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Community Property Across State Lines

Square Pegs and Round Holes

By Karen E. Boxx

The marital property systems of the nine community property states vary greatly from the systems in the 41 remaining states and also vary greatly from each other. Failing to recognize these variations can be dangerous for attorneys with clients who move from one type of marital property system to another and also for attorneys with clients who keep their residences in one state but own property and transact business in other states. This article addresses what can happen when community property crosses state lines, the classification of property for the migratory client, issues of creditor rights, and other implications. The cases discussed below give very little clear guidance other than the rule that the proper approach in these circumstances is to be cautious rather than cavalier.

Existence of Marital Community

For community property to exist, there must be a valid marriage. This can include a common law marriage (and perhaps a same-sex marriage) if valid in the state where the couple resided when the marriage was established. There is a great deal of variation among the community property states when there is no valid marriage, particularly in cases in which one or both spouses innocently believe the marriage is valid. These cases are called putative marriages, and in some states the spouses are granted interests in "quasi-marital" property. The putative (innocent) spouse is entitled to division of such property at death or on divorce on the same principles as community property. It gets more complicated when another party is involved—for example, if "A" has married spouse number one, never dissolved that marriage, and then "married" spouse number two, who does not know of the still valid first marriage. When "A" dies, the court has to decide how to divide the property between spouse number one, spouse number two, and the decedent's ("A's") estate. Courts in different states have come up with different formulations for dividing the property; it gets even more interesting when the bigamist crosses state lines (or even international borders).

Jim Starr

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A good illustration is *Seizer v. Sessions,* 940 P.2d 261 (Wash. 1997). In that case, Elmer and Rosalie Sessions were married in Texas. When Rosalie was diagnosed as mentally ill, Elmer moved to New York, and, although he visited Rosalie at least once, he never resumed living with her on a permanent basis. He never divorced Rosalie, but began a relationship with Barbara, going through a marriage ceremony in Tijuana in 1984 and staying with Barbara until he died in 1991. At some point during the relationship, they moved to Vancouver, Washington, having stayed long enough in Arizona in 1989 to win a $2.5 million lottery. Elmer was listed as the annuitant with Barbara the beneficiary upon Elmer's death. At issue, now that Elmer had died, was Rosalie's and Barbara's respective rights in the lottery winnings. Rosalie's rights under Washington law depended on whether the marriage was defunct. Washington law provides that even if the spouses are still legally married, all property acquired by the spouses after the marriage has become defunct is the separate property of the acquiring spouse. If the marriage was not defunct, the lottery money was community property, owned one-half by Rosalie, the other half owned by Elmer, and passing to Barbara under Elmer's beneficiary designation. If the marriage was defunct, the lottery money was separate property, and Elmer could give it all by beneficiary designation to Barbara. Under Texas law, however, there is no provision for the termination of the community upon the demise of the relationship before divorce. If Texas law applied, Rosalie would be entitled to one-quarter of Elmer's estate, Barbara would be entitled to half the proceeds as an equitable share, and Elmer would be entitled to dispose of one-quarter (which he did by making Barbara the beneficiary). The court relied on *Restatement (Second) of Conflicts of Laws* § 258 cmt. c, which directs the court to look at the law of the spouse's domicile at the time the asset (the lottery ticket) was acquired. That state was Washington. But that only creates a presumption that can be rebutted, depending on which state has the most significant contacts. The court further held that Washington had the more significant contacts and applied Washington law.

Another interesting scenario when the differences in two community property states' laws create havoc is illustrated in *Martin v. Martin,* 752 P.2d 1026 (Ariz. Ct. App.

1986). This case turned not on the validity of the marriage but on the end of the community. The Martins had been domiciled in Wyoming and then in California before Mrs. Martin changed her domicile to Arizona. Three years later, she filed for divorce in Arizona. During their three-year separation, the husband continued to work in California. California has a rule terminating accumulation of community property once the marriage is defunct, similar to Washington's, but Arizona does not. The husband argued that his post-separation earnings were separate as provided by California law. Mrs. Martin argued that such earnings would be community property in Arizona and that, furthermore, Arizona's quasi-community property statute would deem his California earnings to be community property, even if California would not, because this would have been community property if acquired in Arizona. The Arizona court applied its own law, rather than that of the husband's domicile, and concluded that these post-separation earnings should be considered community property.

Characterization Issues

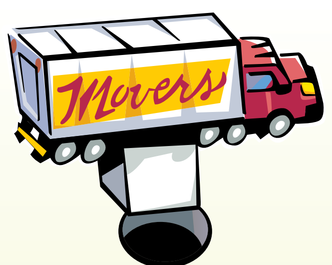
Generally, real property purchased in a community property state with funds earned in a common law state will be characterized as separate real estate, because the out-of-state earnings are characterized as separate property. In *Brookman v. Durkee,* 90 P. 914 (Wash. 1907), Mr. and Mrs. Durkee were married and lived in New York, and, while married, Mr. Durkee used some of his New York earnings to purchase real property in Pierce County, Washington. Mrs. Durkee died intestate a year later and Mr. Durkee about thirteen years after that, with a will leaving his property to persons other than Mr. and Mrs. Durkee's children. Neither of the Durkees had ever lived in Washington. The children claimed that the Washington property was the community property of their mother and father, giving them a right to half of it through their mother's estate. The Supreme Court rejected their claim on the ground that the character of the Washington realty should be determined by reference to the character of the funds used to acquire it, and those funds were to be characterized by reference to the law of the place where the funds were acquired.

> [W]e are clear that personal property acquired by either husband or wife in a foreign jurisdiction, which is by law of the place where acquired the separate property of one or the other of the spouses, continues to be the separate property of that spouse when brought within this state; . . . whether real or personal, received in exchange for it or purchased by it, if it be money, is also the separate property of such spouse.

Id. at 915. Any other rule, the court suggested, raised serious legal questions, because "[i]t would destroy vested rights. It would take from one of the spouses property over which he or she had sole and absolute dominion and ownership, and vest an interest therein in the other." Id.

Using community property to purchase real property in a common law state should similarly preserve the community interests of the spouses. *Restatement (Second) of Conflicts of Laws* § 259. The estate of Billy Martin, the Baseball Hall of Famer, New York Yankee shortstop, and five-time Yankee manager, presents an interesting twist on this theme. Mr. and Mrs. Martin lived in California but had purchased a home in New York, taking title as tenants by the entirety. Before the New York home was purchased, the Martins signed a community property agreement that stated that all real property "'held of record in the name of both parties as individuals, or . . . hereafter acquired as joint tenants or as tenants-in-common, are so held for convenience only and are the community property of the parties.'" The court held that under California law, tenancy by the entirety was inconsistent with community property, and the agreement made no mention of tenancy by the entirety, so the New York residence was not community property. *In re Estate of Martin,* 686 N.Y.S.2d 195, 197 (N.Y. App. Div. 1999).

In the *Martin* case, the characterization of the property as community would have affected distribution of the property between the surviving spouse and Billy Martin's children from another marriage. A more common reason for wanting preservation of the community property characterization is the step-up in basis for the surviving spouse's one-half share of the community under Code § 1014(b)(6). A technique used by practitioners to protect the double step-up is an agreement similar to the one signed by the Martins, confirming the community property character of property regardless of where it is or how it is held. The *Martin* case is fair warning to be as broad and inclusive as possible when describing any alternate title-holding method.



Real property purchased in a community property state with funds earned in a common law state will be characterized as separate real estate, because the out-of-state earnings are characterized as separate property.

Management and Creditor Claim Issues

A particularly thorny area is the treatment of out-of-state creditors who have dealt with residents of a community property state and who have assumed that the rules of the state of the transaction would apply. This can even create problems when two community property states are involved. For example, in *G.W. Equipment*

Leasing, Inc. v. Mt. McKinley Fence Co., 982 P.2d 114 (Wash. Ct. App. 1999), a husband and wife were residents of Arizona. The husband signed a guaranty in Washington, and the creditor was now trying to collect against the husband's marital community. Under Arizona law, the husband and wife must both sign a guaranty in order for it to be enforceable against the community; in Washington, the signature of one spouse would be sufficient. In determining that Arizona law applied, the court noted that

> Washington courts apply Washington law to determine the rights and authority of Washington spouses to enter into contracts affecting their community property. For Washington courts to conclude that residents of other community property states are bound by Washington community property law as well, rather than the law of their own state, would be illogical and unjust.

Id. at 117–18. The court also stated that "when management of community property is at issue, the state with the most significant interests is typically the state where the spouses reside." Id. at 117. Therefore, because Arizona law would require the wife's signature, and that was lacking, the guaranty was enforceable only against the husband's separate property.

Often, when dealing with a creditor from a common law state, community property state courts try to allow access to the same property as would be available in the common law state, but the categories of marital property do not fit very well. In *Blackwell v. Lurie,* 71 P.3d 509 (N.M. Ct. App. 2003), a husband and wife, while residents of Missouri, purchased a valuable sketch by Frederic Remington. The husband was a partner in a law firm that filed for bankruptcy. Around the same time as the bankruptcy filing, the husband and wife placed the sketch on consignment in a Santa Fe, New Mexico, gallery and then moved to Montana. In this action, the bankruptcy trustee had registered a deficiency judgment against the husband as a New Mexico judgment and was attempting to execute on the sketch. The husband and wife claimed that the sketch was held as tenants by the entirety, under Missouri law, which also provided that tenancy-by-the-entirety property was subject to claims only on which both spouses were jointly liable. The bankruptcy trustee argued that the sketch should be characterized as community property under New Mexico law, but the court disagreed, holding that New Mexico would look to the time and place of acquisition (Missouri) to determine the character of the property. Next the trustee argued that the debt represented by the deficiency judgment against the husband should be characterized under New Mexico law as a joint debt of the husband and wife.

The court struggled to characterize the debt as separate under the applicable New Mexico statutes because in the underlying bankruptcy action in Missouri, the court implicitly characterized the debt as the separate debt of the husband (even though the Missouri court would not be dealing with such notions as separate versus community liability because it is not a community property state). The court then said that the characterization was irrelevant, because the New Mexico statutes regarding what property is available for certain debts did not name tenancy by the entirety. The end result was that the court refused the creditor's attempt to execute on the Remington sketch.

The result in this case is not surprising because the only contact New Mexico had with this situation was that the sketch itself was located there at the time of the suit. This court's resolution differs significantly, however, from the Washington court's approach when dealing with out-of-state debts being enforced against marital property in this state. First, it should be noted that the category of separate debt in Washington is much broader than under the New Mexico statute and includes contractual debt incurred for no community purpose (such as debt in relation to separate property). Thus,

A particularly thorny area is the treatment of out-of-state creditors who have dealt with residents of a community property state and who have assumed that the rules of the state of the transaction would apply.

Washington law would not be as quick to characterize a debt as community. Also, only separate torts are enforceable against a tortfeasor's one-half of the community; separate contractual debts are only enforceable against the liable spouse's separate property. New Mexico statutes allow separate debts to be collected from the debtor's one-half of the community. Therefore, underlying Washington law regarding creditors of married persons is not as generous to creditors as New Mexico's.

In *Pacific States Cut Stone Co. v. Goble,* 425 P.2d 631 (Wash. 1967), two husbands, while domiciled in Washington, had incurred debt in Oregon. Previous case law had held that an out-of-state debt incurred by the husband was necessarily the separate debt of the husband, because it was not enforceable against the wife's property in the common law state. Then the court applied the Washington rule regarding a spouse's separate debt to determine liability. That meant that the out-of-state debt was unenforceable not just against the wife's property but against the husband's community property as well. The *Pacific States* court attempted to solve the square-peg-in-round-hole problem by looking instead to what property would be liable in Oregon and tried to carry out that rule in Washington. The result was still uneven, however, because the court held that because the debt was enforceable against everything but the

wife's separate property in Oregon, the debt was enforceable against everything but the wife's separate property in Washington. Of course, the wife's separate property in Washington was a smaller category than under Oregon law, because the wife's earnings in Oregon would be separate property.

