department issued a specific standard for the use of hazardous chemicals in the workplace known as the “OSHA Hazard Communication Standard,” requiring employers to inform employees about “hazardous chemicals” they may be exposed to. Hazardous chemicals are defined broadly and includes carcinogens, toxins, irritants, corrosives, sensitizers, agents that damage the skin, lungs, or eyes, and chemicals that are combustible, explosive, or flammable.

The Standard imposes four basic requirements. First, chemical manufacturers, importers or distributors must label, tag or mark each container of hazardous chemical with the hazardous chemical and an appropriate hazard warning. Second, employers must maintain and make available a material safety data sheet (MSDS), which identifies the specific chemical, the health hazards associated with the chemical, known precautions for safe handling and use of the chemical and first aid procedures. Third, employers must provide employees with information and training on hazardous chemicals in the workplace, both at the time of their initial employment and whenever a new hazard is introduced into the work area. Fourth, employers must develop, implement, and maintain at the workplace a written hazard communication program.



## **EMERGENCY PLANNING AND COMMUNITY RIGHT-TO-KNOW ACT**

The Emergency Planning and Community Right-to-Know Act (EPCRA) imposes reporting requirements on businesses that use hazardous chemicals. The reporting requirements are intended to provide the public with important information on hazardous chemicals in their communities, to enhance community awareness of chemical hazards, and to facilitate state and local emergency response plans. The reporting requirements under EPCRA fall into four categories: (1) the chemical name or the common name as indicated on the MSDS (or SDS); (2) an estimate of the maximum amount of the chemical present at any time during the preceding calendar year and the average daily amount; (3) a brief description of the manner of storage of the chemical; and (4) the location of the chemical at the facility.

### **Emergency Planning Reporting**

An owner or operator of any facility that has any “extremely hazardous substance” present in designated quantities must notify the state and local emergency planning commissions under EPCRA. The presence and location of additional quantities of specified substances must be reported within 60 days of the acquisition and the notification must include the name of a facility representative who can be contacted in the event of an emergency.

### **Chemical Inventory**

Businesses are required to provide an annual inventory of certain chemicals under EPCRA. Any business that prepares a material safety data sheet in compliance with the OSHA Hazard Communication Standard must submit a list of all chemicals for which a material safety data sheet is required that are present at the facility in quantities greater than threshold reporting quantities at any one time during the year or the business must submit the actual material safety data sheet. Additionally, businesses must submit an annual chemical inventory report specifying the average daily amount of a chemical on the premises, the maximum amount present on any given day and the location of the chemicals. A business may be exempted from publicly disclosing the identity of a specific chemical if it can establish that the disclosure would reveal a trade secret; however, the business still must report the specific chemical to EPA, who will determine if the claim to the trade secret exception is valid.

### **Emergency Notification**

Under EPCRA, the owner or operator of any facility that produces, uses or stores any hazardous chemical defined under the OSHA Hazard Communication Standard must report the spill or release of any such chemical outside the facility. The report must be made to the National Response Center, the state emergency response commission and the local emergency planning committee. Two notifications are required: an initial notice and a follow-up notice. The initial notice may be by telephone and must include the identity and amount of the chemical released, the duration of the release, and information regarding any health hazard created by the release. The follow-up notice

must be in writing, must update the information previously submitted, and must identify the actions taken.

### **Toxic Chemical Release Reporting**

EPCRA requires every manufacturing company that has 10 or more full-time employees and that manufactures, imports, processes, or otherwise uses any “toxic chemical” in an amount greater than the designated threshold amount during the calendar year to submit annual reports summarizing the discharge of toxic chemicals into the environment during the preceding year.

## **Superfund Laws**

Federal and state statutes, commonly referred to as “Superfund Laws,” authorize government actions against responsible parties for reimbursement of cleanup costs and for damages to natural resources caused by the release of hazardous substances into the environment. The federal and state statutes also contain citizen suit provisions, which allow private parties in certain situations to bring claims against responsible parties for releases of hazardous substances into the environment. A “responsible party” can include a generator or transporter of the hazardous substance or any present or past owner or operator of a site from which hazardous substances are released.

### **FEDERAL SUPERFUND**

The Federal Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA), as amended in 1986, and most recently in 2002 by the Small Business Relief and Brownfield Revitalization Act (Brownfield Amendments), historically held that owners of property could be strictly liable solely by virtue of ownership of a property on which a “hazardous substance” had been released or was threatened to be released. Liability under the federal Superfund Law is joint and several. Joint liability means that each responsible party may be held liable for the entire amount of cleanup costs and damages at a site, regardless of the responsible party’s actual share of liability. Furthermore, liability is “strict,” which means that a responsible party may be held liable without regard to fault. A purchaser of a site contaminated by a prior owner’s operations may be liable no matter when or by whom the hazardous substances were disposed.

Given the harsh impacts of this stringent liability scheme on purchasers of property, CERCLA provides three affirmative defenses to purchasers or new lessees of properties: (1) the innocent purchaser defense, (2) the bona fide prospective purchaser defense, and (3) the contiguous property owner defense.

### **The Innocent Purchaser Defense**

An important defense to environmental liability where a site has been contaminated by another party’s operations is the “innocent purchaser” defense. This defense protects purchasers who

acquire property without knowledge of contamination on the property and inheritors of contaminated property.

Under the innocent purchaser defense, a party will not be liable if it can be established that after performing “all appropriate inquiry,” the purchaser had no reason to know about the presence of hazardous substances at the site prior to acquisition. Although the Superfund laws are not explicit about the extent of inquiry required, at minimum this inquiry is accomplished thorough a Phase I environmental site assessment. Additionally, eligibility for the defense requires that the property owner or operator (1) exercise due care upon discovery of the hazardous substance; (2) comply with all continuing obligations; and (3) take adequate precautions against the foreseeable acts or omissions of any third party.

### **The Bona Fide Prospective Purchaser Defense**

A purchaser of property, after January 11, 2002, may qualify as a bona fide prospective purchaser (BFPP), even with knowledge of contamination, after performing all appropriate inquiry, provided the buyer also satisfies several other criteria set forth by statute. Specifically, to be a BFPP, a party must not be affiliated with any other person who is potentially liable for response costs. Importantly though, a contractual relationship that is created by the instruments by which title to a property is conveyed or financed do not constitute a prohibited affiliation. Additionally, the purchaser must meet certain continuing obligations, including (1) complying with land use restrictions and any institutional controls; (2) taking reasonable steps with respect to releases of hazardous substance; (3) providing full cooperation, assistance, and access to authorized persons so they may conduct response actions or natural resource restoration; (4) complying with information requests; and (5) providing legally required notices.

The BFPP provision of CERCLA provides landowner liability protection and limits EPA’s recourse for unrecovered response costs to a lien on the property for the increase in fair market value attributable to EPA’s response action.

### **Contiguous Landowner Defense**

The 2002 Brownfields Amendments also created a defense for contiguous property owners (CPOs). Like BFPPs, CPOs must conduct “all appropriate inquiries” prior to acquiring the property and have no affiliation with a liable party. They are also subjected to the same ongoing obligations as a BFPP— (1) complying with land use restrictions and any institutional controls; (2) taking reasonable steps with respect to releases of hazardous substance; (3) providing full cooperation, assistance, and access to authorized persons so they may conduct response actions or natural resource restoration; (4) complying with information requests; and (5) providing legally required notices.

## **STATE SUPERFUND**

The State of Arizona also has its own Superfund laws, which are set forth in its Water Quality Assurance Revolving Fund (WQARF) statutes. Similar to CERCLA, WQARF also classifies an “owner” of contaminated property as a “responsible party.” However, unlike CERCLA, the WQARF program has eliminated joint liability. In addition, WQARF specifically exempts from liability a person who merely owns real property, unless that person: (1) was engaged in the business of generating, treating, storing or disposing of hazardous substances or waste at the site or “knowingly permitted” others to engage in such a business there; (2) permitted a person to use the facility for the disposal of a hazardous substance; or (3) “knew or reasonably should have known that a hazardous substance was located in or on the facility at the time rights, title or interests in the property was first acquired by the person” and “engaged in conduct by which he associated himself with the release.”

WQARF has a defense similar to the CERCLA innocent purchaser defense which is available to purchasers of contaminated property who did not cause or contribute to a hazardous substance release. Additionally, a person is not a responsible party under WQARF “with respect to a hazardous substance that is located on or beneath property that is owned or occupied by that person if the hazardous substance is present solely because it migrated from property that is not owned or occupied by that person and that person is not otherwise a responsible party.”

## **Underground Storage Tank Regulation**

Underground storage tanks are subject to federal and state regulations enforced by ADEQ. An owner of an underground storage tank must notify ADEQ within 30 days after placing the tank into operation. An owner or operator of an underground storage tank may be required to comply with other requirements, including demonstrating the financial ability to take corrective action in the event of a release. Evidence of financial responsibility can be established by an insurance policy, a guaranty, a surety bond, a letter of credit, or qualification with ADEQ as a self-insurer.

### **UNDERGROUND STORAGE TANK SPILL REPORTING AND CORRECTIVE ACTION REQUIREMENTS**

Owners and operators of underground storage tanks must notify ADEQ no later than 24 hours after detection of a release, or suspected release, from a tank. If this occurs, the state also requires the owner/operator to undertake a Leaking Underground Storage Tank investigation. In some instances, particularly if groundwater may be affected by the release, ADEQ may require the owner or operator to implement a corrective action plan.

