

Briefly

. . . from Burns, Figa & Will, P.C.

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Avoiding the Pitfalls of 1031 Exchanges

By Jennifer M. Osgood, D. Sean Velarde and Michael J. Norton



Undoubtedly one of the best methods of deferring capital gains taxes is through the use of Section 1031 of the Internal Revenue Code, 26 U.S.C. § 1031, commonly known as the 1031 Exchange. However, as popularity of the 1031 Exchange increases so do concerns. **In today's market, a basic understanding of 1031 Exchanges is invaluable and thorough due diligence is key.**

Basics of the 1031 Exchange

A 1031 Exchange is a transaction joining together the sale of old property and the purchase of new property in order to defer capital gains. Although 1031 Exchanges can be used for a variety of assets, they are traditionally used in real estate. Exchangers who sell appreciated property and reinvest the proceeds in a new property avoid gain recognition. To realize such benefits and to classify as a valid 1031 Exchange, the exchanger must strictly adhere to several rules. First, the property sold and the property received in exchange must be held for investment or for use in a trade or business. Second, the properties must be

of "like kind," meaning the nature of the properties must be identical. Third, the properties cannot be specifically excluded from tax free exchange treatment, as designated by the Internal Revenue Code. **The taxpayer that sells the old property must be the same taxpayer that purchases the new property and, in order to defer all the gain, the properties purchased must be equal or greater in value to the properties sold.**

The predominant rule for the 1031 Exchange is that all proceeds from the sale of old property must be held by a Qualified Intermediary and must be reinvested in new property. Cash kept from the sale of property is often referred to as "boot" and is taxable. "Boot" is anything that is exchanged that is not "like kind" property. For instance, mortgages are a form of boot. When the mortgage on old property is less than that of the new property, taxes might be paid on the difference. Under certain circumstances, mortgage boot may be offset with additional cash.

1031 Exchanges can be achieved in several ways, but today, **the most common exchange is the delayed exchange. To avoid having to find someone to simultaneously swap properties with, the delayed exchange allows you to sell your property first and then buy replacement property at a later date.** The exchanging party must identify the property to be received within 45 days and the property must be received within 180 days or before the due date of the exchanger's tax return. Security devices, such as cash or cash equivalents held by a qualified intermediary, can be used to secure the delayed transfer.

An Unregulated Market

Qualified Intermediaries are authorized under Section 1.1031 of the Department of the Treasury Regulations and are responsible for receiving, holding and safeguarding 1031 Exchange funds until the exchanger is ready to purchase a replacement property. **Intermediaries** also prepare required documents and help ensure compliance with regulations. **However, they are not licensed, regulated, audited or otherwise monitored by any regulatory body, which can present numerous problems, as evident by the recent rise in intermediary failures.**

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The unregulated intermediary market has recently received attention following The 1031 Tax Group; LLC's filing for Chapter 11 Bankruptcy in May 2007. The 1031 Tax Group was a consolidated group of five qualified intermediary companies doing business throughout the United States. The 1031 Tax Group's bankruptcy filing has left hundreds of exchange customers with open accounts and vulnerable to being unable to complete the second half of their real estate exchange, and potentially losing their exchange funds altogether, which are still subject to capital gains tax. In the months prior to the 1031 Tax Group's bankruptcy filing, Southwest Exchange, a large Qualified Intermediary based in Nevada, improperly invested approximately \$95 million of exchange funds, leaving exchange customers in a similar position.

These events have prompted growing concerns over which intermediaries can be trusted. However, **despite the recent rise in qualified intermediary fraud and failure, there are numerous ways to help protect your assets.**

Avoiding the Pitfalls

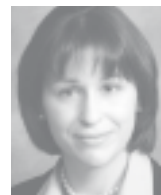
Avoiding the pitfalls of 1031 Exchanges lies in learning the basics and conducting thorough due diligence into the intermediary. When conducting due diligence, it is important to keep in mind the following:

1. Choose an intermediary that utilizes segregated accounts. Keeping your funds in a segregated account may provide you with some security in the event that your intermediary files for bankruptcy.
2. The intermediary with the lowest fee is not always your best option. Often intermediaries lower fees while increasing retention of interest earned on your account. Be sure that you are receiving market rate interest on your funds. Be wary of representations from a Qualified Intermediary that you will receive "all the interest" on your funds; nearly every Qualified Intermediary makes a

portion of their money on aggregating exchange funds for multiple customers and then receiving above market rate interest on the aggregate funds on deposit held by the Qualified Intermediary.