This rule was refined in *Pacific Gamble Robinson Co. v. Lapp,* 622 P.2d 850 (Wash. 1980). In that case, the husband incurred the debt in a common law state while the couple lived there, and then the couple moved to a community property state. Unlike the creditor in *Pacific States,* the creditor would have no reason to question the vulnerability of the husband's earnings to the debt. The court characterized the question as: Is the creditor on an obligation incurred by one spouse in a foreign, noncommunity property state, where both spouses were domiciled, restricted in its recovery to the separate property of the obligor spouse, as the term "separate property" is defined by Washington law, after the couple moves to Washington? The court determined that under Colorado law, where the debt was incurred, all but the wife's separate property (which, unlike Washington, would include her wages) was liable for the debt. To properly apply Colorado law, the court held that the wife's separate property as well as her earnings (which were community property) were exempt from the debt but that the judgment was enforceable against the remainder of the couple's property. The creditors therefore fared better under the Washington cases, but, like the New Mexico case, the court in both these cases was attempting to treat the situation as if it had stayed in the state where it started.

In an Arizona case, *Alberta Securities Commission v. Ryckman,* 30 P.3d 121 (Ariz. Ct. App. 2001), the couple had been Canadian residents, where the husband had entered a settlement agreement with the Alberta Securities Commission, agreeing to pay $250,000 Canadian. The couple then moved to Arizona and defaulted on the obligation. The court stated the rule in Arizona to be that

> a judgment rendered against one spouse in a non-community property jurisdiction may be enforced against the community's property consistent with due process as long as (1) the obligation on which the foreign judgment was based would have been a community obligation if it had been incurred in Arizona, . . . and (2) the non-defendant spouse is joined in the Arizona domestication action and has an opportunity to contend that the foreign judgment was based on an obligation of the other spouse that would have been separate if incurred in Arizona.

Id. at 129. The court found that it would have been a community debt and that the spouse had been joined in the Arizona action. It further stated:

> We live in a mobile society: it is commonplace for people to move from state to state as they pursue job opportunities and better living conditions. Inevitably, some judgment debtors in non-community property states will move to Arizona, where community property is the law. It would be asking too much to require the creditor to foresee such a move, and to comply with Arizona laws at the time it files the original suit.

Id. at 130–31.

Community Property Agreements and Other Spousal Contracts

In *In re Estate of Erickson,* 368 N.W.2d 525 (N.D. 1985), a Washington couple had signed a community property agreement that converted all existing and after-acquired property to community and provided that upon the death of the first spouse, the property would vest in the survivor. The last provision, transferring all community to the survivor, is specifically authorized under Washington statute. The husband had inherited mineral interests in North Dakota. Several years after the husband's death, his son from another marriage petitioned the North Dakota court for distribution of the mineral rights under intestacy laws. The widow argued that the property passed to her under the community property agreement. The court concluded that the community property agreement did not operate to convert the North Dakota real property to community property, because North Dakota did not recognize community property. It distinguished another case in which North Dakota property was purchased with community funds by a California couple, and the court recognized an equal ownership of the property by each spouse, because in this case the wife did not contribute to the purchase of the property. The court did not address the possible application of the Uniform Probate Code provision (currently Section 6–101), adopted in North Dakota, that validates transfer at death provisions in nontestamentary instruments, including "marital property agreements."

It may be possible for a couple in a common law state to create community property in another state, following the model of the Alaska community property trust. For example, in *Stein-Sapir v. Stein-Sapir,* 382 N.Y.S.2d 799 (N.Y. App. Div. 1976), a couple domiciled in New York married in Mexico, where they had to elect community property or separate property. They elected community property, and when they later divorced, the New York court held the election to be valid, so that the wife owned one-half of the property earned by the husband. *Restatement (Second) of Conflicts of Laws* § 258 cmt. (b) (1969) provides that a couple can choose the law of a state other than their domicile to govern their property, and that choice will

govern unless the spouses' choice "is outweighed in the particular case by the intensity of the interest of another state, which would usually be the state of the spouses' domicile at the time of the acquisition, in having its own rules applied." Therefore, it may be possible, at least for some purposes, for a couple in a common law state to elect community property status.

A prenuptial agreement was at issue in *In re Marriage of Shaban,* 105 Cal. Rptr. 2d 863 (Cal. Ct. App. 2001). The couple had been married in Egypt, and the prenuptial agreement asserted by the husband in the dissolution proceedings was a one-page document signed by the husband and the wife's father at the time of the wedding. Translations differed, but, according to the husband, the document was an agreement to have all issues regarding the marriage, including property rights, governed by "Islamic law." Under such law, according to the husband, earnings and accumulations of each party remain that party's separate property. The couple had moved from Egypt to California, where the husband established a medical practice. In the dissolution action, the court noted that "Islamic law" is vague, in that there are several interpretations of Islamic law. In addition, the court noted that certain protections provided under Islamic law for the wife's benefit, such as a deferred dowry payable to the wife upon divorce, would not be enforceable in California, thus illustrating the difficulty of "grafting one part of another system" onto a very different marital property regime. Because of the agreement's insufficient specificity, the court applied California law and treated the couple's property as community.

In *Robinson v. Robinson,* 778 So. 2d 1105 (La. 2001), a husband and wife had lived in several different states during the marriage, but most of their married life was spent in Louisiana. When they split, the husband moved to North Carolina. The dissolution was finalized by a North Carolina court, under a settlement agreement prepared by the husband's North Carolina attorney. The agreement provided that North Carolina law would control. Years after the divorce was final, the parties were fighting over the wife's interest in the husband's pension plan. The agreement did not address the pension plan specifically, except to require the husband to name the wife as beneficiary of the annuity upon his death (which was intended as a backup to alimony payments). There was a general release by the wife of all claims in the husband's property. In determining which state's law would apply, the court stated, "A husband may not divest a wife of her interest in property by choosing a state law that may benefit his interests to the detriment of his spouse." Id. at 1117. Because Louisiana had far more extensive contacts with the subject matter, Louisiana law was held to apply. The conflict between Louisiana and North Carolina law was that North Carolina would have held the general release effective as against her rights in the pension, whereas Louisiana would require a showing that the wife understood the general release to include the pension. The court went on to hold that the wife had a community interest in the pension, which was not released by the boilerplate in the agreement, and then remanded for a determination of the ownership rights in the pension. One of the dissenters would have respected the choice of North Carolina law, because overriding such a choice is allowable only when the choice contravenes public policy, and it is not contrary to Louisiana public policy for a wife to contract away her rights in a pension in exchange for other property.

Conclusion

The possible conflicts issues that can arise when community property and married persons cross state lines is seemingly infinite because of the variations among the community property states, the variations between the two basic systems, and the application of those variations to the possible interstate transactions that spouses may enter. This article has tried to identify the vast potential for conflicts of laws when dealing with marital property and to illustrate how some courts have dealt with the issue. Although it is difficult to predict which law will apply to the property in these cases, courts will often look to the state that had the most contacts with the property, including where the parties resided at the time. In drafting any agreements in these situations, practitioners should make sure to specifically identify the choice of law and possibly even recite that both spouses understand the implications of such choice of law. ■

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ASSIGNMENTS OF RETAIL LEASES IN BANKRUPTCY, PART 1

What's Left of the Lease?

By Susan G. Talley and Harris Ominsky

When negotiating a retail lease—and in particular a lease for space in a shopping center—a landlord will insist on many lease provisions that are critical to it besides rent. A sophisticated landlord reasonably expects that a tenant bankruptcy can cause both an interruption in its rental income stream and delays while the tenant (as debtor in possession) or its trustee decides whether to accept or reject the lease. If the tenant rejects the lease, then the landlord is left with vacant space and a limited damage claim in the tenant's bankruptcy proceeding. What the landlord may not expect is for the lease to be assumed by the debtor and then assigned to another party without the assignee's being bound by key nonmonetary provisions that the landlord negotiated in its lease.

As a result of current case law, a landlord may be in for some unexpected surprises in a retail tenant's bankruptcy. A landlord may be left with a binding lease, but without the nonmonetary protections it negotiated and with a tenant the landlord does not want. This result is becoming even more prevalent in bankruptcies of large retailers, in which auctions of the debtors' "designation rights" are taking place. Landlords, however, are not without hope.

This article is one of a two-part series. The first article will describe the kinds of nonmonetary lease clauses that an assignment in bankruptcy can affect. There will then be an overview of Bankruptcy Code § 365, which governs assignments of leases in bankruptcy, and a review of various reported decisions addressing assignments of leases and the effect on nonmonetary lease clauses, with a focus on the seminal case of *In re Rickel Home Centers, Inc.*, 240 B.R. 826 (D.C. Del. 1998).

The second article, which will appear in the magazine's March/April issue, will discuss the use of designation rights auctions in retailer bankruptcies and the recent Fourth Circuit decision in *In re Trak Auto*, 367 F.3d 237 (4th Cir. 2004), which is very favorable to landlords. The second article will conclude with some suggestions for landlords.

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Max Licht

Key Nonmonetary Clauses

Besides rent and term, a retail lease may include a number of provisions that are very important to a landlord and for which the landlord may have vigorously negotiated, such as:

- the particular identity of the tenant,
- restrictions on assignment and subletting, including provisions calling for the tenant to pay the landlord a percentage of any net profits generated by the assignment or sublease,
- landlord rights of first refusal and recapture in connection with an assignment or sublease,
- use restrictions,
- radius restrictions limiting the tenant's ability to operate a competing store nearby,
- percentage rent clauses providing for additional rent based on a percentage of gross sales,
- operating covenants requiring that the tenant continuously operate and prohibiting the tenant from "going dark" except in limited circumstances,
- provisions governing alterations and improvements to the premises and requiring the landlord's consent to changes, and
- provisions governing the tenant's signage.

For ease of discussion, this article will refer to these and similar provisions as "key nonmonetary clauses."

Bankruptcy Code § 365(b)

Bankruptcy Code § 365 governs a debtor tenant's rights to assume or reject a lease. Code § 365(b)(1) provides, in essence, that a trustee may not assume an unexpired, defaulted lease unless the trustee:

> (A) cures, or provides adequate assurance that [it] will promptly cure, such default;

(B) compensates, or provides adequate assurance that [it] will promptly compensate . . . [the other party] for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such . . . lease.

Code § 365(b)(2) then provides that Code § 365(b)(1) does not apply to a breach of a provision relating to:

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title;

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement. . . .

The provisions listed in Code § 365(b)(2) are commonly referred to as ipso facto clauses and are clearly unenforceable in bankruptcy.

Code § 365(b)(3) creates an important rule intended to protect shopping center owners (the "Shopping Center Rule"). It provides that adequate assurance of future performance of a shopping center lease includes adequate assurance:

(A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, *as of the time the debtor became the lessee under the lease*;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that *assumption or assignment of such lease* is *subject to all the provisions thereof,* including (but not limited to) provisions such as a *radius, location, use, or exclusivity provision,* and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease *will not disrupt any tenant mix* or balance in such shopping center.

Bankruptcy Code § 365 (b)(3) (emphasis added).

Code § 365(f)(1) and (2) purport to invalidate so-called anti-assignment clauses by providing that "notwithstanding a provision in an . . . unexpired lease of the debtor . . . that *prohibits, restricts, or conditions the assignment of such . . . lease,* the trustee may assign such . . . lease" (emphasis added) if:

(A) the trustee assumes such . . . lease in accordance with the provisions of this section; and

(B) adequate assurance of future performance by the assignee of such . . . lease is provided, whether or not there has been a default in such . . . lease.

Code § 365(f)(3) then states:

Notwithstanding a provision in an . . . unexpired lease . . . of the debtor, or in applicable law that terminates or modifies, or *permits a party other than the debtor to terminate or modify, such . . . lease* or a right or obligation under such . . . lease *on account of an assignment of such . . . lease,* such . . . lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such . . . lease by the trustee.

Bankruptcy Code § 365(f)(3) (emphasis added).

In all of these provisions, references to the trustee include a debtor in possession.

Although Code § 365(b)(3) would appear to give shopping center owners a certain amount of comfort in a tenant bankruptcy, bankruptcy courts have been reading Code § 365(f) broadly to override, as "de facto" anti-assignment provisions, just the kinds of clauses that the Shopping Center Rule is supposed to protect.

Rickel

The case of *In re Rickel Home Centers, Inc.,* 240 B.R. 826 (D.C. Del. 1998), affirmed on grounds of mootness, 209 F.3d 291 (3d Cir.), cert. denied, 531 U.S. 873 (2000), is a good starting point for discussion. *Rickel* involved a debtor home improvement store that sought bankruptcy court approval to sell 41 of its leases to Staples for a total of $35.5 million. The agreement provided that leases could be subsequently assigned to a nominee, which the parties testified would be a Staples affiliate. *Rickel* technically did not involve a sale of designation rights, primarily because the assignments were to one initial end user—Staples. Nevertheless, given the number of stores, differing landlords, and varying lease provisions, the *Rickel* court addressed many of the same issues arising in the designation rights cases.