## National Environmental Policy Act

The National Environmental Policy Act (NEPA) establishes the national environmental policy and goals for the protection, maintenance, and enhancement of the environment. NEPA implements this policy by requiring federal agencies to incorporate environmental considerations into their planning and decision-making processes. Federal agencies accomplish this task by preparing Environmental Assessments (EAs) or more detailed Environmental Impact Statements (EIS) that assess the environmental impact of federal actions and alternative actions.

NEPA is frequently a consideration for new projects in Arizona because the state has substantial quantities of land owned or managed by the federal government. Examples of projects that trigger NEPA may include building an air strip, expanding a facility located on federal lands, building a road on forest service land, or constructing a dam. In some instances, issuance of a permit or other approval by a federal agency can also trigger the NEPA process.

Certain categorical exclusions may preclude the need for undertaking an EA or EIS. If no categorical exclusion applies, a federal agency will prepare a written Environmental Assessment (EA) that determines whether the federal undertaking could significantly impact the environment. If the EA determines that there will not be such impact, it will issue a Finding of No Significant Impact. If the EA determines that there will be a significant impact, then the agency will proceed to prepare an EIS. An EIS can be a lengthy and expensive undertaking, particularly if the proposed project is contested, controversial, or will have a large impact on the environment.

## Endangered Species

Plans for future development can also be impacted by the requirements of the Endangered Species Act (ESA).

### THE PROCESS FOR LISTING SPECIES AND DESIGNATING HABITAT

ESA protection extends to species listed by the U.S. Fish and Wildlife Service (U.S. FWS) as threatened or endangered, such as the desert tortoise. Once the species is listed as endangered, the U.S. FWS is generally required to designate land as “critical habitat” for the species.

Under the ESA, a federal agency, and non-federal applicants whose actions may impact a critical habitat, will be subject to substantive and procedural requirements. ESA Section 7(a)(2) requires federal agencies to ensure that “any action authorized, funded, or carried out by such agency... is not likely to jeopardize the continued existence of any endangered species or threatened species or result in the destruction or adverse modification of habitat of such species” that has been designated as critical. Thus, federal actions may not proceed if they would either jeopardize the existence of a listed species or destroy or adversely modify a listed species’ critical habitat, unless an exemption

is granted. In addition, Section 7(a)(2) imposes a procedural obligation to “consult” with U.S. FWS to ensure that the federal action is not an ESA violation. Agency consultation may begin with an “informal consultation,” an optional process in which the U.S. FWS and another federal agency determine whether formal consultation is required. The consultation process will end if the U.S. FWS and federal agency agree that the action will not adversely affect the species or critical habitat. During informal consultation, an action may be modified, or impacts mitigated, to avoid adverse impacts. The federal agency is required to review its action and decide whether the action “may” affect a listed species or critical habitat. If the federal agency decides there might be some impact, the agency must enter into a formal consultation with the U.S. FWS.

Formal consultation requires U.S. FWS to evaluate both direct and indirect effects of the federal action on the species or critical habitat, including the effects of other activities that are interrelated or interdependent with the federal action.

If there is a formal consultation, the federal agency must complete a biological opinion on whether the federal action is likely to jeopardize the continued existence of the listed species or to adversely affect a critical habitat, referred to as a “take” in the applicable regulations. “Take” is defined as “harass, harm, pursue, hunt, shoot, wound, kill, trap, capture, or collect, or to attempt to engage in any such conduct.” If the agency finds a “take” will occur, it is required to impose “reasonable and prudent measures” necessary or appropriate to minimize impact to the species. These measures are known as an incidental take statement. If the agency finds that no take will occur, the U.S. FWS may still provide discretionary conservation recommendations to assist the agency to reduce or eliminate impacts the agency action may have on listed species.

## **The Arizona Native Plant Act**

The Arizona Native Plant Act (Native Plant Act) sets forth procedures for protecting certain groups of native Arizona plants from vandalism, theft, over-depletion, and unnecessary destruction. Although the Native Plant Act does not expressly prohibit the destruction or relocation of protected native plants, it does impose some minor procedural hurdles to encourage and facilitate prospective land developers to salvage native Arizona plants to the greatest extent feasible.

The Native Plant Act applies to native plants growing on public as well as private land. The Act applies to a large variety of native plants found in Arizona, with the most common example being the Saguaro cactus.

## Renewable Energy

Given the significant amount of sunshine and large expanses of undeveloped land, Arizona has undertaken several important initiatives to promote renewable energy growth, particularly for solar power.

### RENEWABLE ENERGY TAX CREDITS

There are several state and federal tax programs to incentivize renewable energy development. For example, a federal investment tax credit is available for renewable energy that is calculated based on installation cost and wattage, and another federal production tax credit calculated based on kilowatt hours produced is also available.

### STREAMLINED ZONING AND FEE REDUCTIONS FOR SOLAR INSTALLATIONS

State law requires municipalities and counties to streamline permitting procedures for the installation of solar photovoltaic systems and also limit the fees that a local government can assess for such devices. Importantly, these statutes create consistent permit requirements to prevent major variations among Arizona's cities and counties. Likewise, the statutes also prevent cities and towns from assessing permitting fees that exceed the actual cost of permit issuance.

### RENEWABLE ENERGY SOURCING REQUIREMENTS

Numerous businesses are rushing to Arizona to develop large-scale sources of renewable energy given recent requirements that Arizona utilities produce or obtain a set percentage of their energy from renewable sources. This required percentage increases annually, with the requirement that Arizona utilities obtain 15 percent of their output from renewable sources by 2025.

## Practical Tips

### PRE-ACQUISITION ENVIRONMENTAL ASSESSMENTS

The acquisition of real property or an existing business normally should be preceded by an environmental assessment of the property and/or business. Environmental assessments serve at least two important purposes. First, environmental assessments identify liabilities that may significantly affect the economic viability of an acquisition. Cleanup costs, expenses, and delays in planned operations may make the acquisition economically unattractive. Further, knowledge as to whether operating permits are transferable is important if the business will continue to be operated in the same fashion after acquisition. Second, the prospective purchaser may be able to take advantage of an affirmative defense under the Superfund Laws, as noted above, if proper due diligence (typically in the form of an environmental assessment) is undertaken.

## **TRANSFERS OF PERMITS**

Changes in ownership or control of an Arizona business frequently require amendments to environmental permits to “transfer” the permit to the new business. Transfer requirements and procedures vary from permit to permit. For example, some permits must be transferred prior to any change in ownership or control while others must occur following the restructuring. Consequently, prior to engaging in any restructuring or the purchase or sale of a business, a party should plan ahead to ensure that all environmental permits are properly transferred and amended to maintain compliance with the law.

## **TRANSFER OF LIABILITIES**

Given that most liability for environmental harm is not restricted by any form of statute of limitations, buyers of a business should carefully evaluate the method of acquisition—such as through a stock purchase or asset purchase—to determine whether the buyer will assume a previous parties’ known or unknown environmental liabilities. The parties to a transaction also typically should address the possibility and allocation of environmental liabilities in their agreement through appropriate representations, warranties, and indemnities.

## **LITIGATION ISSUES**

Given Arizona’s unique environment, businesses that intend to use significant amounts of water or emit a large quantity of pollutants into the air are likely to draw attention from state and national environmental interest groups. Further, Arizona businesses should note that Arizona state courts have unique discovery rules that differ from most other states and the federal court system by requiring the disclosure of all information pertaining to a case—good or bad—to an opposing party.

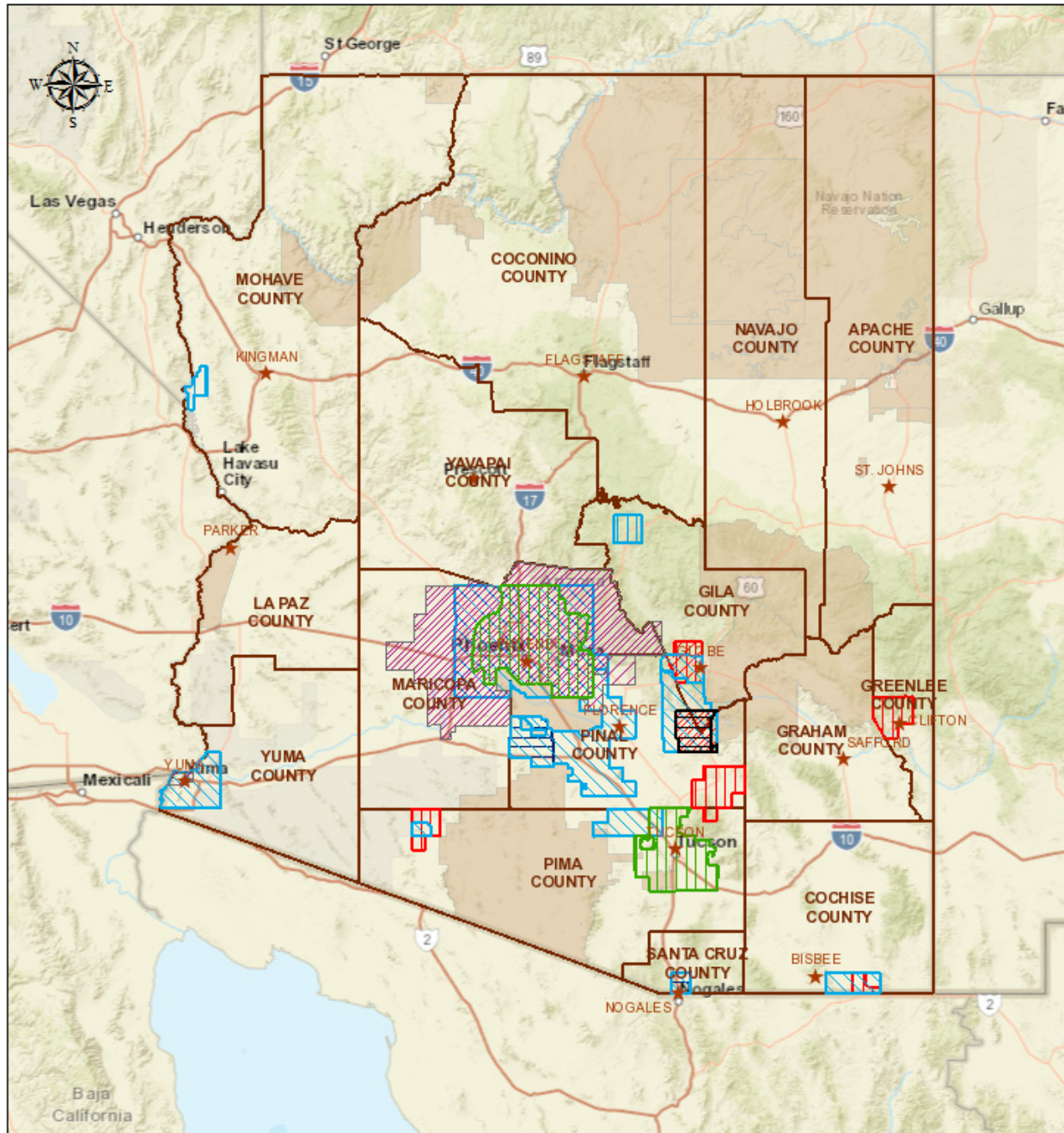
Although Arizona is a comparative fault state, whereby a party is ordinarily only liable for its proportion of fault, many state and federal environmental laws utilize joint and several liability. Under joint and several liability, a party may be deemed liable regardless of whether it is at fault and regardless of its proportion of liability.