3. Different exchanges present different issues. Understand the packages intermediaries provide and diligently discuss and review your needs.
4. Make sure your intermediary has necessary and appropriate levels of bonding and insurance coverage as well as equity capitalization in order to account for losses.
5. Finally, conduct a background and reference check. Look for intermediaries with long term track records, experience, and professional recommendations without professional licensure issues or criminal convictions.
6. Require multiple signatures on the account to transfer the funds. However, be sure that required signatures are for trust individuals who are not exchange customer-signatory authority by the exchange customer likely would constitute constructive receipt of the sale proceeds by the customer which would destroy the tax-deferred exchange.

While the steps above cannot guarantee a successful 1031 Exchange, they can help you make the best possible choice when evaluating qualified intermediaries.



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Considerations in Taking Your Company Public

By Colleen R. Belak

This article is intended to provide a very general overview of the considerations of “going public” and the process for an initial public offering by a company. **A company “goes public” by registering an offer and sale of its securities with the U.S. Securities and Exchange Commission** (the “SEC”).

Section 5 of the Securities Act of 1933 (the “1933 Act”) requires that a registration statement relating to the offer or sale of a security be filed unless an exemption from registration exists. **Typically when a company is young, it raises capital through private placements from a relatively small pool of investors.** Usually such investments are designed to be exempt from these registration requirements. The securities issued in exempt transactions are restricted securities that may not be resold or transferred except under certain limited circumstances.

At some point, a company may decide that its potential for the future calls for public financing and thus will decide to file a registration statement for a public offering of its shares. Such a public offering may result in increased liquidity, a broadened investor base and, potentially, the raising of **larger amounts of capital than may be raised in private placement transactions.**

Going Public

What Constitutes Going Public

“Going public” by registering an offer and sale of securities with the SEC may result in the development of a public market for a company’s securities on either a national securities exchange or on the over-the-counter bulletin board. The initial registration of a company’s securities is called an initial public offering (“IPO”). Registration is achieved by preparing and filing a registration statement. The registration statement is reviewed in depth by the SEC and often, during this review process, accounting and disclosure issues are raised which must be further addressed in the registration statement.

The purpose of the registration statement is to inform potential investors about all significant aspects relevant to a potential purchase of the company’s stock, including detailed discussions about the industry in which the company operates, the company’s business operations, the business risks to the company, biographical information on the company’s officers and directors, financial condition, and shareholders who will be selling shares pursuant to the registration statement. A registration statement must include audited financial statements that meet the SEC’s requirements. These are some of the topics covered in the registration statement. This list is by no means intended to be an exhaustive list. If and when the SEC is satisfied with the content of the registration statement, the SEC will allow the registration to be effective. Once the registration statement is effective, shares of the company’s securities may be sold to the public in accordance with the plan of distribution contained in the registration statement.

Advantages

A public company may have greater ability to generate funds than a privately held company. A successful public offering may increase the visibility and appeal of the company and potentially may increase the demand and value for shares of the company. Additionally, a higher value may be placed on publicly held securities because they can be sold more readily than restricted securities are able to be sold in private offerings.

Disadvantages

The IPO process is complex and expensive and there is no guarantee that the IPO will be successful even after the expenses are incurred. Furthermore, the ongoing securities compliance obligations after the IPO are extensive.

Once a company becomes public, the company must comply with a myriad of securities and accounting disclosures, including filing annual audited financial statements, quarterly financial statements, holding annual shareholder meetings and preparing and distributing to shareholders in advance of such meetings a detailed proxy statement discussing the issues to be addressed at

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the shareholder meeting. In addition, the company must disclose material events promptly after they occur and the company's officers and directors and beneficial owners of 10% or more of any class of the company's securities must disclose when they buy, sell, receive or transfer securities of the company. The disclosure is not limited to information regarding the company. A fair amount of information must be disclosed regarding the executive officers and

have had. The individual officers and directors may have individual liability for violations of the securities laws and for breaches of their duties to stockholders.