As part of the court-approval process in *Rickel,* various objections to the sale terms were settled with a number of landlords. Three of the affected landlords, however, did not settle. They argued that the sale would violate various restrictions in their leases because the sale would, among other things:

- cause the stores to be closed for a period of time,
- violate use restrictions in the leases,
- require subdividing the leased premises and subletting excess space not used by Staples,
- disrupt the tenant mix because the stores would "go dark" for a period of time, and
- cause a loss of percentage rent.

In approving the sale, the court cited Code § 365(f)(1) for its anti-assignment provisions. It stated that the Shopping Center Rule must be read in conjunction with the anti-assignment prohibitions of Code § 365(f). The court found that Code § 365(f) bans not only lease provisions that specifically prohibit assignment

but also lease provisions that are so restrictive that they constitute de facto anti-assignment provisions. It concluded that the provisions asserted by the landlords were de facto anti-assignment provisions.

Use Restrictions. The landlords had raised varying degrees of objections that the proposed sale to Staples violated use restrictions in their leases. One limited its objection to a potential use other than a Staples. Another objected even to a Staples. The court accepted the debtor's testimony that the type of home improvement center operated by Rickel would either become obsolete or would struggle to compete against stores like Home Depot. It stated that the lessors offered no evidence to rebut the debtor's position. Given the market conditions, the court found the use clauses were anti-assignment provisions.

Altering/Dividing Space. The court found that restrictions on altering and dividing the space were "nuisance" provisions that should not be used to thwart an assignment of the leases. One landlord, Vornado, had argued that the consent provisions on alterations were more substantive and should be read in the context of the use restrictions. The court noted that Vornado, in fact, had eight Staples stores in other locations. The court indicated that Vornado's concerns about alterations were disingenuous. Another landlord argued that a smaller store would not serve as an anchor to its center. In rejecting that claim, the court accepted the debtor's evidence that Staples stores did serve as anchors to a number of shopping centers.

Tenant Mix. Two of the landlords argued that changing the use of the premises would disrupt the tenant mix of their centers. The third landlord argued that allowing the premises to remain dark during the renovations (in violation of a continuous operations clause) would disrupt the tenant mix of the center. As to the use restrictions, the court fell back on its earlier conclusions. The court also found it was reasonable to go dark for the limited period of time necessary to complete the alterations. Testimony indicated it would take about six months for a Staples store to become operational. The court did not find that period of time so unreasonable as to affect the use or disrupt the tenant mix.

Percentage Rent. One landlord argued that an assignment to Staples would cause a substantial decline in percentage rent. It argued that other tenant percentage rents in the shopping center would drop because Staples would not be as much of a draw. The court refused to look at other tenants' percentage rents. Staples had also submitted evidence that the debtor had not been paying percentage rent, so that percentage rent for the leased premises would not substantially decline by reason of an assignment to Staples.

Financial Condition of Assignee. One landlord argued that Staples had not submitted sufficient evidence of its financial condition. At the hearing, Staples offered evidence of its financial condition, which the court found sufficient to meet the lease obligations.

The court did give the landlords some relief. It:

- reserved the landlords' rights to pursue Staples if Staples acted to violate other "reasonable" lease provisions in violation of Code § 365,
- made it clear that, in its approval of partitioning the space into smaller stores and subleasing, it did not authorize further partitioning or subleasing for future tenants, and
- left open the landlords' ability to enforce use restrictions if they were necessary to protect other shopping center tenants' exclusive rights.

Other Case Law

The *Rickel* case is not an aberration. As evidenced by other reported decisions, bankruptcy courts have tended to find key nonmonetary clauses as de facto anti-assignment clauses and to allow retail debtor/tenants to assign or sublet. A few illustrative

A TYPICAL LANDLORD AND ITS COUNSEL MIGHT NOT SEE A USE RESTRICTION AS NECESSARILY A RESTRICTION ON ASSIGNMENT.

decisions, organized by types of key nonmonetary clauses, follow.

Landlord Consent to Assign/Sublet

Lease restrictions on assignment and subletting come in a variety of forms, ranging from absolute bans to requirements for a landlord's consent, which might be withheld in the landlord's sole and absolute discretion, to requirements for a landlord's consent, which might not be unreasonably withheld, to landlord consent provisions conditioned on a number of somewhat objective criteria such as the tenant's financial condition, reputation, and proposed use. Are all of these clauses anti-assignment provisions? Some cases seem to suggest so.

For example, in the case of *In re Bradlees Stores, Inc.*, Nos. 00-16033(BRL), 00-16035(BRL), 00-16036(BRL), 01-CV-3934, 2001 WL 1112308 (S.D.N.Y. Sept. 20, 2001), the court dealt with a lease-assignment clause. In the debtor's first bankruptcy, the bankruptcy court approved a settlement among a lessor, lessee, and the debtor sublessee to resolve a dispute over the primary lease and the debtor's sublease. The court-approved settlement made the sublease subject to the terms and conditions of the primary lease, including a use restriction (use only as a department store) and a restriction on assignment without lessor consent, except to certain affiliates and similar successors (it is not clear from the case whether a reasonableness standard applied). The debtor filed a second bankruptcy proceeding after financial difficulties kept it from consummating its prior plan of reorganization. In the second bankruptcy, the court approved an assign-

ment of a number of lease rights (including the sublease) to a third party (to act like a broker) for purposes of further assignments to ultimate users. The court found that the settlement was an executory contract, held that the restrictions on assignment violated the anti-assignment provisions of Code § 365(f), and allowed the debtor to assign the sublease as contemplated.

Use Restrictions

A typical landlord and its counsel might not see a use restriction as necessarily a restriction on assignment. When the landlord has demonstrated real harm if the use restriction is ignored, the courts have shown some restraint in approving assignments. This article will discuss cases leading up to the landlord-favorable decision in *Trak Auto.* The second article in this series will contain a discussion of *Trak Auto.*

IT IS COMMON FOR A LANDLORD TO NEGOTIATE FOR KEY NONMONETARY CLAUSES THAT OBLIGATE A TENANT TO MAINTAIN A PARTICULAR NET WORTH, ACHIEVE A CERTAIN LEVEL OF SALES, OR MEET OTHER FINANCIAL TESTS.

In re Federated Department Stores, Inc., 135 B.R. 941 (Bankr. S.D. Ohio 1991), dealt with an assumption and assignment of a lease from a retail department store to a "specialty" department store geared toward the cost-conscious customer. In this case, the court found that the Federated store was an anchor store of a shopping center. The court did not approve the assignment, finding that it would disrupt the tenant mix by changing the image of the shopping center, would require subdivision of the space, and would leave part of the space dark until another tenant was found. In reaching its conclusion, the court stressed that an anchor store has a major effect on the entire shopping center.

The *Federated* decision is distinguishable from the *Rickel* case in several respects. In *Federated,* the landlord presented very specific arguments why a "specialty" department store would frustrate the long-term goals of the shopping center to appeal to a more upscale clientele. In contrast, the *Rickel* court found that Staples would not hurt the tenant mix and that the landlord's objections appeared "disingenuous." Also, for at least one of the *Rickel* leases, the contract rent payments were significantly lower than then-current fair market rent. That landlord stood to make a large profit if it could prevent the lease assignment.

In the case of *In re Paul Harris Stores, Inc.,* No. 91-2100-RLB-11, 1992 Bankr. LEXIS 2418 (Bankr. S.D. Ind. Feb. 14, 1992), the court allowed the assignment of leases for women's apparel stores to a maternity apparel store chain. The court found that lease provisions requiring the tenant to operate under the name "Paul Harris" were de facto anti-assignment provisions and that other lease restrictions, including a provision restricting the use to selling "women's apparel," would not be violated by the proposed assignment. The court looked at testimony and the mall's own brochures to determine that maternity apparel was women's apparel.

The case of *In re Martin Paint Stores,* 199 B.R. 258 (Bankr. S.D.N.Y. 1996), aff'd, *Southern Blvd., Inc. v. Martin Paint Stores,* 207 B.R. 57 (S.D.N.Y. 1997), involved a paint store in a three-story commercial building. A ladies' dress shop was located in the street level of that building. The lease for the dress shop included an exclusive use clause for ladies' clothing. Martin sought to assume and assign its lease to another ladies' dress shop. After first finding that the premises were not located in a shopping center, the court permitted the assumption and assignment without imposing the use restriction.

By allowing the assignment, the court put the landlord at risk of defaulting under its other lease. If another tenant's lease is breached, then who has liability for the breach? The landlord who is acting under a court order? The debtor's bankruptcy estate? The new assignee?

In the case of *In re Sun TV and Appliances, Inc.,* 234 B.R. 356 (Bankr. D. Del. 1999), the debtor proposed a temporary assignment of an outparcel ground lease to a third party to "shop" the lease, with no specific use proposed. The court found that the proposed assignment would violate the use restriction in the lease and that the use clause in the lease did not violate the Bankruptcy Code anti-assignment rules. Therefore, the proposed assignment was not permitted. It is interesting that the proposed assignment in *Sun TV* was very similar to the sales of designation rights that will be described in the second article of this two-part series. In *Sun TV,* however, it appears that only one ground lease was involved.

The case of *In re J. Peterman Co.,* 232 B.R. 366 (Bankr. E.D. Ky. 1999), involved a use restriction and a 60-mile radius restriction. The use clause specifically required use of the "J. Peterman" brand name. The proposed assignee, a children's clothing retailer, did operate stores within the 60-mile radius. The proposed assignee did not and would not operate under the name "J. Peterman" or sell similar merchandise. The bankruptcy court denied approval of the assumption and assignment. The court looked at the tenant mix of the shopping center in which the space was located. It also found that the radius restriction was reasonable for the relevant market and was not in violation of the Bankruptcy Code anti-assignment rules. In this case, the court seemed to give more weight to the Shopping Center Rule than to the anti-assignment rules of Code § 365(f).

Continuous Operations/Going Dark

Having a shopping center store, especially an anchor store, go dark can be a devastating event for a landlord. Although the courts have tended not to allow a complete closure of a store in violation of a continuous operations clause, they have allowed partial clo-

sures or closures for what are deemed reasonable periods of time to allow assignment, renovation, refixturing, restocking, and the like.

The case of *In re Goldblatt Bros., Inc.,* 766 F.2d 1136 (7th Cir. 1985), did not involve an assignment, but illustrates a bankruptcy court treatment of a continuous operations covenant. There, the debtor/lessee sought to assume an unexpired lease. The debtor proposed closing for two months for renovation and planned to discontinue using its second floor (about 50% of the leased premises). By downsizing, the debtor would likely not pay percentage rent. The court found that, as long as the debtor/lessee did not violate any explicit provisions of the lease, the temporary closure and discontinuance of use of the second floor would not violate the operating covenant. The court allowed the debtor/lessee to assume the lease. The operating covenant in this lease did refer to operating "without interruption," but apparently did not specifically reference *all* of the leased premises. It is important to note that the *Goldblatt* court did not find sufficient evidence that a shopping center was involved and did not apply the Shopping Center Rule.

In *Connellsville Plaza v. Jiffy Foods Corp.,* 92 B.R. 136 (W.D. Pa. 1988), the lease authorized the lessee to make improvements to the leased premises. The proposed assignee (a new entity formed by shareholders of the debtor) needed to close 60 days for remodeling. As a result of lengthy appeals, the premises were vacant for a considerably longer period of time. The court found that there would be no breach of the lease by the assignee's temporary closure.

Minimum Sales Levels/Financial Tests

It is common for a landlord to negotiate for key nonmonetary clauses that obligate a tenant to maintain a particular net worth, achieve a certain level of sales, or meet other financial tests. Questions have been raised by bankruptcy debtors about whether these provisions are de facto anti-assignment clauses.

In the case of *In re Joshua Slocum, Ltd.,* 922 F.2d 1081 (3d Cir. 1990), the debtor's lease included a minimum sales requirement that was averaged over a six-year period. Either party could terminate the lease if the sales did not meet the requisite test after either three or six years. The debtor/lessee's trustee sought to assume and assign the lease without the minimum sales requirement. The trustee argued that it would be unlikely for any new store to be able to meet the average in the short period of time left on the six-year window. After first finding that the premises were located in a shopping center, the court found that the landlord could enforce the minimum sales requirement against subsequent tenants. In doing so, the court emphasized that Congress intended for bankruptcy courts to be very sensitive to the contractual rights of nondebtors when applying Code § 365(b)(3).