## **ADEQ REGULATORY ENFORCEMENT**

ADEQ is authorized to inspect permitted facilities under the applicable environmental program. To ensure compliance with state environmental law, ADEQ utilizes a variety of enforcement mechanisms, ranging from informal compliance tools to formal enforcement through civil and criminal proceedings. The ADEQ Compliance and Enforcement Handbook outlines ADEQ’s various enforcement policies and enforcement mechanisms.

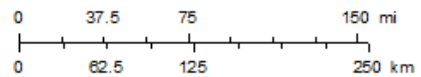


# Arizona - Clean Air Act Maintenance and Nonattainment Areas



July 24, 2018

1:4,622,324



- Carbon Monoxide (CO) - Maintenance
- PM-10 - Nonattainment
- Lead (Pb) - Nonattainment
- PM-2.5 - Nonattainment
- Sulfur Dioxide (SO2) - Maintenance
- Sulfur Dioxide (SO2) - Nonattainment
- Ozone (O3) - Nonattainment
- YUMA
- PHX 2008
- PHX 2015
- PM-10 - Maintenance
- 2010
- 1971

The Arizona Department of Environmental Quality has compiled this map as a service to our customers using information from various sources. ADEQ cannot ensure that the information is accurate, current or complete. Neither the information presented nor the maps themselves are official documents.

ADEQ: Arizona Department of Environmental Quality  
 Sources: Esri, HERE, Garmin, USGS, Intel map, INCREMENT P, NRCan, Esri Japan, METI, Esri China (Hong Kong), Esri Korea, Esri (Thailand), NGCC, © OpenStreetMap contributors, and the GIS User Community



# **WATER RIGHTS**

L. WILLIAM STAUDENMAIER AND FARRIS J. GILLMAN

**M**UCH of Arizona is arid. As a consequence, Arizona has developed an extensive system of statutes and regulations for allocating water among competing users. These laws are widely recognized as a fair and effective means of managing Arizona's water resources.

Most who need water in Arizona will have little direct involvement with Arizona's water laws. Those who locate industrial, commercial or residential developments within metropolitan areas of Arizona usually will find fully developed water supplies and delivery systems. Hooking up to a water line and paying a usage fee to the municipal water company will be all that is required. But water rights can be an important element in certain types of real estate purchases or industrial ventures, especially in the smaller metropolitan areas of Arizona. Agricultural, commercial or industrial developments locating in rural or undeveloped areas may find that the availability of water is a key factor in the successful development of these types of properties.

## **Types of Water Rights in Arizona**

Water rights in Arizona are classified into three broad categories: (1) rights to use surface water, such as the water in streams, rivers, lakes, ponds and springs; (2) rights to use groundwater; and (3) contractual rights to water.

While each of these categories is discussed below, it must be remembered that in Arizona, the nature of a "water right" is defined by the courts and by Arizona's legislature. As our courts or the legislature

resolve conflicts between competing water users, the nature of specific water rights may be altered or restricted as to use.

## **SURFACE WATER RIGHTS**

### **Doctrine of Prior Appropriation**

In the arid western United States, early miners, irrigators, settlers and pioneers found that streams, rivers and lakes were sparse. These early water users often claimed surface water under an informal process that had previously been used to claim minerals under mining laws. A water user would “stake a claim” to surface water by diverting it from its source and applying it to some beneficial use—usually mining, irrigation or domestic consumption. This informal process became known as the Doctrine of Prior Appropriation.

Arizona, like most other western states, follows the Doctrine of Prior Appropriation. Under this doctrine, the first person to divert and beneficially use surface water acquires a “prior right” or “senior right” to the water necessary to continue his or her beneficial use. An appropriator with a senior right is entitled to have his or her right protected from interference by subsequent water users with “junior rights.” For example, a water user who appropriated water in 1950 is entitled to protection against a person who initiated a water use from the same source in 1991. Thus, the Doctrine of Prior Appropriation translates into “first-in-time is first-in-right.” Because surface water is scarce in most areas of Arizona, very little, if any, unappropriated surface water is available today. As a result, anyone seeking a surface water right will likely need to acquire it from an existing water user.

### **The Administrative Process for Acquiring Surface Water Rights**

During the late 1800s and early 1900s, most western states adopted a water code of some sort in which the Doctrine of Prior Appropriation was legislatively reduced to an administrative process. Statutes varied widely from state to state, but often the enactments of one state were subsequently adopted by another state. In 1919, Arizona enacted its surface water code based on Oregon’s code.

Despite variations from state to state, most statutory schemes based on the Doctrine of Prior Appropriation require a person who desires to appropriate surface water to first file an application to appropriate with the applicable state agency. In Arizona, this agency is now the Arizona Department of Water Resources (ADWR).

After the application is filed, ADWR issues a permit to appropriate under which an applicant is entitled to construct the diversionary facilities necessary to put the surface water to beneficial use. Once the facilities have been constructed and the water has been applied to beneficial use, ADWR issues yet another document recognizing, at least on an administrative level, the validity of the appropriation. In Arizona, this document is referred to as a certificate of water right.

### **Registration of Certain Types of Surface Water Rights**

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Arizona's 1919 Surface Water Code did not provide a mandatory, statewide system for registering surface water rights based on uses initiated prior to 1919. Water rights that had been acquired before 1919 were not subject to the Surface Water Code's requirement that a water user first file an application to appropriate surface water. As a result, there was no centralized database of water rights that had been perfected prior to June 12, 1919. To deal with various problems in determining conflicting rights to surface water, Arizona's legislature enacted a law in the 1970s requiring those who claimed pre-1919 water rights to register their claims with ADWR.

### **General Stream Adjudications**

In the mid-1970s, surface water users initiated adjudications in two major river systems in Arizona: the Gila River and Little Colorado River systems. General stream adjudications in Arizona's state courts determine the nature, extent and relative priority of surface water rights in an entire river system.

Under the current law, it is unclear exactly what claims fall within the scope of a general stream adjudication. In many cases, groundwater may be hydrologically connected to surface water flow. A portion of this underground water is known as "subflow," and for purposes of adjudicating water rights subflow will be treated as surface water. The nature and extent of subflow continues to be a key element of litigation in the adjudications. Because the characteristics of subflow remain uncertain, many groundwater users in Arizona have filed statements of claimant in the adjudications to protect their water rights should the water they are using be determined to be subflow. Many water rights may be affected by the outcome of this litigation.

Indian tribes with reservations in Arizona have asserted significant claims to water. It was hoped that in these adjudications, the Arizona courts would determine the nature and extent of these claims. However, the adjudications have become extremely complex and protracted. Rather than adjudicate their water rights, many Indian tribes have settled their water rights claims as to other water users in the state.

## **GROUNDWATER RIGHTS**

"Groundwater" means water found under the surface of the earth regardless of the geologic structure in which it is standing or moving. While Arizona has limited supplies of surface water in most locations, it is blessed with abundant supplies of groundwater in numerous aquifers located throughout the state. To access this supply, many water users in Arizona drilled wells and then pumped groundwater from the highly productive aquifers. In the 1960s and 1970s, municipalities and mining companies drilled wells to tap aquifers already pumped by agricultural groundwater users. As a result, groundwater levels declined and pumping costs increased, leading to protracted litigation among these competing groundwater users.

To resolve these disputes, Arizona passed the 1980 Groundwater Management Act. The Groundwater Management Act governs the use of groundwater in active management areas (AMAs), which include most of the metropolitan areas of Phoenix, Prescott and Tucson, as well as the upper Santa Cruz Valley (near Nogales, Arizona) and Pinal County in central Arizona. More than 80% of Arizona's population resides in these AMAs.

### **Groundwater Rights in AMAs**

Pursuant to the Groundwater Management Act, ADWR adopted management plans for each AMA that require groundwater users to gradually implement conservation measures intended to help the AMA achieve specific management goals. For example, in the Phoenix, Tucson and Prescott AMAs, groundwater usage is to be managed to achieve "safe-yield" by the year 2025. Safe-yield is a long-term balance between the annual amount of groundwater withdrawn and the annual amount of natural and artificial groundwater recharged or replenished in the same AMA. The management goals for the Pinal and Santa Cruz AMAs are similar to the goal of safe yield, although other management objectives are also recognized.