The Parties Involved in an IPO

The following categories of persons generally are involved in an IPO: the company, its officers and directors, the company's counsel and accountants, the shareholders who will be selling shares in the IPO and their counsel, the managing underwriter and its counsel and any other underwriters and their counsel (the underwriters purchase the shares being registered and resell them to investors), any experts that are required, the company's public relations firm, and the financial printer selected to produce the registration statement and related materials for the offering. After submission of the initial draft of the registration statement, the following additional persons will be involved: the SEC, the National Association of Securities Dealers, Inc. ("NASD"), and the state securities regulators in each state in which the offered securities will be offered ("State Regulators").

The IPO Process

The IPO process requires a great deal of preparation, planning and time. The following are broad generalizations of the steps that are required in an IPO:

- Identify potential managing underwriters and negotiate the proposed terms of the offering, the letter of intent, underwriting agreement and the various other documents used in the syndication process;
- With the involvement of all parties to the IPO (including the company, officers, key employees, underwriters, accountants and legal counsel) determine a timetable for the offering and the list of responsibilities to be performed by each category of persons involved in the IPO.
- Educate company management regarding the IPO process and the rules applicable to the IPO process to ensure compliance with Section 5 of the 1933 Act.
- Evaluate all existing charter documents and material contracts of the company and make any necessary amendments to same.
- Collect information regarding the company, its officers, directors and significant shareholders for use in drafting the registration statement.
- Collect information regarding the shareholders who will be selling their shares in the IPO.

directors of the company also, including the details of all compensation paid to them by the company and its affiliates.

Where a company has previously raised funds through private placements and other unregistered offerings, the details of those fund raising activities must be disclosed to the SEC. The disclosure must identify the exemptions relied on and information about the purchasers. In addition, because of risks associated with all unregistered offerings, additional disclosure in risk factors and perhaps financial statements is required. **It is for this reason that, before even commencing the IPO process, your attorneys must engage in detailed due diligence and look at all prior fund raising activities during the previous three years.**

The risks of noncompliance with federal and state securities laws increase because of the greater level of disclosure that is required. The risk of litigation may also increase as a result of the company's securities being held by a larger group of people who may not have any associations with or loyalty to the company that the prior, private stockholders may



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- Conduct due diligence of all aspects of the company (performed by the company, its counsel, and the underwriters).
- Apply for listing on a national securities exchange or quotation on the over-the-counter bulletin board.
- Prepare the registration statement and prospectus. The prospectus is the portion of the registration statement that is considered the sales portion of the document, but also acts as an insurance policy for the company and underwriters by providing full disclosure to potential investors. The prospectus includes extensive disclosure regarding the company's business, properties, legal proceedings, management, financial condition, securities and the offering. The prospectus will be distributed to potential investors upon approval of the registration statement. The remainder of the registration statement is filed with the SEC, but generally is not distributed to potential investors.
- Submission of the registration statement to the SEC, NASD and State Regulators.
- Review of the registration statement by all of the regulatory authorities.
- Participate in "road show" presentation to generate interest in the company's offering.
- Amend the registration statement in light of the comments from the regulatory authorities. There may be several rounds of comments and amendments.
- The registration statement is declared effective and the securities may be sold to the public.

The company should plan on the IPO process taking about six months. Generally about three months of concentrated effort is required prior to filing the initial registration statement and the remainder of the time is required for the regulatory approval process.

The Cost of an IPO

The Company generally pays all of the costs of preparing the registration statement, including all legal and accounting fees for all parties to the transaction (including the underwriters) and all registration filings fees. The legal and accounting fees for a company may vary widely depending on the size of the company and the circumstances. In addition, the underwriters typically receive a commission that is a percentage of the offering price of the securities sold in the offering. The managing underwriter generally receives as a management

fee a percentage of the total underwriting commission (usually about 20%). The filing fee, commissions and management fee are tied directly to the amount of securities sold. Additionally, the underwriters may receive additional compensation in the form of options and warrants to purchase additional securities of the issuer after the offering.