The relevant lease was signed in 1983 and the events leading up to the case took place in 1989. It is not entirely clear from the reported decision how the court would enforce the three- and six-year tests against the assignee or even a further assignee. For example, would a new period of time start to run on the assignment?

The case of *In re R&J, Inc.,* 140 B.R. 316 (Bankr. D. Mass. 1992), affords an interesting analysis. *R&J* involved the existing debtor/tenant's assumption of its own Faneuil Hall restaurant lease. An assignment was not involved. The lease included a percentage rent clause. In reaching its decision to permit the assumption by the debtor/tenant, the court looked at the tests for analyzing a prospective assignee under Code § 365(b)(3)(A) and for reviewing the debtor's percentage rent under Code § 365(b)(3)(B). As cited above, Code § 365(b)(3)(A) requires a proposed lease assignee (and its guarantors, if any) to have a similar financial condition and operating performance as did the debtor (and its guarantors, if any) *at the time the debtor became the lessee under the lease.* Code § 365(b)(3)(B) is the test for percentage rent under the Shopping Center Rule. The percentage rent test of Code § 365(b)(3)(B) states that "any percentage rent due under such lease will not decline substantially."

The landlord in *R&J* argued that the approach of Code § 365(b)(3)(A)—looking to the time the debtor first became a lessee—should likewise apply to the test for percentage rent under Code § 365(b)(3)(B). The court did not accept that argument. It is interesting that the court did not address the language in clause (B) of the Shopping Center Rule that percentage rent is not to "decline substantially." It would seem that language, which defines, in part, adequate assurance of future performance, should apply to a simple debtor assumption, as well as to an assumption and assignment.

Share of Net Profits on Assignment/Sublease

A lease may require a tenant to share with the landlord any profits that the tenant gains in assigning the lease or subletting the premises. Those clauses discourage a tenant from assigning or subletting purely to take advantage of a rising market. Bankruptcy courts have consistently found these provisions to be de facto anti-assignment clauses.

In the case of *In re Boo.com North America, Inc.,* No. 00-15123 (JHG), 2000 WL 1923949 (Bankr. S.D.N.Y. Dec. 15, 2000), the lease required the lessee to pay the landlord 100% of the profit generated by a lease assignment or sublease. The court held that was a de facto anti-assignment provision. See also *In re Office Products of America, Inc.,* 140 B.R. 407 (Bankr. W.D. Tex. 1992) (invalidating lease provision requiring tenant to pay over sale proceeds from

any lease assignment); *Robb v. Schindler,* 142 B.R. 589 (D. Mass. 1992) (invalidating a requirement to pay the landlord 80% of profits from an assignment or sublease); *In re Standor Jewelers West, Inc.,* 129 B.R. 200 (B.A.P. 9th Cir. 1991) (invalidating a requirement to pay the landlord 75% of the profit resulting from an assignment, even though valid under state law).

In re Jamesway Corp., 201 B.R. 73 (Bankr. S.D.N.Y. 1996), involved three leases. One had a 50% (at a certain point increasing to 60%) profit-sharing provision. The other two leases granted the landlord one-third of any profits on assignment. The court found that all three provisions, including those only requiring a one-third share, violated the anti-assignment rules. It is interesting that the *Jamesway* court found a share as low as one-third to constitute a de facto anti-assignment provision.

Is that share of profits (or an even lower share) really a burden on assignment or a "termination" or "modification" of the lease "on account of" the assignment within the meaning of Code § 365(f)? What if the lease makes it clear that the landlord's minority share is net of all assignment costs? Do these cases suggest that a landlord will never be allowed to share in any profits on an assignment in bankruptcy? In these cases, the courts may be trying to maximize the value of the assignment to the debtor's estate but clothing their reasoning in the provisions of Code § 365(f).

A different but similar tactic a landlord might try is to increase rent on an assignment of the lease. In many instances, a landlord might grant rent concessions to a particular tenant for other reasons. For example, the tenant may have multiple leases with the same landlord or other dealings that would justify a lower rent.

In the case of *In re David Orgell, Inc.,* 117 B.R. 574 (Bankr. C.D. Cal. 1990), the debtor/lessee operated several high-end silver, crystal, and china shops in California. The debtor sought to assign the lease for its Rodeo Drive location. The lease in question included a provision that the rent would increase to then-current market rates if the lease were ever assigned. The court found

the rent increase invalid under Code § 365(f)(3). The court concluded that Congress had adopted a policy favoring assumption and assignment of contracts as a means of assisting debtors. Any rent increase clause tied to an assignment of a commercial lease would be unenforceable under Code § 365.

In light of the existing cases, there can be no assurance that a bankruptcy court will protect any clause that may appear to be a deterrent to assignment or appear to provide additional income to a landlord on assignment. If, however, the lease formula provides a fair share of profits to a landlord, a court might support it. A court might also enforce reasonable review and processing charges or legal fees or legal fee provisions that compensate a landlord for the inevitable time and expense of reviewing a proposed assignment or sublease.

Rights of First Refusal/Recapture

In conjunction with requirements for assignments and subleases, it is also typical for a landlord to negotiate a right of first refusal or a right to "recapture" the premises if the tenant proposes to enter into an assignment or sublease. These provisions do not prohibit assignments or subleases. They simply require that the tenant give the landlord the first chance to gain back the premises. By and large, the courts have still found these provisions to be de facto anti-assignment clauses.

In the case *In re Mr. Grocer, Inc.,* 77 B.R. 349 (Bankr. D.N.H. 1987), the lease granted the landlord a right of first refusal if the lessee proposed to assign the lease. The right of first refusal extended to assignments by operation of law. The court found that the landlord's right of first refusal violated the anti-assignment rules of the Bankruptcy Code. In reaching that result, the court first suggested that any condition on assignment would violate the anti-assignment rules. It then noted the chilling effect a right of first refusal has on third-party bids. Would the court have reached the same conclusion if the landlord had retained only a right of first offer? A right of first offer would not seem to have the same "chilling effect" on assignment.

The court in *In re E-Z Serve Convenience Stores, Inc.,* 289 B.R. 45 (Bankr. M.D.N.C. 2003), reached a different result from the court in *Mr. Grocer.* The *E-Z Serve* affiliated debtors operated convenience stores throughout the United States at a variety of owned and leased locations. The Chapter 11 trustee conducted an auction sale of a number of the leased locations. Hartrampf was the lessor of the site known as "Store 48." He also owned the property across the street on which one debtor's Store 68 was located. The lease for Store 48 included a right of first refusal. Without knowledge of the right of first refusal, another party, Hewatt, submitted a bid for Store 48 in the amount of $250,000. That bid was part of a larger "all or nothing" bid by Hewatt on a group of stores. The lessor, Hartrampf, also participated in the auction and placed a bid of $301,000 for Store 48. The trustee nevertheless accepted Hewatt's bid and Hartrampf objected.

In this case, the court enforced the lessor's right of first refusal and rejected the rationale of *Mr. Grocer.* The court applied a three-pronged test:
(1) the extent to which the lease provision hampers a debtor's ability to assign,
(2) whether the provision would prevent the bankruptcy estate from realizing the full value of its assets, and (3) the economic detriment to the nondebtor party. Here, the court agreed with the lessor's evidence of economic detriment. The lessor demonstrated that the right of first refusal was bargained for and agreed to as a material element of the lease and in consideration of below-market rent.

The court also considered Hartrampf's argument that an inappropriate use of the Store 48 site could put him in breach of radius restrictions he committed to in the Store 68 lease. The court found that the right of first refusal would not burden or restrict future assignments of the lease.

The court further noted that a right of first refusal did not limit bidding on Store 68 nor did it compel a sale at a price below what might be offered in the open market. Finally, the court determined that Hartrampf's higher bid would yield value to the estate.

Rights Personal to Lessee

It is not unusual for a lease to provide that certain rights, such as renewal options, are personal to the initially named lessee and may not be exercised by an assignee or sublessee. The case of *Double K Properties, LLC v. Aaron Rents, Inc.,* No. 1:03CV00044, 2003 WL 21657914 (W.D. Va. July 15, 2003), involved a lease with an option to renew that was stated to be personal to the original tenant, Helig-Meyers Furniture Company. In its bankruptcy, Helig-Meyers assigned the lease to Aaron Rents. Aaron Rents then exercised the renewal option contained in the lease.

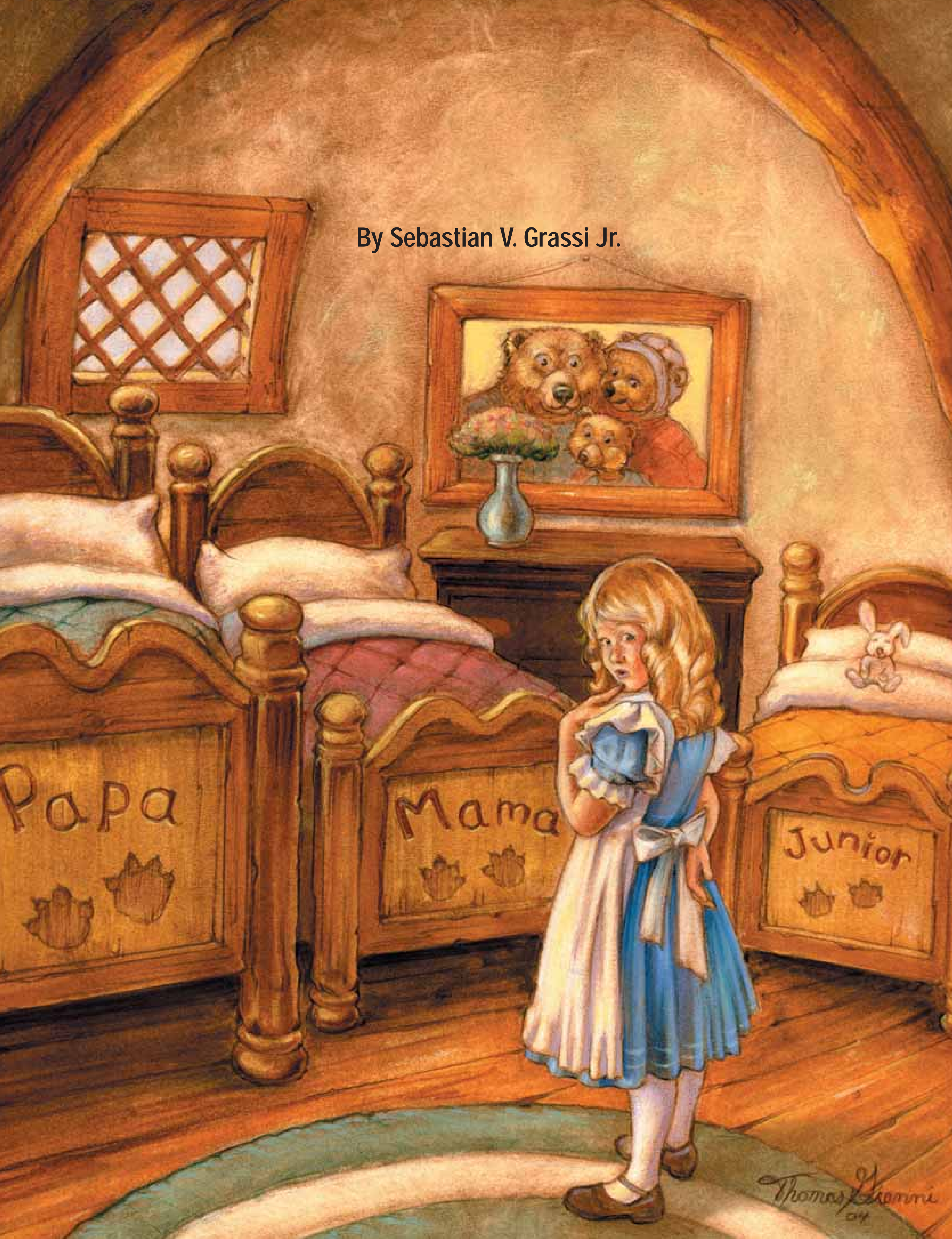
In response to the landlord's objections, and on cross motions for summary judgment, the court ruled that Code § 365(f) invalidated the lease provision purporting to make the renewal right personal to the original tenant. The court found that the provisions of Code § 365(f) must be read in conjunction with the provisions of Code § 365(b)(3). The court found that the language in question did "modify" the lease "on account of assignment," bringing it within the ambit of Code § 365(f)(3). Of course, if simply naming lessee rights as personal in the lease could move those provisions outside the ambit of Code § 365(f), then landlords would be tempted to make all lease provisions "personal" to the originally named tenant.