Within an AMA, to legally pump groundwater, a person must have a grandfathered right, a withdrawal permit, or a service area right, unless the use is for domestic purposes and is less than 35 gallons per minute. There are three types of grandfathered rights: irrigation grandfathered rights, type 1 rights, and type 2 rights. A property owner who used groundwater for agricultural irrigation on a particular parcel of land during the five-year period before January 1, 1980, acquired an irrigation grandfathered groundwater right. The irrigation grandfathered right entitles the owner of the property or the owner's successors to indefinitely continue using groundwater on that property for agricultural irrigation. A type 1 right is created when land is permanently retired from farming and used for a non-irrigation purpose. Both irrigation grandfathered rights and Type 1 rights are "appurtenant" to specific acres of land and can only be conveyed with the land. A type 2 right is based on pre-1980 uses of groundwater for non-agricultural purposes. A type 2 right is the most flexible grandfathered right because it can be sold or leased separate from the land where the original water use occurred. Type 2 rights can be either leased or sold for use anywhere within the same AMA where they were created, and they can be used for a wide variety of non-irrigation uses. However, Type 2 rights that were originally created based on either power generation or mining uses may only be transferred to other power generation or mining uses, respectively.

In addition to grandfathered rights, the Groundwater Management Act also authorizes ADWR to issue a variety of groundwater withdrawal permits, including general industrial use permits, poor quality groundwater withdrawal permits, dewatering permits, and a number of other permits authorizing groundwater withdrawals for specific purposes.

Finally, cities, towns, private water companies, and irrigation districts have statutorily-granted service area rights. These rights allow these entities to withdraw groundwater within their service areas and serve it to their customers and landowners. For cities, towns, and private water companies, service area rights are also affected by assured water supply requirements, an issue discussed in greater detail below.

### **Groundwater Rights Outside AMAs**

Outside of the AMAs, there are areas where property owners are prohibited from using groundwater to irrigate new tracts of land. These areas are designated as irrigation non-expansion areas (INAs). In INAs, groundwater usage for agricultural cannot increase beyond those lands that were being irrigated prior to creation of the INA. There are, however, no restrictions in INAs prohibiting new uses of groundwater for nonagricultural purposes.

In most of the rest of the state, groundwater withdrawals are governed by the doctrine of reasonable use. Under this doctrine, a property owner is authorized to withdraw and use groundwater on the owner's property for all reasonable purposes. In addition, landowners may be able to transport groundwater from their land to other locations of use. This right to transport groundwater is subject to a number of geographic and use-based restrictions imposed by the Groundwater Management Act.

## **CONTRACTUAL WATER RIGHTS**

Rights to water also may be established under contract, such as when an owner of property enters into a contract with a municipality or a private water company to obtain water. Often, developers in Arizona will have to negotiate the terms and conditions of water service with a private water company or a municipality. If the entity that supplies the water is a private water company, the water service contracts typically must be approved by the Arizona Corporation Commission (ACC), the state agency that regulates private companies that supply utility services in Arizona.

In addition, various water suppliers have entered into water service contracts to acquire water from the Central Arizona Project (CAP), a large aqueduct system that transports approximately 40% of Arizona's overall water supply from the Colorado River to water users in central and southern Arizona.

### **The Central Arizona Project**

The CAP is an aqueduct system consisting of canals and a large reservoir through which Colorado River water is imported from Lake Havasu (on the Colorado River) to the Phoenix and Tucson metropolitan areas, as well as various irrigation districts and Indian tribes along the aqueduct system. It has a capacity of approximately 1.6 million acre-feet per year.<sup>1</sup> The CAP was constructed

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<sup>1</sup> [www.cap-az.com](http://www.cap-az.com) (Central Arizona Project).

by the U.S. Bureau of Reclamation under the authority granted to the U.S. Secretary of the Interior in the Colorado River Basin Project Act of 1968, which authorized federal funding of this project.

The CAP is operated by an Arizona political subdivision, the Central Arizona Water Conservation District (CAWCD). The CAWCD is responsible for repaying to the United States a portion of the construction cost of the CAP, as well as operating and maintaining the system. Payments to the United States are made with funds acquired by CAWCD from three sources: (1) property taxes levied on taxable real property in Maricopa, Pinal and Pima Counties; (2) water service charges assessed to all CAP water users; and (3) the sale of surplus electrical power from several facilities that were constructed to generate electrical power for pumping Colorado River water through the CAP aqueduct system. In order to receive CAP water, municipalities, irrigation districts, and other types of non-Indian water users enter into three-party contracts between the water user, CAWCD, and the U.S. Bureau of Reclamation. Indian tribes contract directly with the Secretary of the Department of Interior.

### **Reclaimed Water**

Reclaimed or recycled water has become an important water source in Arizona. After extensive treatment of municipal wastewater, the resulting reclaimed water is commonly used to irrigate golf courses, parks, and other common areas, or for industrial purposes. In addition to the direct uses, reclaimed water is often used to “recharge” aquifers – allowing this water supply to be stored underground until needed for future uses. The level of treatment wastewater receives dictates how the reclaimed water can be used. Unlike most sources of water, the amount of reclaimed water generally expands with population growth. As a result, reclaimed water is expected to be an increasingly important means of meeting Arizona’s growing demand for water.

## **SPECIAL WATER ISSUES AFFECTING LAND ACQUISITIONS**

Because of the importance of water, a prospective purchaser of real property in Arizona should conduct a thorough investigation of all applicable water rights that might either be legally appurtenant to the land to be acquired or, alternatively, required for future development. This investigation usually is made during a due diligence period included in most purchase agreements for major real estate transactions. If the property is in a metropolitan area, the investigation may involve no more than confirmation of the availability of water and terms of water service from the local municipality or water company. If the property is located outside an area served by a municipality or private water company, or if the property includes existing wells or other water sources, the purchaser will need to undertake a more comprehensive analysis of water availability.

### **Review of Title Report and Survey**

Most water rights are appurtenant to specific parcels of real property. The ability to acquire water rights may depend on the geographic location of the real property—often the types of water rights



that might be appurtenant to a tract of real property vary from location to location within Arizona. For example, grandfathered irrigation groundwater rights, as discussed above, exist only within AMAs. Similar rights, identified by certificates of historical withdrawal, exist in INAs. However, farmland outside of an AMA or INA must rely on the more general doctrine of reasonable use as the basis for the right to irrigate the land. If the real property is served with water from a commonly owned well or irrigated with water received from a surface water source, then any recorded contractual arrangements under which the water is used often will be referenced in a title report.

If the real property to be acquired is of significant acreage, a prospective purchaser may elect to have the property surveyed to determine the existence of wells, ponds and similar water sources; this will aid in the evaluation of what water rights will actually be acquired in connection with the acquisition of the real estate. Close review of all such title reports and surveys is essential.

### **Warranties**

A seller of property usually makes warranties of title to the purchaser, but sellers rarely make warranties relating to water rights because, as noted above, the uncertain outcome of the general stream adjudications may affect existing rights to both surface water and groundwater. Sellers are often unwilling or unable to make unqualified warranties regarding the validity of water rights.

### **Post-Acquisition Documentation**

If real property includes appurtenant water rights, documents should be prepared and filed with ADWR to reflect the transfer of water rights from seller to buyer. Water right claims in the adjudications should also be transferred, as should ownership of wells. In many cases, the documentation can be submitted using forms available from ADWR. Although not required, these updates should be accomplished through the real estate escrow process whenever possible. In addition to updating ADWR's records, water rights are also typically transferred by quit claim deed.

## **SPECIAL WATER ISSUES AFFECTING LAND DEVELOPMENT**

### **Assured Water Supply Requirements**

A purchaser who acquires property within an AMA and who intends to subdivide the property into six or more lots or parcels is required to demonstrate to ADWR that an assured water supply exists for the proposed subdivision before splitting the property. Demonstration of an assured water supply requires a showing that enough water is physically, legally, and continuously available to meet the demands of the subdivision for a 100-year period. Additionally, projected groundwater use must be consistent with the management plan for the AMA and the developer must show financial ability to construct the water delivery system. Similar requirements apply to the subdivision of real property located outside of the AMAs, although, in such cases, the limitations on sub-dividing real property if adequate supplies of water are not available are somewhat more relaxed.

Both the assured and adequate water supply programs are administered by ADWR pursuant to detailed regulations it adopted in the 1990s. Generally speaking, a developer must either directly demonstrate an assured or adequate supply and secure a certificate of assured water supply (inside the AMAs) or a water report (outside the AMAs) from ADWR, or it must secure a written commitment to serve from a municipal water provider that has been “designated” by ADWR as having an assured or adequate water supply. ADWR maintains a list of designated water providers throughout the state and also makes available the forms required to apply for a certificate of assured supply, a water report, a designation, and various other assured and adequate water supply options under its rules. Both the list and the forms can be found on the ADWR’s website, [www.azwater.gov/aaws/forms-applications](http://www.azwater.gov/aaws/forms-applications).

### **Water Service Providers**

A person seeking to subdivide real estate in an area that lacks an existing water service option may have to create a water service provider to build and operate the water supply infrastructure. There are several alternative types of water providers, but two options commonly are considered—a developer might form a private water company or a domestic water improvement district. Both alternatives involve additional expense and require various governmental approvals, but these alternatives may be the only way to develop a tract of real property in areas where no existing water service provider is available.