Alternatives to Going Public

Alternatives exist to going public. A company can raise money through private offerings of securities, although it may be more difficult to raise the same amount of funds that can be raised in a public offering. For some, selling franchises may be a great way for the company to expand its business. Additionally, selling the business may be an attractive alternative.

Conclusion

Whether going public is desirable for your company must be analyzed with the company's status and goals in mind. The foregoing information is a very general overview of the considerations and process involved in an initial public offering. You should consult an attorney experienced in securities laws if you are interested in more information.



Colleen R. Belak

For more information, please contact Colleen R. Belak at (303)796-2626 or cbelak@bfw-law.com. Ms. Belak has a substantial amount of experience in business transactions, corporate law, intellectual property and commercial litigation. Ms. Belak represents clients in many aspects of their businesses, including assisting clients in forming their businesses; the purchase or sale of a business; negotiating and drafting contracts of all types, including business acquisitions, intellectual property license agreements, non-competition agreements, confidentiality agreements, distributorship agreements and employment agreements.

Firm News

- **Merc Pittinos** wrote a tribute to Senator Allott highlighting his accomplishments as an attorney and politician. The tribute was part of a series titled “Five of the Greatest: A Tribute to Outstanding Lawyers in Colorado History” published in the Colorado Lawyer.
- **Geoffrey P. Anderson** has published “Colorado Quiet Title Actions”, Colorado Quiet Title Actions provides a step-by-step discussion of how to evaluate, investigate, file, and resolve lawsuits over real estate title problems. Useful to the novice as well as the skilled practitioner, the book includes discussions about identification of parties, whether the parties have a right to a jury trial, how to handle defunct companies, service of process, military parties, and many other issues that arise in preparing a quiet title lawsuit. Lawyers handling quiet title cases will learn about statutes of limitations, working with title companies, lis pendens, working with experts, judicial foreclosures, receiverships, private condemnation, settlement strategies, trial considerations, and ethical issues. For more information contact Bradford Publishing Co. 800-446-2831 or cle@bradfordpublishing.com Geoffrey P. Anderson at ganderson@bfw-law.com
- **Herrick K. Lidstone, Jr.** will be presenting “Advanced LLC Issues” for National Business Institute in Denver, Colorado on December 9, 2007. For more information contact Herrick K. Lidstone, Jr. at hklidstone@bfw-law.com
- **Herrick K. Lidstone, Jr.** has published the “Securities Law Deskbook: For Business Lawyers, Public Accountants, and Corporate Management”. The Deskbook is a practical reference guide to securities law, in one convenient volume. With 17 chapters and hundreds of citations to securities rules, statutes, and cases, it is an essential tool for researching securities regulation, litigation, compliance issues, and much more. For more information contact Bradford Publishing Co. 800-446-2831 or cle@bradfordpublishing.com or Herrick K. Lidstone Jr. at hklidstone@bfw-law.com
- **Bernie Gehris** an associate at Burns, Figa & Will and his wife Connie rode in the Courage Classic race this July. They joined the Colorado and Denver Bar Associations with leading law firms and local businesses to sponsor the Wheels of Justice riding team. The team goal was to recruit 200 riders and raise \$200,000. The Courage Classic stretches over 3 days and 154 miles. The Wheels of Justice team dedicated its ride and donated all monies raised directly to the Children’s Hospital Center for Cancer and Blood Disorders. For more information about the team visit www.couragetours.com/2007/team/wheelsofjustice
- **Geoff Anderson** and his son Nick Anderson; Scott Clark; Aaron Jones; Tim Knight and Kathleen Knight; Ruth Rouse; and Tracy Vilecco spent a Saturday building a home with Habitat for Humanity at the Tollgate Crossing Project. The Tollgate Crossing project is a mixed income community and one of the largest developments of Habitat homes anywhere in the metro area. For more information call (303) 534-2929 or www.habitatmetrodenver.org

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While focusing in our primary areas, our attorneys maintain expertise in a broad range of specialized practice areas and subspecialties including:

- Business law and transactions
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- Real estate
- Wealth Preservation and Estate Planning
- Legal ethics

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