Conclusion

As the cases described in this article demonstrate, bankruptcy courts have tended to decide lease assignment cases so as to facilitate assignments and subleases and bring value to the debtor's estate. The use of designation rights in large retail bankruptcies has brought even more insecurity to landlords, as will be described in the second article.

Landlords, however, are not without protections. The Fourth Circuit decision in *Trak Auto,* discussed in the second part of this series in the March/April issue, may bring much needed relief to retail landlords. ■

By Sebastian V. Grassi Jr.



When planning a marital deduction estate plan for a married couple, a practitioner's "one size fits all" type of marital deduction funding formula clause may not always be the most effective formula for dividing and distributing the client's estate. Informal surveys conducted by marital deduction commentators indicate that many, if not most, estate planning practitioners tend to favor one or two "tried and true" types of marital deduction funding formulas. This article summarizes the seven (five different pecuniary funding formulas and two different fractional funding formulas; see Sebastian V. Grassi Jr., *A Practical Guide to Drafting Marital Deductions Trusts (with Sample Forms and Checklists)* (ALI-ABA 2004) ch. 15, for a detailed discussion of each formula and sample drafting language) types of commonly used marital deduction funding formulas and highlights their similarities and differences. As will be seen, each formula has benefits and detriments. Determining which formula best suits a client's needs will help the practitioner better tailor the estate plan to meet the client's objectives and circumstances.

Summary of Marital Deduction Pecuniary Funding Formulas

True-Worth Marital Deduction Funding Formula

Use when:

• ***The marital trust amount will be smaller than the credit shelter trust amount.*** (For purposes of this article, the nonmarital share is referred to as the credit shelter trust.) This will minimize capital gains on funding because the pecuniary marital bequest amount will be smaller than the (initial) amount of the residue payable to the credit shelter trust.

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Thomas Gianni

• ***You want to freeze the marital trust amount.*** Because the pecuniary amount is determined as of the grantor's date of death (or alternate valuation date), the amount to be paid to the marital trust is fixed, regardless of how much the grantor's estate appreciates (or depreciates) during the course of its administration.

• ***You want limited revaluations of the grantor's estate.*** (For purposes of this article, and unless otherwise expressly stated, the term the "grantor estate" refers to either the grantor's probate estate or the grantor's revocable living trust (as a will-probate substitute).) Assets distributed in satisfaction of the pecuniary marital bequest amount are valued at their date of distribution value, and because the pecuniary marital bequest amount is less than the residue, less property has to be revalued when satisfying the marital bequest.

• ***The grantor's estate has Code § 2032A special use valuation property.*** Special use valuation property is valued at its date of distribution value when satisfying the pecuniary bequest (not at its reduced special use value). This provides leverage to the residue because the marital pecuniary bequest amount, which is determined in part based on the reduced special use valuation, is in fact satisfied with the same asset using its date of distribution value.

• ***You want the ability to pick and choose the assets for funding the trusts.*** There is no requirement that the assets used to satisfy the pecuniary marital bequest amount be fairly representative of appreciation or depreciation. Thus, the grantor's fiduciary has maximum flexibility in selecting assets to satisfy the pecuniary marital bequest amount.

• ***You want easy administration.*** Because the pecuniary marital bequest amount is anticipated to be smaller than the residuary amount, and because assets are valued at their date of distribution values (with pick-and-choose flexibility), administration of the grantor's estate should be easier.

• ***You want to allow the credit shelter trust to fluctuate in value.*** Because the credit shelter trust receives the residue of the grantor's estate (and not a fixed pecuniary amount), the credit shelter trust will enjoy any appreciation (or suffer any depreciation) that occurs during the administration of the grantor's estate.

• ***You want to do GST tax exemption planning.*** The GST regulations favor date of distribution values when funding trusts for GST purposes.

Don't use when:

• ***You have DNI concerns.*** If the pecuniary marital bequest amount is not entitled to receive its pro rata share of income during the administration of the grantor's estate, there may be no DNI carried out on the funding of the pecuniary marital bequest. This means the grantor's estate will have to pay income taxes on income distributed to the marital trust (but not eligible for deduction by the grantor's estate). Any income taxes paid by the grantor's estate will reduce the residue of the grantor's estate and ultimately the amount received by the residuary credit shelter trust.

• ***You want to freeze the credit shelter amount.*** Because the credit shelter trust receives the residue of the grantor's estate (and not a fixed pecuniary amount), the credit shelter trust will enjoy any appreciation (or suffer any depreciation) that occurs during the administration of the grantor's estate.

• ***There is significant IRD in the grantor's estate.*** If the right to receive IRD (such as retirement benefits) is distributed in satisfaction of the pecuniary marital bequest, the underlying IRD will be accelerated and recognized, and income taxes will have to be paid.

• ***You anticipate significant capital gains in the assets during the administration of the grantor's estate.*** The funding of the pecuniary marital bequest is treated as a sale or exchange of assets, and funding the pecuniary marital bequest with appreciated assets will trigger capital gains.

Fairly Representative Marital Deduction Funding Formula

Use when:

• ***You anticipate significant capital gains during the administration of the grantor's estate.*** Because assets used to satisfy the pecuniary marital bequest

Marital Deduction Funding Formula Checklist

If your primary concern is:	Consider using this formula:	Avoid this formula:
Contentious family	• Fractional pro rata	• Minimum-worth marital deduction • Pick-and-choose fractional
Avoiding or minimizing capital gains on funding	• Minimum-worth marital deduction • Either fairly representative formula • Either fractional formula	• Either true-worth formula
Significant IRD—avoiding acceleration	• Either fractional formula	• Any pecuniary formula
GST tax exemption funding issues	• Either fractional formula • Either true-worth formula • Either fairly representative formula	• Minimum-worth formula
Greatest flexibility in funding (pick and choose)	• Either true-worth formula • Minimum-worth formula • Fractional pick and choose	• Fractional pro rata
Assets that are difficult to revalue	• Fractional pro rata • Either true-worth formula • Minimum-worth marital deduction	• Fractional pick and choose • Either fairly representative formula
Reducing overall taxes and administrative expenses	• Either true-worth formula	• Either fractional formula • Either fairly representative formula
Preserving the marital share for the surviving spouse	• First choice: minimum-worth marital deduction • Second choice: true-worth marital deduction	• True-worth or minimum-worth credit shelter
Desire for a fixed amount in either the marital trust or credit shelter trust without reduction of that amount if the assets depreciate between the date of death and the date of funding	• Either true-worth formula • Minimum-worth marital deduction	• Either fairly representative formula • Either fractional formula

are valued at their adjusted income tax basis, there is no capital gain when appreciated assets are used to satisfy the pecuniary marital bequest amount.

• ***You want to be evenhanded to all beneficiaries.*** A fairly representative formula allows beneficiaries of both the marital and credit-shelter shares to enjoy a ratable portion of both gains and losses during administration, reducing claims that the fiduciary has funded the trust shares unfairly.

• ***You want to do GST tax exemption planning.*** The GST regulations favor fairly representative asset values when funding trusts for GST purposes.

• ***The marital trust amount will be smaller than the credit shelter trust amount.*** If the pecuniary bequest amount payable to the marital trust is smaller than the credit shelter amount, funding of the pecuniary amount theoretically should be easier and faster.

Don't use when:

• ***You have property that is difficult to value.*** Because this formula requires the pecuniary marital bequest to be funded in a manner that is fairly representative of the estate's appreciation and depreciation, all property (including difficult to value assets) available to satisfy the pecuniary marital bequest amount must be revalued at its date(s) of distribution.

• ***You have significant IRD in the grantor's estate.*** If the right to receive IRD (such as retirement benefits) is distributed in satisfaction of the pecuniary marital bequest, the underlying IRD will be accelerated and recognized, and income taxes will have to be paid.

• ***You want to freeze the marital or credit shelter trust amounts.*** Because this formula requires the pecuniary marital bequest amount to be funded in a manner that is fairly representative of the estate's appreciation and depreciation, both the marital share and credit shelter trust will share in the appreciation and depreciation of the grantor's estate.

• ***You want to avoid revaluations of the grantor's estate.*** Because this formula requires the pecuniary marital bequest amount to be funded in a manner that is fairly representative of the estate's appreciation and depreciation, all property available to satisfy the pecuniary marital bequest amount must be revalued at its date(s) of distribution.

Minimum-Worth Marital Deduction Funding Formula

Use when:

• ***You want easy administration.*** This funding formula avoids the realization of capital gains when funding the pecuniary marital bequest, requires limited revaluations of the grantor's estate, and gives the fiduciary tremendous flexibility in selecting assets to fund the marital bequest amount.

• ***You want limited revaluations of the grantor's estate.*** Only assets that have decreased in value during the administration of the grantor's estate have to be revalued at the time of their distribution to the marital share.

• ***You anticipate significant capital gains during the administration of the grantor's estate.*** Because the individual asset minimum-worth marital deduction funding formula requires the marital trust to be funded at the lower of the asset's income tax basis or date of distribution value, noncash property (such as stocks and bonds) distributed to the marital trust by the grantor's estate is treated as being sold by the grantor's estate to the marital trust for the property's income tax basis or its date of distribution value, whichever is lower. Thus, there is no realization of gain by the grantor's estate when it distributes appreciated property to the marital trust. Loss, however, may be realized by the grantor's estate if the property distributed by the estate to the marital deduction trust has decreased in value below its income tax basis.

• ***You want to favor the surviving spouse.*** The fiduciary of the grantor's estate has increased flexibility for which assets to use in funding the pecuniary marital bequest. Although the marital trust can be overfunded, it cannot be underfunded with this type of funding formula.

• ***You want the ability to pick and choose assets for funding.*** There is no requirement that the assets used to satisfy the pecuniary marital bequest be

fairly representative of appreciation or depreciation. Thus, the grantor's fiduciary has maximum flexibility in selecting assets to satisfy the pecuniary amount owed to the marital trust.

Don't use when:

• ***You have significant IRD.*** If the right to receive IRD (such as retirement benefits) is distributed in satisfaction of the pecuniary bequest owed to the marital trust, the underlying IRD will be accelerated and recognized, and income taxes will have to be paid.

• ***You want to do GST tax exemption planning.*** The GST regulations do not permit minimum-worth distribution values when funding trusts with noncash property for GST purposes.

Summary of Credit Shelter Pecuniary Funding Formulas

True-Worth Credit Shelter Funding Formula

Use when:

• ***The credit shelter trust amount will be smaller than the marital trust amount.*** This will minimize capital gains on funding because the pecuniary credit shelter bequest amount will be smaller than the (initial) amount of the residue payable to the marital trust.

• ***You want easy administration.*** Because the pecuniary credit shelter bequest amount is anticipated to be smaller than the residuary amount, and because assets are valued at their date of distribution values (with pick-and-choose flexibility), administration of the grantor's estate should be easier.

• ***You want limited revaluations of the grantor's estate.*** Assets distributed in satisfaction of the pecuniary credit shelter amount are valued at their date of distribution value, and, because the pecuniary credit shelter amount is less than the residue that passes to the marital trust, less property has to be revalued when satisfying the pecuniary amount payable to the credit shelter trust.

• ***You want to freeze the credit shelter amount.*** Because the pecuniary credit shelter amount is determined as of the grantor's date of death (or alternate valuation date), the amount that has to be paid to the credit shelter trust is fixed, regardless of how much the grantor's estate appreciates (or depreciates) during the course of its administration.

• ***You want to be able to pick and choose the assets for funding.*** There is no requirement that the assets used to satisfy the pecuniary bequest payable to the credit shelter trust be fairly representative of appreciation or depreciation. Thus, the grantor's fiduciary has maximum flexibility in selecting assets to satisfy the pecuniary credit shelter bequest.

• ***You want to allow the marital trust to fluctuate in value.*** Because the marital trust receives the residue of the grantor's estate (and not a fixed pecuniary amount), the marital trust will enjoy any appreciation (or suffer any depreciation) that occurs during the administration of the grantor's estate.