### **Formation of a Private Water Company**

In some cases, a developer may elect to form a private water company. Sometimes several developers will join to form a water company to serve their collective developments. Formation of a water company is a complicated process that may take significant time to complete. Approval must be obtained from the ACC, which will grant the water company a certificate of convenience and necessity (CC&N). CC&Ns authorize water companies to serve customers in a specific geographic area. Additionally, a water company must obtain a franchise from the county or municipality in which it proposes to operate. If the water company conducts business within the boundaries of a municipality, the grant of a franchise requires approval of the municipality’s voters. Furthermore, a water company that proposes to operate within an AMA must satisfy conservation requirements imposed by ADWR. Approvals also are required from state and local health and environmental departments.

### **Formation of a Domestic Water Improvement District**

An alternative to the formation of a private water company is the formation of a domestic water improvement district to construct or acquire an existing water system. Every landowner within such a district pays assessments that are used to pay the costs and expenses of the district. In some cases, a district has the capacity to issue bonds and the proceeds from the bond sale are used to construct water service facilities. There are extensive requirements for the formation of such districts, including obtaining the approval of the Board of Supervisors of the county in which the

district is located and sometimes obtaining the approval of other districts that operate in the same geographical area.



# FEDERAL INCOME TAXATION

BILL KASTIN AND SOHEILA SHAHIDI

**T**HIS chapter deals with certain federal income tax considerations relevant to foreign individuals and entities investing or doing business in the United States.

## I. Taxation of Foreign Individuals

The federal income taxation of a foreign individual depends, almost entirely, on whether that foreign individual is properly treated as either a “U.S. resident” or a “nonresident.” That determination is discussed in Part I.A. Once that determination is made, Part I.B addresses certain general federal income tax rules applicable to foreign individuals taxed as U.S. residents and Part I.C addresses certain federal income tax rules applicable to foreign individuals taxed as nonresidents. Parts II and III briefly address the federal income tax rules applicable to doing business in the United States by way of a corporation or partnership, respectively. Finally, Part IV briefly addresses certain general federal tax rules that may apply to individuals, corporations and partnerships doing business in Arizona.

### A. DETERMINATION OF STATUS AS A U.S. RESIDENT

A foreign individual who is a U.S. resident is oftentimes referred to as a “resident alien,” and is treated as such if he or she meets one of the following two tests for the calendar year.

#### The Green Card Test

A foreign individual is classified as a resident alien if he or she is in the United States by way of an immigrant visa (a green card) and the individual's green card status has not been revoked or abandoned. Unlike the substantial presence test, discussed below, the length of time during which the individual is in the United States is irrelevant in determining whether the individual is a resident alien pursuant to the green card test.

### **The Substantial Presence Test**

Alternatively, pursuant to the substantial presence test, a foreign individual is classified as a resident alien if he or she is physically present in the United States for at least (i) 31 days during the current year and (ii) 183 days during the three-year period that includes, as explained in detail below, the current year and the immediately preceding two years.

There are special rules applicable for the manner in which days are counted for purposes of the substantial presence test. Specifically, to satisfy the 183-day requirement, you count (i) all the days the individual was present in the United States during the current year, (ii) one-third of the days the individual was present in the United States during the first year before the current year, and (iii) one-sixth of the days the individual was present in the United States during the second year before the current year. In addition, you do not count certain days (e.g., days during which the individual was in transit between two places outside of the United States and was physically in the United States for less than 24 hours, and days the individual was prevented from leaving because of a medical condition that arose while in the United States).

In addition, certain individuals do not count those days during which they were in the United States as an "exempt individual." For example, an exempt individual may include (i) an individual temporarily present in the United States as a foreign government-related individual and (ii) certain teachers, trainees and students in the United States and in compliance with specified visas (e.g., J, Q and F visas).

Even if a foreign individual meets the substantial presence test, such foreign individual may be treated as a "nonresident alien" if he or she (i) is present in the United States for fewer than 183 days during the current calendar year, (ii) maintains a tax home in a foreign country during the year, and (iii) has a closer connection to that country than to the United States (collectively commonly referred to as the "Closer Connection Exception"). In applying the Closer Connection Exception, factors taken into consideration include the locations of the individual's family and business, bank accounts, and the social, political, cultural and religious affiliations. An individual who otherwise satisfies the substantial presence test must file a statement justifying the claim to the Closer Connection Exception. The statement must be filed with the Internal Revenue Service (IRS), the principal enforcement agency of the U.S. tax laws. Alternatively, if a foreign individual satisfies the substantial presence test, but does not come within the Closer Connection Exception, such foreign individual may still be treated,

for tax purposes, as a nonresident alien under the “tie-breaker” rules set forth in a tax treaty between the United States and such individual’s country of residency.

### **Dual Status Years**

Special rules govern the first and last year in which a foreign individual is classified as a resident alien.

### **Initial Year as a Resident Alien**

A foreign individual who is classified as a resident alien is regarded as a resident alien only for the portion of the calendar year that begins on such resident alien’s “residency starting date.”

If a foreign individual is classified as a resident alien during the calendar year pursuant to the green card test, then such person is generally considered a resident alien for the entire year.

If a foreign individual is classified as a resident alien for any calendar year pursuant to the substantial presence test, then such person’s residency starting date is generally the first day he or she is present in the United States during that calendar year. Thus, a foreign individual may be taxed as (i) a nonresident alien for a portion of a calendar year, and (ii) a resident alien for the remainder of that year, a year sometimes referred to as a “dual status” year. An exception to this rule arises if the individual was classified as a resident alien at any time during the preceding calendar year. If an individual is classified as a resident alien in the immediately preceding calendar year and, pursuant to the substantial presence test, such individual is considered a resident alien in the current year, then such person’s residency starting date is January 1 of the current year.

### **Final Year as a Resident Alien**

In general, if a foreign individual is classified as a resident alien in one year, but is not classified as a resident alien during any part of the following year, then such person ceases to be a U.S. resident on his or her “residency termination date.” In general, a resident alien’s residency termination date is December 31 of the last year during which such individual qualified as a resident alien. However, a resident alien may qualify for an earlier termination date in certain circumstances. For example, under certain circumstances, if the individual is a resident alien pursuant to the green card test, then his or her residency termination date is the first day of the year that such individual is no longer a lawful permanent resident. Similarly, under certain circumstances, if the individual is a resident alien pursuant to the substantial presence test, then his or her residency termination date is the last day in the year that he or she was physically present in the United States.

## **B. TAXATION OF RESIDENT ALIENS**

A foreign individual who is classified as a resident alien for federal income tax purposes is taxed in the same manner as a U.S. citizen. Accordingly, the individual’s income earned worldwide (as opposed to being limited to the individual’s income earned from within the United States) is subject

to U.S. taxation. In general, ordinary income is taxed at graduated rates, currently ranging from 10 to 37 percent. This rate generally applies to rents, royalties, interest and compensation for personal services performed. Currently, the maximum U.S. federal long-term capital gains rate is 20 percent. This rate generally applies to gains from the sale of capital assets held for more than 12 months. The United States, unlike certain other countries, does not permit a capital gains tax adjustment in the tax basis of a capital asset to fair market value upon arrival; as such, all appreciation in the value of capital assets, including the appreciation accumulated prior to arrival in the United States, is potentially subject to U.S. tax upon the disposition of such capital asset.

In many instances, classification as a resident alien will result in greater U.S. taxes than if the individual were classified as a nonresident alien. However, there are circumstances in which a resident alien pays lower taxes than a nonresident alien. For example, a resident alien may pay lower taxes than a nonresident alien because the resident alien is able to claim various deductions that reduce taxable income or may be able to claim a credit for certain taxes paid to foreign countries.

Special rules apply to resident aliens and U.S. citizens alike in determining U.S. taxable income arising from foreign holdings. For example, ownership in certain foreign corporations may result in a “deemed” dividend on which U.S. taxes must be paid, even though a dividend is not actually received by the taxpayer. This could occur, for example, with respect to a resident alien’s ownership in a “controlled foreign corporation” (CFC). A CFC is a foreign corporation of which more than 50 percent, by vote or value, is owned by U.S. shareholders. For purposes of that definition, U.S. shareholders are defined as U.S. citizens, resident aliens, corporations, etc. that own, directly or indirectly, at least 10 percent of the voting stock, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation. As another example, ownership of “foreign personal holding companies” or “passive foreign investment companies” can also result in unanticipated U.S. income tax liabilities arising from such holdings, in some instances, even if no cash is actually received from such companies. Additional tax and information returns must also be filed with respect to such foreign corporate holdings. In some instances, a timely election may reduce certain adverse tax implications associated with such holdings. Foreign individuals who are classified as resident aliens for U.S. tax purposes should be mindful of how these rules could apply to such individual’s non-U.S. holdings and investments.

In general, a resident alien is required to report its income on a timely filed IRS Form 1040 (U.S. Individual Income Tax Return) and timely pay its U.S. taxes respecting such income.

### **C. TAXATION OF NONRESIDENT ALIENS**

In general, there are two sets of federal income tax rules applicable to nonresident aliens—one set of rules applicable to passive investment income (discussed in Part I.C.1) and another set of rules



applicable to income “effectively connected” with the conduct of a trade or business in the United States (discussed in Part I.C.2).

## **1. Investment Income**

Investment income (sometimes referred to as “fixed or determinable annual or periodic income” or FDAP) earned from U.S. sources by a nonresident alien is generally taxed in the United States at a flat tax rate of 30 percent. The tax is generally collected by withholding at the source and applies to the gross amount of the investment income. The amount of investment income subject to federal income taxation is computed without any deductions. Investment income is income not effectively connected with a U.S. trade or business and includes interest, dividends, rents and royalties. Investment income earned from foreign sources by a nonresident alien is not subject to U.S. taxation. In this respect, whether the income is “U.S.-sourced” or “foreign-sourced” is important for determining whether such income is subject to U.S. income tax and withholding. Below is a brief summary of certain types of investment income and the manner in which such income is sourced.