• ***You want to do GST tax exemption planning.*** The GST regulations favor date of distribution values when funding trusts for GST purposes.

Don't use when:

• ***You have DNI concerns.*** If the pecuniary bequest amount payable to the credit shelter trust is not entitled to receive its pro rata share of income during the administration of the grantor's estate, there may be no DNI carried out on the funding of the pecuniary credit shelter bequest. This means the grantor's estate will have to pay income taxes on income distributed to the credit shelter trust (but not eligible for deduction by the grantor's estate). Any income taxes paid by the grantor's estate will reduce the residue of the grantor's estate and ultimately the amount received by the residuary marital trust.

• ***There is significant IRD in the grantor's estate.*** If the right to receive IRD (such as retirement benefits) is distributed in satisfaction of the pecuniary credit shelter bequest, the underlying IRD will be accelerated and recognized, and income taxes will have to be paid.

• ***You anticipate significant capital gains during the administration of the grantor's estate.*** The funding of the pecuniary bequest payable to the credit shelter trust is treated as a sale or exchange of assets, and funding the pecuniary credit shelter bequest with appreciated assets will trigger capital gains.

• ***You want to freeze the marital trust amount.*** Because the marital trust receives the residue of the grantor's estate (and not a fixed pecuniary amount), the marital trust will enjoy any appreciation (or suffer any depreciation) that occurs during the administration of the grantor's estate.

Fairly Representative Credit Shelter Funding Formula

Use when:

• ***You anticipate significant capital gains during the administration of the grantor's estate.*** Because assets used to satisfy the pecuniary bequest payable to the credit shelter trust are valued at their adjusted income tax basis, there is no capital gain when appreciated assets are used to satisfy the pecuniary credit shelter bequest amount.

• ***You want to be evenhanded to all beneficiaries.*** A fairly representative formula allows beneficiaries of both the marital and credit shelter shares to enjoy a ratable portion of both gains and losses during administration, reducing claims that the fiduciary has funded the trust shares unfairly.

• ***You want to do GST tax exemption planning.*** The GST regulations favor fairly representative asset values when funding trusts for GST purposes.

• ***The credit shelter trust amount will be smaller than the marital trust amount.*** If the pecuniary bequest amount payable to the credit shelter trust is less than the marital trust amount, funding of the pecuniary amount theoretically should be easier and faster.

Don't use when:

• ***You have property that is difficult to value.*** Because this formula requires the pecuniary credit shelter bequest to be funded in a manner that is fairly representative of the estate's appreciation and depreciation, all property (including difficult to value assets) available to satisfy the pecuniary bequest amount payable to the credit shelter trust must be revalued at its date(s) of distribution.

• ***There is significant IRD in the grantor's estate.*** If the right to receive IRD (such as retirement benefits) is dis-

tributed in satisfaction of the pecuniary bequest payable to the credit shelter trust, the underlying IRD will be accelerated and recognized, and income taxes will have to be paid.

• ***You want to freeze the credit shelter or marital trust amounts.*** Because this formula requires the pecuniary credit shelter bequest to be funded in a manner that is fairly representative of the estate's appreciation and depreciation, both the marital share and credit shelter trust will share in the appreciation and depreciation of the grantor's estate.

• ***You want to avoid revaluations of the grantor's estate.*** Because this formula requires the pecuniary credit shelter bequest to be funded in a manner that is fairly representative of the estate's appreciation and depreciation, all property available to satisfy the pecuniary bequest amount must be revalued at its date(s) of distribution.

Summary of Fractional Marital Deduction Funding Formulas

Pro Rata Fractional Funding Formula

Use when:

• ***You anticipate significant capital gains during the administration of the grantor's estate.*** Because property distributed to the marital trust is divided on a fractional basis, there is no deemed sale or exchange between the grantor's estate and the marital trust. Consequently, the distribution of appreciated property to the marital trust does not result in capital gains being incurred by the grantor's estate.

• ***There is significant IRD in the grantor's estate.*** Because property distributed to the marital trust is divided on a fractional basis, there is no deemed sale or exchange between the grantor's estate and the marital trust. Consequently, the distribution of the right to receive an item of IRD does not result in its acceleration for income tax purposes.

• ***You want to do GST tax exemption planning.*** The GST regulations favor a fractional distribution of assets when funding trusts for GST purposes.

• ***You want to avoid revaluations of the grantor's estate.*** There is no need to revalue assets when the marital trust is funded because the funding formula fraction is applied against the federal estate tax value of the assets.

• ***There is a difficult family situation with competing interests.*** Because each asset distributed to the marital trust is divided on a fractional basis, both the marital and credit shelter trusts share proportionately in each asset's appreciation and depreciation, reducing claims that the fiduciary has funded the trust shares unfairly.

Don't use when:

• ***You have property that is difficult to fractionalize or divide.*** Because the formula requires each and every asset to be fractionalized, assets that are difficult to divide on a fractional basis, such as bonds, present a problem.

• ***You want easy administration.*** Because each asset has to be divided on a fractional basis, the administration of the grantor's estate will require more time than if a true-worth pecuniary formula were used. Furthermore, disproportionate or nonsimultaneous funding of the marital and credit shelter trusts will require a recomputation of the initial funding formula fraction.

• ***You want pick-and-choose funding.*** Because each asset has to be fractionalized, the fiduciary has no flexibility in selecting assets to be distributed to the marital or credit shelter trusts.

• ***You want to freeze the marital or credit shelter trust amounts.*** Because each asset has to be fractionalized, both the marital and credit shelter trust will share proportionately in the appreciation and depreciation of the grantor's estate.

Pick-and-Choose Fractional Funding Formula

Use when:

• ***You have property that is difficult to fractionalize or divide.*** Because this formula does not require each asset to be fractionalized, the fiduciary can distribute nonfractionalized assets to the marital and credit shelter trusts using the assets' date of distribution value or in a manner that fairly reflects the net appreciation or depreciation in the assets' value.

• ***There is significant IRD in the grantor's estate.*** Because property distributed to the marital trust is on a fractional basis, there is no deemed sale or exchange between the grantor's estate and the marital trust. Consequently, the distribution of the right to receive an item of IRD does not result in its acceleration for income tax purposes.

• ***You anticipate significant capital gains during the administration of the grantor's estate.*** Because property distributed to the marital trust is on a fractional basis, there is no deemed sale or exchange between the grantor's estate and the marital trust. Consequently, the distribution of appreciated property to the marital trust does not result in capital gains being incurred by the grantor's estate.

• ***You want to do GST tax exemption planning.*** The GST regulations favor a non-pro-rata fractional distribution of assets when funding trusts for GST purposes, provided the assets are valued at their date of distribution value or in a manner that is fairly representative of the assets' overall net appreciation and depreciation.

• ***You want the ability to pick and choose the assets for funding.*** The non-pro-rata fractional funding method permits the fiduciary some flexibility to pick and choose which assets are distributed to the marital and credit shelter trusts. But the fiduciary must act fairly when selecting assets; and when funding on a non-pro-rata basis, the fiduciary must apply the fraction to the assets' date of distribution value or select assets that are fairly representative of the net appreciation and depreciation in the value of all assets available for distribution to the marital trust.

Don't use when:

• ***You want an easy administration.*** Because assets have to be distributed by applying the fraction to the assets' date of distribution value (or in a fairly representative manner), the administration of the grantor's estate will require more time than if a true-worth pecuniary formula were used. Furthermore, disproportionate or nonsimultaneous funding of the marital and credit shelter trusts will require a recomputation of the initial funding formula fraction.

• ***There is a contentious family.*** Because the fiduciary has the ability to pick and choose among the assets, con-

tentious beneficiaries may claim that the fiduciary favored one class of beneficiaries over another. A pure pro rata fractional funding formula will avoid this type of claim.

• ***Assets are difficult to revalue.*** Because assets have to be distributed by applying the fraction to the assets' date-of-distribution value (or in a fairly representative manner), assets will have to be revalued each time a funding distribution is made.

• ***You want to freeze the marital or credit shelter trust amounts.*** Both the marital trust and credit shelter trust will share in the appreciation and depreciation of the grantor's estate in a fairly representative manner. ■

Chart of Pecuniary and Fractional Funding Formulas and Their Consequences

	True-Worth Pecuniary Funding Formula	Fairly Representative Pecuniary Funding Formula	Minimum-Worth Funding Formula	Fractional Funding Formula
Funding value	Property distributed to fund the pecuniary bequest is valued at its date of distribution value.	Property distributed to fund the pecuniary bequest is valued at its federal income tax basis (usually federal estate tax value).	Property distributed to fund the pecuniary bequest under the individual asset style formula is valued at the lesser of its date of distribution value or its federal income tax basis value (usually federal estate tax value). Property distributed to fund the pecuniary bequest under the collective style is valued at its income tax basis.	Property distributed under a pro rata funding formula is valued at its federal estate tax value. Property distributed under a pick-and-choose funding formula is (generally) valued at its date of distribution value.
Which trust share is frozen in value?	The marital share is frozen in value under an upfront pecuniary formula. The credit shelter share is frozen in value under a reverse pecuniary formula.	Neither share is frozen in value. Both shares fluctuate in value during the administration of the grantor's estate.	Neither share is frozen in value. Both shares fluctuate in value during the administration of the grantor's estate.	Neither share is frozen in value. Both shares fluctuate in value during the administration of the grantor's estate.
Does the grantor's estate realize gain or loss on funding the bequest/trust with noncash property?	Yes.	No.	No gain is realized. Loss can be realized but is not recognized due to Code § 267(b)(6).	No.
Is the Code § 643(e)(3) election available to recognize gain or loss on funding with noncash property?	No.	Yes.	Yes.	Yes.
Does funding with the right to receive IRD accelerate its recognition by the grantor's estate?	Yes.	Yes.	Yes.	No.
Are the marital and credit shelter trusts separate shares under Code § 663(c) for income tax and DNI carryout purposes?	Yes, but DNI may be $0 for a marital trust established under an upfront pecuniary formula if it does not receive income from the grantor's estate. (Note: The same rule applies for a credit shelter trust established under a reverse pecuniary formula.)	Yes.	Yes, but DNI may be $0 for the marital trust if it does not receive income from the grantor's estate.	Yes.
How much DNI is carried out from the grantor's estate on funding?	If DNI is carried out (see immediately above), the amount of DNI will be the FMV of the distributed assets.	DNI will be the lesser of the distributed asset's income tax basis or FMV of the distributed assets.	If DNI is carried out (see immediately above), the amount of DNI will be the lesser of the distributed asset's income tax basis or FMV of the distributed assets.	DNI will be the lesser of the distributed asset's income tax basis or FMV of the distributed assets.
Do assets in the grantor's estate have to be revalued at the time of funding?	Yes, but only assets that are distributed in satisfaction of the pecuniary amount have to be revalued.	All assets in the grantor's estate must be revalued.	Only assets that have decreased in value have to be revalued.	No revaluation is required for pro rata funding. All assets in the grantor's estate must be revalued for pick-and-choose funding.
Does the grantor's fiduciary have flexibility in selecting assets to fund the bequest/trust?	Yes. The fiduciary can favor the marital or credit shelter trust in its selection of assets.	Yes, but the fiduciary's flexibility is limited to choosing assets that fairly represent the overall appreciation and depreciation of all the assets in the grantor's estate.	Yes. The fiduciary can favor the marital or credit shelter trust in its selection of assets.	The fiduciary has no flexibility in pro rata funding. But the fiduciary has more flexibility in selecting assets under a pick-and-choose funding formula.
Does the funding formula work well for GST tax exemption allocation purposes?	Yes.	Yes.	No.	Yes.
Does the funding formula work well for Code § 2032A special use valuation property?	Yes.	No.	No.	No.
Does the formula generally require quick funding?	Yes.	No.	Yes.	No.
Ease of administration.	Easy.	Moderate.	Easy.	Difficult.

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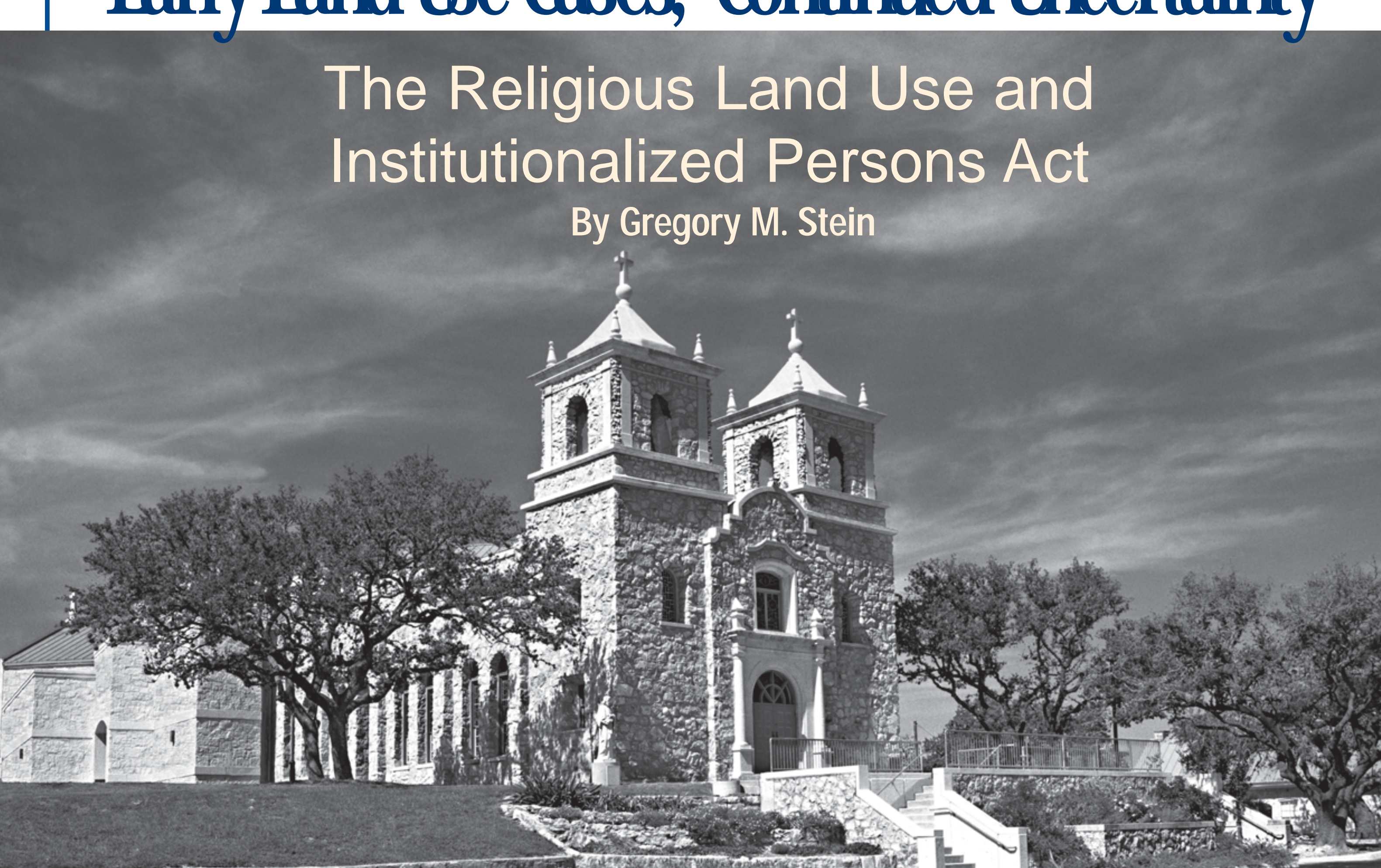
Early Land Use Cases, Continued Uncertainty

The Religious Land Use and Institutionalized Persons Act

By Gregory M. Stein



St. Peter the Apostle Church, Boerne, Texas.

The Religious Land Use and Institutionalized Persons Act (RLUIPA), 42 U.S.C. §§ 2000cc–2000cc-5 (2000), was passed by Congress and signed by President Clinton in 2000. RLUIPA limits the right of a government (1) to impose or implement a land use regulation in a manner that creates a substantial burden on religious exercise and (2) to impose a substantial burden on the religious exercise of a person residing in, or confined to, a state-owned or state-operated penal institution or institution for the disabled.

This odd law, with two seemingly unrelated goals, is the latest maneuver in an ongoing struggle between Congress and the Supreme Court to define the balance between a government's right to enact and administer reasonable, neutral regulations and a person's right to exercise his or her religion freely. The disagreement between these two co-equal branches over who gets to make this decision masks the even larger battle between Congress and the states concerning who has the power, in our federal system, to control the use of land. Lawyers who handle zoning and land use matters, especially those who represent religious institutions or municipal entities, need to be familiar with the land use provisions of RLUIPA. This article examines the law's land use provisions and some of the early cases to construe them and assess their constitutionality.

Events Leading to the Enactment of RLUIPA

In *Employment Division v. Smith,* 494 U.S. 872 (1990), the Court addressed the conflict between religious practice and neutral state laws. The case involved two men who unsuccessfully sought unemployment compensation from the Oregon Employment Division after they were fired from their jobs with a private drug rehabilitation organization for using the illegal hallucinogenic drug peyote.

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The Employment Division denied their applications because they had been fired for misconduct related to their work; they argued in response that they were members of the Native American Church and had used the drug for sacramental purposes. The Court held that the Free Exercise Clause of the First Amendment does not prevent a state from enforcing a law that incidentally proscribes certain religiously motivated acts if that law is not aimed specifically at religious practice.

Congressional reaction was negative, and, in 1993, Congress passed and the president signed the Religious Freedom Restoration Act (RFRA), 42 U.S.C. §§ 2000bb–2000bb-4 (2000). RFRA's stated purposes included requiring the government to demonstrate a compelling interest in all cases in which government action substantially burdens the free exercise of religion and providing a claim or defense to a person when the government substantially burdens his or her free exercise of religion. To achieve these purposes, RFRA prohibited government from "substantially burden[ing] a person's exercise of religion even if the burden results from a rule of general applicability," except when the burden "is in furtherance of a compelling governmental interest" and "is the least restrictive means of furthering that compelling governmental interest." Id. § 2000bb-1.

The Court responded, in *City of Boerne v. Flores,* 521 U.S. 507 (1997), by striking down these provisions of RFRA, at least as they apply to the states. Flores, the Catholic archbishop of San Antonio, sought a building permit to enlarge St. Peter the Apostle Church in Boerne, Texas. The city denied the application because the enlargement did not meet the requirements of the city's historic preservation ordinance. The archbishop sued in federal court, and the case reached the Supreme Court on the question of RFRA's constitutionality. A majority of the Justices determined that RFRA exceeded the constitutional power of Congress.

Section 1 of the Fourteenth Amendment prohibits each state from "depriv[ing] any person of life, liberty, or property, without due process of law" or "deny[ing] to any person within its jurisdiction the equal protection of the laws." U.S. Const. amend. XIV, § 1. In enacting RFRA, Congress claimed to be relying on Section 5 of the Fourteenth Amendment, which empowers it to enforce Section 1 by appropriate legislation. The city responded that RFRA exceeded mere enforcement of Section 1 and extended into the impermissible realm of constitutional interpretation. The Court agreed with the city, concluding that RFRA could not stand because it interpreted, and did not merely enforce, the provisions of the Fourteenth Amendment.

RLUIPA

The battle between Congress and the Court did not end with *City of Boerne v. Flores,* and RLUIPA became effective in 2000. RLUIPA echoes RFRA in many significant ways but affects only religious land uses and the free exercise rights of institutionalized persons. (This article examines only the former issue.) Subsection 2000cc(a)(1) states RLUIPA's general land use rule:

> No government shall impose or implement a land use regulation in a manner that imposes a substantial burden on the religious exercise of a person, including a religious assembly or institution, unless the government demonstrates that imposition of the burden on that person, assembly, or institution—
>
> (A) is in furtherance of a compelling governmental interest; and
>
> (B) is the least restrictive means of furthering that compelling governmental interest.

This subsection, then, restates the rule that the Court rejected in *Smith,* that Congress sought to impose in RFRA, and that the Court rejected again in *Boerne,* but it limits the rule to the single context of religious land uses.

Language immediately following this general rule restricts its scope to three specific settings, those in which the substantial burden: (1) is imposed on programs or activities that receive federal funds, (2) affects interstate commerce, or (3) "is imposed in the implementation of a land use regulation or system of land use regulations, under which a government makes, or has in place formal or informal procedures or practices that permit the government to make, individualized assessments of the proposed uses for the property involved." 42 U.S.C. § 2000cc(a)(2). The next subsection forbids treating religious assemblies or institutions less favorably than nonreligious ones, prohibits unequal treatment on the basis of religious denomination, and denies governments the right to exclude religious entities entirely or to limit them unreasonably. Id. § 2000cc(b).

The rules of construction and the definitions that follow highlight the expansive interpretation Congress intended. For example, a subsection entitled "Broad construction" states, "This chapter shall be construed in favor of a broad protection of religious exercise, to the maximum extent permitted by the terms of this chapter and the Constitution." Id. § 2000cc-3(g). More specifically, three of the definitions set forth at the end of the statute clarify the intended range of these land use provisions. The phrase "land use regulation" is defined in Subsection 2000cc-5(5) to mean

> a zoning or landmarking law, or the application of such a law, that limits or restricts a claimant's use or development of land (including a structure affixed to land), if the claimant has an ownership, leasehold, easement, servitude, or other property interest in the regulated land or a contract or option to acquire such an interest.

Subsection 2000cc-5(7) defines the term "religious exercise," somewhat circularly, as follows:

> (7) Religious exercise.
>
> (A) In general. The term "religious exercise" includes any exercise of religion, whether or not compelled by, or central to, a system of religious belief.

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(B) Rule. The use, building, or conversion of real property for the purpose of religious exercise shall be considered to be religious exercise of the person or entity that uses or intends to use the property for that purpose.

Finally, RLUIPA sheds light on the wide reach of the regulations to which it applies in its definition of "government," a term that includes states, counties, municipalities, and other governmental entities created under a state's authority; branches, departments, agencies, instrumentalities, or officials of any of these entities; persons acting under color of state law; and, for purposes of some of RLUIPA's provisions, the federal government as well. Id. § 2000cc-5(4).

The Supreme Court is likely to address the issue of RLUIPA's constitutionality within the next few years, just as it was forced to resolve the validity of RFRA. Until this uncertainty is settled, however, religious land users will presume that the law is constitutional, and government entities that do not wish to challenge its legality must comply with it.

Analyzing a Claim Under RLUIPA

A court facing a land use claim under RLUIPA needs to employ a step-by-step approach to ensure that each of the parties carries the burden of proof it bears on different elements of a claim, and each of the parties must be attentive to these elements and burdens. First, the plaintiff has to demonstrate that the defendant's imposition or implementation of a land use regulation imposes a substantial burden on the plaintiff's religious exercise. Because the statute defines the terms "land use regulation" and "religious exercise" in the broad manner just noted, the most challenging question the court ordinarily must answer is whether the defendant's land use regulation has substantially burdened that religious exercise. RLUIPA does not define the term "substantial burden," which forces any court facing a claim under the statute to determine the meaning of this pivotal phrase from prior case law. The landowner bears the

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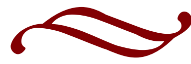


burden of persuasion on this issue. Id. § 2000cc-2(b).

If the plaintiff makes this showing, the burden of persuasion shifts to the government defendant to demonstrate that its imposition of a substantial burden on the plaintiff's religious exercise both furthers a compelling governmental interest and is the least restrictive means of doing so. Id. RLUIPA defines neither of these clauses, forcing the court once again to glean their meaning from precedent. The discussion that follows will illustrate the ways in which lower courts have begun to appraise the meaning of these critically important terms.

Note also that, as a federal law, RLUIPA is relevant only to cases with the constitutionally required federal contacts. Congress attempted to address this issue by limiting the applicability of parts of the statute to three types of cases, including those in which a government must make individualized assessments of the proposed property use. Because most land use laws and regulations—including the zoning and landmarking laws to which RLUIPA specifically applies—require a government body to make precisely this sort of assessment, these cases are likely to fall within the scope of the statute.

RLUIPA in the Lower Courts

Lower court cases applying the land use provisions of RLUIPA fall into three categories:

1. those that apply RLUIPA without evaluating its constitutionality and then rule in favor of the regulatory body,
2. those that apply RLUIPA without evaluating its constitutionality and then rule in favor of the religious use, and
3. those that address the constitutionality of the statute.