### **Interest**

In general, interest paid by a U.S. borrower to a foreign lender is treated as U.S. source investment income. Accordingly, it is subject to the 30 percent tax and corresponding withholding rules mentioned above.

Not all interest earned from U.S. sources is subject to such treatment. For example, neither (i) interest payments arising from deposits with U.S. banks nor (ii) “portfolio interest” are subject to these U.S. tax and withholding rules. Portfolio interest generally includes interest that accrues from an obligation issued in registered form. However, in general, portfolio interest does not include either contingent interest or interest paid to a non-U.S. payee that owns 10 percent or more of the U.S. payor.

### **Dividends**

In general, dividends paid by a U.S. corporation are treated as U.S. source investment income. As such, it is subject to the 30 percent tax and corresponding withholding rules mentioned above.

### **Rents**

Rental income that is not effectively connected with a U.S. trade or business is U.S. source investment income if the property producing the rent is located in the United States. As such, that non-effectively connected rental income is subject to the 30% tax and corresponding withholding rules mentioned above.

### **Royalties**

Royalties from the licensing of intangible property, such as patents, copyrights, secret processes, goodwill and similar properties are treated as U.S. source income if the intangible property is

used in the United States. As such, such royalty income is subject to the 30 percent tax and corresponding withholding rules mentioned above.

### **Disposition of Investments**

In general, assets that generate investment income may qualify as capital assets. A nonresident alien's gain arising from the disposition of a capital asset will often, but not always, be exempt from U.S. taxation. There are, of course, exceptions to this general rule. For example, dispositions of U.S. real property (including U.S. property held indirectly through a U.S. entity) is subject to a special set of rules, discussed below, subjecting such transactions to both U.S. tax and withholding rules. Another exception arises when, in certain instances, the disposition of a capital asset gives rise to ordinary income. In that case, such ordinary income will be subject to the 30 percent tax and withholding rules discussed above.

### **Tax Treaties and Certain Forms**

The United States has entered into income tax treaties with numerous foreign countries. If applicable, the rules set forth in the treaties can reduce the U.S. taxation and withholding rates otherwise applicable to the U.S.-sourced investment income discussed above. For example, some treaties may reduce or eliminate the 30 percent tax applicable to dividend income.

In connection with investing in the United States and receiving payments of investment income, a nonresident alien may be required to submit to the U.S. payor an IRS Form W-8BEN, certifying under penalties of perjury that the payee is, in fact, a nonresident alien.

### **Trade or Business Income**

#### **General**

As mentioned above, a nonresident alien's U.S.-sourced investment income is subject to a 30 percent tax and withholding rate, which applies to the gross amount of such investment income. By contrast, a nonresident alien's income that is effectively connected with a U.S. trade or business is taxed on a net basis at graduated rates. Thus, certain expenses associated with the trade or business can be claimed as a deduction to offset the amount of income subject to tax. The rates of taxation vary between 10 and 37 percent, similar to the rates applicable to U.S. citizens and resident aliens. Although most effectively connected income is derived from U.S. sources, a nonresident alien may be taxed on certain foreign source income if such foreign source income is effectively connected with a U.S. trade or business.

There are no specific guidelines for determining whether a nonresident is considered to be engaged in a U.S. trade or business. The most important factor is the "continuity and regularity" of activities carried on in the United States. The number of transactions and the nature and kind of undertakings carried on are important criteria. For example, isolated sales or "net leases" by a foreign person (leases that do not compel the nonresident alien to provide any services in

connection with the leased property) to only one tenant may not be considered a U.S. trade or business. As another example, trading in securities or commodities, through brokers or for one's own account, also may not constitute a U.S. trade or business. However, the purchase and sale of goods and the regular solicitation and advertising of sales in the United States are both activities regarded as engaging in a U.S. trade or business.

Even if a nonresident alien is not directly engaged in a U.S. trade or business, the nonresident alien may be deemed to be engaged in a trade or business as a result of the activities of others. For example, activities engaged in by a partnership (foreign or domestic) in which the nonresident alien is a partner are attributed to the foreign partner. Similarly, activities engaged in by an agent on behalf of a nonresident alien may be attributed to the nonresident alien.

Compensation for the performance of personal services in the United States is treated as income effectively connected with a U.S. trade or business. A limited exception applies for certain nonresident aliens performing services in the United States for a relatively short period of time, i.e., up to 90 days and for those who earn less than \$3,000 for such services. Additional exceptions to this general rule may also be available pursuant to an applicable income tax treaty.

### **Tax Treaties and Certain Forms**

As mentioned previously, the United States has entered into income tax treaties with numerous foreign countries. Even if income is effectively connected with a U.S. trade or business, many treaties exempt such income from U.S. taxation if the nonresident alien does not have a "permanent establishment" in the United States. The definition of a permanent establishment varies from treaty to treaty, but is often defined as an office, branch, factory or similar facility in the United States. A permanent establishment generally does not include the casual and temporary use of a storage facility. A tax advisor can help nonresident aliens determine whether their U.S.-related operations rise to the level of a permanent establishment under the applicable U.S. income tax treaty.

In connection with engaging in a trade or business in the United States and receiving payments of income in connection with such trade or business, a nonresident alien may be required to submit to the U.S. payor an IRS Form W-8ECI, certifying under penalties of perjury that the payee is in fact a nonresident alien and that the income received from the payor will be treated by the nonresident alien as effectively connected income.

### **United States Real Property Interests**

A special set of rules generally applies to the taxation of income relating to a U.S. real property interest.

U.S. source rental income could be taxed either as (i) investment income, in which case the gross amount of such rental income would be subject to the flat 30 percent rate of tax (discussed above in Part I.C.1.c), or (ii) effectively connected with a U.S. trade or business, in which case the net amount of such rental income (i.e., after reduction for rental expenses, including depreciation deductions) would be subject to tax at graduated rates. Whether rental income is properly taxed as investment income or effectively connected income depends on the facts and circumstances of each case, taking into account the various landlord-related services provided by the nonresident alien or the nonresident alien's agents. If the rental income would otherwise be treated as investment income, but the nonresident alien prefers to treat such income as effectively connected with a U.S. trade or business so as to allow the nonresident alien to claim rental expenses as deductions and subject the net rental income to tax at graduated rates, then he or she may elect to treat the rental income as effectively connected with a U.S. trade or business. The election, if made, applies to all rental income from U.S. real property earned by the nonresident alien and remains in effect for all subsequent taxable years unless permission to revoke the election is granted by the IRS.

Special rules apply to the gain or loss associated with the taxable disposition of a U.S. real property interest. In general, those rules provide that, regardless of whether the ownership and operation of the U.S. real property constitute a trade or business, gain or loss associated with the taxable disposition of such U.S. real property interest is treated as income effectively connected with a U.S. trade or business.

In addition, to ensure that nonresident aliens pay tax on any gain arising from the disposition of a U.S. real property interest, special withholding rules generally provide that the purchaser or transferee of a U.S. real property interest from a nonresident alien transferor must withhold 15 percent of the amount realized by the nonresident alien with respect to such transfer. Because the 15 percent withholding rate is applied to the "amount realized" on the sale, as opposed to the gain from the sale, it is possible that the amount withheld will be greater than the tax ultimately due with respect to the sale. Careful planning, well in advance of a disposition of a U.S. real property interest, may reduce the amount required to be withheld in connection with the transfer. If less tax is withheld than the non-U.S. transferor's tax liability, then the transferor may have to pay estimated taxes prior to the filing of the income tax return for that year and will have to pay any remaining tax due upon the nonresident alien's filing of its U.S. tax return. Alternatively, if more tax is withheld than the non-U.S. transferor's tax liability, then the non-U.S. transferor may file a claim for refund.

For these purposes, a U.S. real property interest includes direct and indirect ownership of real property in the United States. In general, stock in a U.S. corporation generally constitutes a U.S. real property interest if, at any time during the five-year period preceding the nonresident alien's

disposition of the stock, the corporation held U.S. real property worth 50 percent or more of the fair market value of the corporation's total assets. However, there are some exceptions to this general rule. For example, publicly traded stock of a U.S. corporation does not constitute a U.S. real property interest connected with a U.S. trade or business unless a foreign individual directly or indirectly owns more than 5 percent of the corporation's stock.

In general, a nonresident alien is required to report its U.S.-sourced income on a timely filed IRS Form 1040NR (U.S. Nonresident Alien Income Tax Return) and timely pay its U.S. taxes respecting such income.

## **II. Taxation of Corporations**

The federal income taxation of corporations depends on whether the corporation is a U.S. corporation (also referred to as a domestic corporation) or a foreign corporation. In general, the corporation's "place of incorporation" determines its status for federal income tax purposes. As such, a U.S. corporation is a corporation created or organized in the United States. And, unless an election is made to be treated as a U.S. corporation, a corporation created and organized outside of the United States is a foreign corporation.

### **A. TAXATION OF UNITED STATES CORPORATIONS**

A United States corporation is taxed on its income earned worldwide. Generally, a U.S. corporation is taxed on its income at a flat rate of 21 percent and there is no preferential rate for capital gains as there is for individuals.

In addition to the income tax paid by the corporation on its worldwide income, shareholders of a corporation are subject to tax on dividends distributed or deemed to be distributed, from the corporation. The federal taxation of those dividends depends, in part, on whether the shareholder is taxed as a resident or nonresident alien. As a result of both the corporate level tax and the shareholder level tax, corporate profits are generally subject to two levels of taxation.

Certain U.S. corporations may avoid the imposition of corporate level taxes by making a special election under Subchapter S of the federal income tax code. In lieu of taxes payable by the S corporation, only the shareholders of the corporation pay taxes on income earned by the corporation. A corporation can make this election only if, among other requirements, its shareholders meet certain eligibility requirements and the number of permissible shareholders does not exceed 100 (subject to certain exceptions that increase the number of permissible shareholders when the shareholders are members of the same family). As a general rule, nonresident aliens, corporations, partnerships and many types of trusts are not eligible S corporation shareholders.

## **B. TAXATION OF FOREIGN CORPORATIONS**

Foreign corporations are taxed in a manner similar to the taxation of nonresident aliens. A foreign corporation's gross investment income is subject to U.S. tax and withholding at the source at the generally applicable flat rate of 30 percent, except as may be reduced by an applicable tax treaty.

A foreign corporation's net income effectively connected with its U.S. trade or business is not subject to withholding. Instead, except as may be provided by an applicable income tax treaty, such net income is taxed at the corporate tax rate, similar to the taxation of U.S. corporations. In addition to the tax on net income effectively connected with a U.S. trade or business, a foreign corporation that directly engages in a U.S. trade or business may be liable for the "branch profits tax."

The branch profits tax subjects a foreign corporation that directly engages in a U.S. trade or business to U.S. taxes roughly equivalent to those that would be payable by a nonresident alien shareholder of such foreign corporation if (i) the foreign corporation's U.S. trade or business were incorporated as a U.S. subsidiary of such foreign corporation, and (ii) the foreign corporation distributed a "dividend equivalent amount" to its non-resident shareholder. When a foreign corporation is engaged in a U.S. trade or business through a U.S. subsidiary, income generated by the U.S. subsidiary is taxed twice. First, the U.S. subsidiary is subject to a U.S. corporate level tax; second, dividends from the U.S. subsidiary to its nonresident alien shareholder are generally taxed at the flat rate of 30 percent on the U.S. source investment income. Without the branch profits tax, a foreign corporation doing business directly in the United States (as opposed to doing business through a U.S. subsidiary) would be subject to a U.S. corporate level tax on net income effectively connected with a trade or business, but because the earnings of the foreign corporation when repatriated abroad would merely be transferred and would not be paid out as dividends, there would be no second shareholder level tax or withholding. To eliminate the distinction between the two structures, the branch profits tax imposes a tax on the amount deemed to be repatriated abroad by the U.S. branch. The amount deemed to be repatriated is intended to approximate the difference between the profits earned by the branch and the amount of branch profits reinvested in branch operations. Unless reduced by treaty, the branch profits tax is imposed at a rate of 30 percent.

## **III. Taxation of Partnerships**

United States tax rules govern the characterization of an entity as a partnership or corporation for U.S. income tax purposes, notwithstanding the characterization of that entity under foreign law.

In general, unlike corporations, which are subject to corporate level income taxes, partnerships do not incur U.S. federal income tax liability. Instead, each partner of the partnership is required to take into account his or her respective distributive share of the partnership's net income or loss, as well as his or her respective distributive share of certain specially characterized items (e.g., capital gain),

in computing such partner's income tax liability. In general, the activities of a U.S. partnership are attributed to its foreign partners. For example, if a U.S. partnership (or an entity taxed as a partnership for U.S. tax purposes, such as a multi-member limited liability company) is engaged in a U.S. trade or business and has a fixed place of business in the United States, then a foreign partner of that partnership is itself treated as being engaged in a U.S. trade or business and as having a fixed place of business in the United States. Although the partners are primarily liable for the U.S. federal income tax liability arising from their ownership interest in a partnership, under certain circumstances the partnership itself may become liable for the payment of such taxes.

A U.S. partnership generally must withhold, on a quarterly basis, at the highest U.S. tax rate (37% for non-corporate foreign partners and 21% for corporate foreign partners) of a foreign partner's distributive share of the partnership's income effectively connected with a U.S. trade or business. When the foreign partner later files its U.S. tax return (e.g., IRS Form 1040NR) with respect to such effectively connected income, the foreign partner may claim, as a credit against its U.S. tax, the U.S. federal income tax previously withheld by the partnership. If more tax is withheld relative to the foreign partner than is owed by such foreign partner, then, in most instances, such foreign partner may file a claim for a refund. The tax rules applicable to partnerships are complex. A professional tax advisor can provide advice on any applicable U.S. federal income tax consequences to individuals, partnerships and corporations seeking to invest in a partnership or do business in the United States through a partnership.

## **IV. Additional Tax Considerations**

### **A. TRANSFER PRICING**

Transactions between foreign taxpayers and "related parties" under "common control" are closely scrutinized by the IRS. The principal purpose of such scrutiny is to ensure that the related parties deal with each other at arm's length and do not unreasonably inflate or reduce the costs of goods and services performed between the two in an effort to shift income artificially from one entity to the other for tax advantage. The IRS has extensive authority to reallocate income and deductions among related parties if it determines that arm's length dealing has not occurred.

### **B. DISCLOSURE AND RECORD KEEPING REQUIREMENTS**

#### **Foreign Bank Account Reporting**

Separate and apart from the federal tax liabilities arising from foreign holdings, there are annual disclosure requirements applicable to resident aliens, some non-resident aliens, U.S. partnerships, and U.S. corporations, which may apply to a foreign individual or business entity in connection with doing business or investing in the United States. In general, these rules apply if: (i) the individual or entity has a financial interest in, or has signature authority over, a foreign financial account (e.g., a bank

account, brokerage account, certain mutual funds and retirement accounts) and (ii) the aggregate value of all such foreign financial accounts exceeds \$10,000 at any time during the calendar year. In such a case, the individual or entity may be required to report the foreign financial account to both the IRS and the U.S. Treasury Department, even if the account produces no taxable income (e.g., no interest income).

In general, this disclosure obligation is satisfied if the applicable party both checks the appropriate box on its U.S. federal income tax return and files FinCEN Form 114 (Report of Foreign Bank and Financial Accounts, commonly referred to as the FBAR). The FBAR is filed separately from the applicable party's U.S. federal income tax return and must be received by the U.S. Treasury Department on or before April 15 of the year immediately following the calendar year being reported. There is also a six-month extension for filing the FBAR.

Failure to meet this annual disclosure obligation could subject the applicable party to (i) criminal charges including, but not limited to, charges related to tax evasion, and filing a false return, (ii) criminal penalties for failing to file the FBAR, and (iii) civil penalties including but not limited to a penalty for willfully failing to file the FBAR, in an amount equal to the greater of \$100,000 or 50 percent of the total balance of the foreign account;<sup>1</sup>. In the case of corporate entities subject to these rules, officers and directors may also be subject to penalties for corporate non-compliance.

In addition to the FBAR, additional disclosures may have to be made, e.g., on an IRS Form 8938 (Statement of Specified Foreign Financial Assets).

### **Disclosure and Record Keeping Requirements on Certain Corporations**

The federal tax code imposes disclosure and record keeping requirements on corporations used by foreign persons for investment or business in the United States. The disclosure and record keeping requirements apply to any "reporting corporation" that is either a foreign corporation engaged in business in the United States or is a U.S. corporation that has at least one "foreign person" who directly or indirectly owns at least 25 percent of the vote or value of the corporation's stock. A "foreign person" includes a nonresident alien or foreign corporation.

A reporting corporation must file an annual return that discloses, among other information, the name, business, principal business location and country of incorporation or residence of any related party who engaged in one or more transactions with the reporting corporation during the year. For these purposes, "related party" is defined very broadly.

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<sup>1</sup> Or, in the case of non-willful violations, a penalty of not more than \$10,000 per violation.



In addition to maintaining all records necessary to determine its correct U.S. tax liability, a reporting corporation must also maintain all records necessary to establish the correct tax treatment of any “related party” transaction.

The disclosure and record keeping requirements for reporting corporations are complex and include exceptions for certain corporations,. Failure to comply with the disclosure and record keeping requirements could subject the reporting corporation to sanctions for non-compliance.

### **Tax Treaties**

As mentioned throughout this chapter, the benefits of tax treaties entered into by the United States and certain treaty countries may be available to foreign nationals of, and foreign corporations organized under, the laws of such treaty countries. For example, tax treaties may reduce (or eliminate) the otherwise applicable U.S. withholding applicable to dividends or similar investment income payable by a U.S. payor to a foreign payee. Resident aliens, nonresident aliens and foreign corporations doing business or investing in the United States and Arizona should carefully consider how the provisions set forth in an applicable tax treaty impact their particular circumstances.



# STATE AND LOCAL TAXATION

CRAIG R. MCPIKE, JULIE H. QUIGLEY AND HSIN PEI

**T**HE State of Arizona and various local governments impose taxes in connection with income, investments and business operations in Arizona. This chapter outlines several of the most significant state and local taxes in Arizona, beginning with taxes levied only by the state, such as state individual and corporate income taxes and estate taxes. The next part of this chapter deals with taxes that may be levied by the state, its counties and its municipalities, such as the transaction privilege (sales) tax and taxes on real and personal property.

## Income Taxation

The Tax Cuts and Jobs Act of 2017 (P.L. 115-97) (“Tax Cuts and Jobs Act”) was signed into law by President Trump on December 22, 2017 and contains some of the most significant changes to the Internal Revenue Code of 1986, as amended (“IRC”), in over 30 years. The Tax Cuts and Jobs Act provisions have the net effect of broadening the income tax base at the federal level yet achieving an overall reduction in federal income tax for the vast majority of filers by reducing federal tax rates. Federal tax reform has implications for the states, however, since every state that imposes an income tax incorporates parts of the IRC into their own system of taxation in some way, shape or form. Due to the fact that Arizona begins with federal adjusted gross income (individual income tax) or federal taxable income (corporate income tax) as the income tax base, particular attention must be paid to whether Arizona has conformed to the current IRC since the federal income to be used on the Arizona return may not be the same as reported on the federal tax return for the same tax year if Arizona has not passed IRC conformity legislation.

Arizona adopts the IRC as it existed on a fixed date rather than adopting all changes on an automatic rolling basis. Consequently the Arizona legislation must enact legislation to conform to the current IRC. As of December 18, 2018, Arizona has a static IRC conformity date of January 1, 2017 and has not yet enacted provisions to conform to the current IRC which includes the Tax Cuts and Jobs Act provisions.

## **Income Taxation of Individuals**

Two different classifications govern state income taxation of individuals. One applies to “Arizona residents,” the other to “Arizona nonresidents.”

### **DETERMINATION OF RESIDENT STATUS**

An individual is classified as an Arizona resident for state income tax purposes if such individual is in the state for other than a temporary or transitory purpose or is domiciled in Arizona. An individual is considered to be domiciled in Arizona if present in the state with the intent to remain in the state permanently. An individual who spends more than nine months of a year in the state is presumed to be an Arizona resident for that year, but evidence that the individual is in the state for a temporary or transitory purpose can overcome the presumption. An individual is classified as an Arizona nonresident if he or she is not classified as an Arizona resident under either of the above two tests.

### **TAXATION OF ARIZONA RESIDENTS**

An individual classified as an Arizona resident for state income tax purposes is taxed by the state on the individual’s income worldwide. The income tax rates range from 2.59 to 4.54 percent of taxable income.

### **TAXATION OF ARIZONA NONRESIDENTS**

An individual classified as an Arizona nonresident for state income tax purposes is taxed by the state only on income earned from sources within the state. The income tax rates for a nonresident are the same as for a resident.

### **SIMILARITIES TO FEDERAL TAXATION**

The income tax in Arizona is imposed on “Arizona taxable income.” For residents, an individual’s Arizona taxable income is the individual’s federal adjusted gross income, modified by certain additions and subtractions. Two of these modifications relate to interest income. First, interest received on obligations issued by any state or municipality, although excluded from federal taxable income, is included in Arizona taxable income unless paid by the State of Arizona or by an Arizona municipality. Second, interest received on U.S. government obligations, such as savings bonds and treasury bills,

although included in federal taxable income, is not subject to tax by Arizona or any other state. Many other modifications exist.

## **Income Taxation of Corporations**

### **IN GENERAL**

Arizona currently taxes 4.9 percent of the taxable income of corporations or \$50, whichever is greater. A corporation's Arizona taxable income is determined by reference to the corporation's federal taxable income, with certain adjustments.

### **MULTI-STATE ACTIVITIES**

If a corporation has income attributable to activities in more than one state and more than one state imposes a corporate income or similar tax, the corporation's aggregate income must be "apportioned or allocated" among the states. Only the amount properly apportioned or allocated to Arizona is subject to the Arizona corporate income tax.

For purposes of apportioning "business income," Arizona uses the three-part formula method of the Uniform Division of Income for Tax Purposes Act. Under this method, business income is generally apportioned among the states on the basis of three factors: the relative value of the corporation's real and personal property in Arizona as compared to the value of the corporation's property nationwide (the property factor); the relative amount of compensation paid by the corporation in Arizona as compared to the amount of the compensation paid by the corporation nationwide (the payroll factor); and the relative amount of sales made in Arizona as compared to the amount of the corporation's sales nationwide (the sales factor). Under Arizona law, a taxpayer may annually choose one of two options for weighting these factors. The first option is to weight the sales factor at 50 percent of the formula and to weight the property factor and the payroll factor each at 25 percent of the formula. The second option is to weight the sales factor at 100 percent of the formula and to exclude the payroll and property factors.

In Arizona, for purposes of the sales factor, receipts from services are sourced based on the greater of the cost of performance of the income producing activities. However, a "multistate service provider" may elect to source sales from services to Arizona based on where the market for the services is located. A "multistate service provider" is defined as a taxpayer that derives more than eighty-five percent of its sales from services provided to purchasers who receive the benefit of the service outside Arizona in the taxable year of election. The election to use market sales must be made on the taxpayer's timely filed original income tax return and is binding on the taxpayer for at least five consecutive taxable years, regardless of whether the taxpayer no longer meets the percentage threshold of a multistate service provider during the time period.

Nonbusiness income, which is income received by the corporation outside the regular course of its trade or business, is allocated under different rules. Dividends and interest received by a corporation are allocated to the state of the corporation's commercial domicile. Income from real property rentals is allocated to the state where the real property is located. Patent and copyright royalties are generally allocated to the state where the patent or copyright is used.

### **Multi-State Corporations Involving Related Corporations**

In Arizona, combined returns are mandatory for multi-state corporations that are part of a unitary business group. On the combined return, unitary businesses are required to use water's edge reporting and the entire net income of the unitary group is used to determine combined taxable income. The common parent of an affiliated group filing a federal consolidated return may elect to report the consolidated taxable income of all members of the group on an Arizona consolidated return, regardless of whether each member is subject to Arizona tax or unitary. Once elected, an affiliated group must continue to file consolidated returns unless the Arizona Department of Revenue consents to a change. Even if an election is not made, the Arizona Department of Revenue may require a consolidated return to clearly reflect income.

### **Transaction Privilege (Sales) Taxes**

The State of Arizona, all counties and incorporated municipalities, and various Indian tribes within the state's boundaries impose a "transaction privilege" tax ("TPT"), which is collected in lieu of the sales taxes levied in many other states. TPT is imposed on the privilege of engaging in the business activities specified within the particular taxing jurisdiction's tax code, and can include retail sales, transporting, utilities, telecommunications, publication, job printing, pipeline, private car line, hotel/motel, amusement, restaurant/bar, mining, personal property leasing, residential and commercial real property leasing, contracting, and "speculative building" (sales of improved commercial or residential real property). Note that any particular jurisdiction may levy tax on some activities to the exclusion of others. TPT is usually imposed on the vendor or person who engages in the taxable business activity, rather than the purchaser or end consumer of the good or service. However, the person who engages in the business is legally permitted to pass the tax through to the customer.

Any person wishing to engage in a business subject to TPT by an Arizona taxing jurisdiction must first obtain a license from the Arizona Department of Revenue—which centrally administers licensing for the state and its political subdivisions—or applicable tribal taxing authority. In most instances, a tax return, accompanied by payment of any tax owed, must thereafter be remitted on a monthly basis.

The tax base is the gross income or gross proceeds from the business activity. The rate of tax imposed by the state is currently 5.6 percent for most categories of taxable activities. Municipal tax rates vary greatly, but commonly range from 2 percent to 4 percent. Additionally, counties impose

a tax of 0.25 percent to 2 percent on most taxable business activities. Various tax exemptions and deductions, typically specific to the business activity being taxed, may be utilized to reduce or eliminate some or all of the tax liability.

It should be noted that Arizona's TPT operates very differently with respect to taxes imposed on the construction industry when compared against the treatment in many other states. Instead of a materials-based sales tax, Arizona's contracting taxes are commonly based on the proceeds an owner pays to its general or prime contractor, with the materials purchased by the contractor and subcontractors for use in a project being exempt from the retail tax. However, certain maintenance, repair, replacement, and alteration activities that are performed by a contractor or in a construction project may be subject to TPT only on the materials used under specific circumstances.

Additionally, of the various taxable business activities mentioned above, one of the most notorious and least understood among taxpayers is the city-level speculative builder tax. This generally applies to the sale of improved real property if the seller caused the improvements to be made to the property. In essence, this tax is a disguised real estate transfer tax applicable to certain transfers of improved real property, and can pose a significant risk to unsuspecting purchasers of the real estate through successor liability if sellers fail to pay the speculative builder taxes due on such transfers. While the vast majority of municipalities do not allow taxpayers to take a land deduction, city contracting taxes paid for improvements to the property can be taken as credits when calculating speculative builder tax liability.

### **Real Property Taxes**

All levels of government, including state, county and local jurisdictions, have the authority to impose taxes on real property. The counties are primarily responsible for property tax assessment and collection for most property.

The tax is determined by the use of the property and its value. Real property is classified into one of several use categories, including, but not limited to, commercial and industrial, owner-occupied residential, rental residential and agricultural. The use or class of the property determines the percentage of the property's value that is subject to tax. Each parcel is assigned a primary "limited" value and a higher secondary "full cash" value. There is no limit on the amount that a property's full cash value can increase from year to year; the property's full cash value is intended to reflect the property's fair market value. The limited value, however, may not increase more than 5% over the limited value for the prior year, and in no event may the limited value for a particular year be higher than the full cash value for such year. The property taxes for a particular year are assessed on the limited value. An administrative and a judicial appeal process are available for property owners to dispute a property's valuation or classification.

### **Personal Property Taxes**

Personal property used for a commercial purpose also is subject to taxation in Arizona. Although there are exceptions, most commercially owned personal property is subject to tax. The owner or person in control of personal property subject to tax is required to file with the local county assessor a report of all taxable personal property by April 1 each year. If no report is filed, the county assessor can estimate the property and its value. After receiving the property report, the county assessor will then assign a depreciated market value to each item of personal property. An administrative appeal and a judicial appeal process are available for challenging the valuation or classification assigned by the particular county.