The remainder of this article examines the leading cases in each of these three groups. These categories are not mutually exclusive, of course, as a court might both consider the validity of the law and apply it. Several courts have done precisely that, a fact that serves as a reminder of the overlap among these three groups.

Cases in Which a Court Applies RLUIPA in Favor of a Regulatory Body

In roughly half the cases in which landowners proposing religious uses have raised RLUIPA arguments, courts have applied RLUIPA and ruled in favor of the government defendant. Within this group of cases, the court either has stated that the statute is constitutional with little or no discussion and then has proceeded to apply it or has assumed the constitutionality of the Act without mentioning it. Either way, the government has won, not because the law is invalid, but because the government acted as required by the law.

A recent Ninth Circuit case, *San Jose Christian College v. City of Morgan Hill,* 360 F.3d 1024 (9th Cir. 2004), is illustrative. San Jose Christian College (SJCC) wished to operate a religious college on land zoned for hospital use; the pro-

posal required city approval of a zoning amendment. The city's planning commission, and then the city itself, rejected SJCC's request because of SJCC's failure to meet all application requirements. SJCC filed a complaint in federal district court, alleging, among other things, that the city had violated RLUIPA. The district court granted the city's motion for summary judgment, and the Ninth Circuit affirmed in a lengthy opinion.

The appeals court assumed the constitutionality of RLUIPA on the basis of an earlier Ninth Circuit case involving the rights of prisoners and spent little time on this point. Focusing on the statutory question, the court determined that SJCC's argument could not survive the city's summary judgment motion, because SJCC could not demonstrate the requisite "substantial burden" on its religious practice. Turning to a standard dictionary to elucidate the meaning of the word "substantial," which is not defined in RLUIPA, the court paraphrased the language of the statute and determined that "the government is prohibited from imposing or implementing a land use regulation in a manner that imposes a 'significantly great' restriction or onus on 'any exercise of religion.'" Id. at 1034–35. SJCC argued that its inability to carry on its religious educational mission met this burden, but the court responded that nothing in the city's ordinance restricts this mission. Rather, the local law requires SJCC, like any other applicant, to submit a complete application. The court observed that there was no evidence the city would deny an application that is formally correct.

The Seventh Circuit reached a similar result in *Civil Liberties for Urban Believers v. City of Chicago,* 342 F.3d 752 (7th Cir. 2003), a case addressing many of the same issues as *San Jose Christian College.* Civil Liberties for Urban Believers, an association of Chicago-area religious organizations, challenged certain portions of that city's zoning ordinance as violating RLUIPA and several provisions of the Constitution. The claimants particularly objected to those sections that prohibited religious institutions from locating in specified zones without receiving approval from the zoning board of appeals as special uses. The district court granted summary judgment in favor of the city, and the Seventh Circuit affirmed.

The court noted that RLUIPA contains a broad definition of "religious exercise," one that includes "any exercise of religion, whether or not compelled by, or central to, a system of religious belief," but contains no definition of the equally important term "substantial burden." The legislative history of the law suggests that the latter term should be given a meaning no broader than that articulated by the Supreme Court in other free exercise cases. The city, relying on earlier case law from the Seventh Circuit, suggested that a "substantial burden" should be construed as "'one that forces adherents of a religion to refrain from religiously motivated conduct, inhibits or constrains conduct or expression that manifests a central tenet of a person's religious beliefs, or compels conduct or expression that is contrary to those beliefs.'" Id. at 761 (quoting *Mack v. O'Leary,* 80 F.3d 1175, 1179 (7th Cir. 1996)).

The court seemed reluctant to follow this standard, given RLUIPA's definition of "religious exercise." At the same time, the court did not wish to overlook the word "substantial," for if it did so, "the slightest obstacle to religious exercise incidental to the regulation of land use—however minor the burden it were to impose—could then constitute a burden sufficient to trigger RLUIPA's requirement that the regulation advance a compelling governmental interest by the least restrictive means." Id. Stated differently, Congress must have intended for the word "substantial" to have some meaning beyond the language already included in the statute. The Seventh Circuit concluded that RLUIPA applies only to a land use regulation "that necessarily bears direct, primary, and fundamental responsibility for rendering religious exercise—including the use of real property for the purpose thereof . . . —effectively impracticable." Id.

With this definition in hand, the court had little trouble upholding the district court's grant of summary judgment. The procedural requirements that Chicago's religious institutions must meet are typical of land use conditions found in any densely packed city: they may be difficult to comply with, but they are costs of doing business for religious and secular uses alike. And substantively, RLUIPA requires only that governments treat religious land users no worse than other land users; it does not require favoritism or exemptions from laws that apply to others. "[N]o such free pass for religious land uses masquerades among the legitimate protections RLUIPA affords to religious exercise." Id. at 762. Concluding that RLUIPA did not apply to the facts presented by the claimant, the court had no occasion to consider whether the law is constitutional.

Other courts have reached similar results. The Third Circuit, in an unpublished opinion that relied on *Civil Liberties for Urban Believers,* affirmed the district court's denial of a motion for preliminary injunction brought by an evangelical institute. *Lighthouse Institute for Evangelism Inc. v. City of Long Branch,* 100 Fed. Appx. 70 (3d Cir. 2004), available at 2004 WL 1179268. After failing to receive the necessary permission to relocate within the city, the institute

In roughly half the cases in which landowners proposing religious uses have raised RLUIPA arguments, courts have applied RLUIPA and ruled in favor of the government defendant.

raised several claims, including one under RLUIPA. The court noted that there was no substantial burden under RLUIPA because the institute had operated for years in rented space across the street from its proposed new location. Moreover, the institute could not show that the ordinance in question treated it differently from similar nonreligious assemblies, could not prove that the law drew any distinction between religious and secular congregational halls, and was unable to demonstrate that the ordinance sought to exclude religious groups or limit them unreasonably.

In a somewhat different context, the District of Columbia Circuit ruled in favor of the federal government, while apparently assuming RLUIPA's constitutionality. *Henderson v. Kennedy,* 265 F.3d 1072 (D.C. Cir. 2001). The plaintiffs' claims involved the federal government, to which RFRA still applies, so the court construed and enforced RFRA's substantive provisions and RLUIPA's definitions. The court acknowledged RLUIPA's broad definition of the term "religious exercise" but noted that it still must inquire into the centrality of a particular action—here the religiously motivated selling of T-shirts on the National Mall—to a claimant's religious practice. The court concluded that the noncentrality of a practice such as this one remains important in determining whether the statute imposes a substantial burden on the claimants under RFRA and found that, in this case, the law did not impose such a burden. Id. at 1074. Several lower federal courts and state courts have reached similar results when applying RLUIPA, with the number of cases growing weekly. See, e.g., *Corporation of the Presiding Bishop v. City of West Linn,* 86 P.3d 1140 (Or. Ct. App. 2004) (holding that city's denial of conditional use permit did not substantially burden church's religious exercise in violation of RLUIPA).

Cases in Which a Court Applies RLUIPA in Favor of a Religious Use

In a smaller number of cases, courts have applied RLUIPA in favor of a landowner wishing to pursue a religious use without addressing the constitutionality question directly. Generally speaking, these courts have assumed the constitutionality of the Act—although they have occasionally been more direct—and then have issued rulings that allow landowner actions to proceed in the face of motions by the government entity, without ever reaching the merits.

The Michigan Court of Appeals, for example, reversed the trial court's granting of a municipality's motion for summary disposition, concluding that there were genuine issues of material fact regarding whether the property owner had established its prima facie case under RLUIPA. In *Shepherd Montessori Center Milan v. Ann Arbor Charter Township,* 675 N.W.2d 271 (Mich. Ct. App. 2003), the plaintiffs wished to operate a religious elementary school in an area zoned for office parks. After the township ultimately denied the school's request, the school filed suit in state court, alleging violations of RLUIPA and various other statutory and constitutional provisions. The trial court found that the school had not met RLUIPA's jurisdictional elements and also had failed to establish the prima facie case required under the statute, because it had not shown a substantial burden on its free exercise of religion.

In a smaller number of cases, courts have applied RLUIPA in favor of a landowner wishing to pursue a religious use without addressing the constitutionality question directly.

The appellate court reversed. After first expressly disclaiming any views on the constitutionality of RLUIPA, an issue the township had not raised, the court proceeded to walk through the statute in an organized fashion, beginning with its legislative history. The court next determined that it had jurisdiction over the case because the township had made an individualized assessment of the school's proposed property use. Given the case's procedural posture, the next question was whether the school had introduced adequate evidence to cause reasonable minds to differ over whether the law imposed a substantial burden on the free exercise of religion. The court was not in a position to ascertain the importance to the school of the proposed site and the availability of alternative sites, so it concluded that summary disposition was inappropriate.

An unpublished Sixth Circuit opinion did reach a final determination on the merits. In *DiLaura v. Township of Ann Arbor*, No. 03-1635, 2004 WL 2297869 (6th Cir. Oct. 6, 2004), the appeals court agreed with the trial judge's finding that the township's insistence on classifying a religious retreat as a bed-and-breakfast violated RLUIPA. The bed-and-breakfast designation would preclude the religious operator from serving alcohol or providing meals other than breakfast, and this constituted a substantial burden on religious exercise.

Other cases have reached similar results. See, e.g., *Cottonwood Christian Center v. Cypress Redevelopment Agency,* 218 F. Supp. 2d 1203 (C.D. Cal. 2002) (noting that RLUIPA appears to have avoided constitutional pitfalls of RFRA, examining provisions of RLUIPA, granting property owner's motion to enjoin condemnation by city, and denying defendant's motion to dismiss on procedural grounds).

Cases That Address the Constitutionality of RLUIPA

The final, most interesting, and potentially most significant group of cases are those in which courts have exam-

ined whether RLUIPA violates the U.S. Constitution. Courts have assessed the constitutionality of the statute rather than merely applying it in just a handful of land use cases. Those courts that upheld the statute then proceeded to apply it. In the one case to date in which a court invalidated the law, of course, the property owner's RLUIPA case ended there.

In *Midrash Sephardi, Inc. v. Town of Surfside,* 366 F.3d 1214 (11th Cir. 2004), the Eleventh Circuit became the first—and, to date, only—federal appeals court to examine RLUIPA's land use provisions in detail and then uphold the law's constitutionality. Two synagogues claimed that a town's zoning ordinance violated RLUIPA by excluding churches and synagogues from its business district while permitting private clubs and lodges. A federal magistrate judge granted summary judgment for the town and issued an injunction that prevented the synagogues from continuing to operate within the business district, but the Eleventh Circuit reversed and remanded. The appellate court first concluded that the town had violated the statute and next determined that the statute was constitutional. Because the Eleventh Circuit found that the town had violated only one portion of RLUIPA—the prohibition against treating a religious assembly or institution on less than equal terms with a nonreligious assembly or institution contained in Subsection 2000cc(b)(1)—the court confined its constitutionality review to that one provision.

The court assessed RLUIPA's constitutionality under Section 5 of the Fourteenth Amendment, the Establishment Clause of the First Amendment, and the Tenth Amendment. It concluded that Congress properly enforced existing constitutional principles, as permitted by Section 5, rather than improperly altering substantive law. The statute did not work an improper establishment of religion because it served a secular legislative purpose, it had a primary effect that neither advanced nor inhibited religion, and it did not lead to excessive church–state entanglement. Id. at 1240–42 (applying three-part test from *Lemon v. Kurtzman,* 403 U.S. 602 (1971)). Finally, although RLUIPA did affect the activities of local land use bodies, it did so in a way that was grounded in other provisions of the Constitution and thus did not violate Tenth Amendment federalism principles. A few lower courts have reached similar results. See, e.g., *Guru Nanak Sikh Society of Yuba City v. County of Sutter*, 326 F. Supp. 2d 1140 (E.D. Cal. 2003) (applying RLUIPA in favor of religious user and then finding it constitutional).

One reported case so far has found RLUIPA's land use provisions

The final, most interesting, and potentially most significant group of cases are those in which courts have examined whether RLUIPA violates the U.S. Constitution.

to be unconstitutional. In *Elsinore Christian Center v. City of Lake Elsinore,* 291 F. Supp. 2d 1083 (C.D. Cal. 2003), the Elsinore Christian Center hoped to move its congregation three blocks to a site that offered more on-site parking and asked the city of Lake Elsinore for a necessary conditional use permit. The city denied the permit, citing concerns about the loss of a needed grocery store currently operating at the site, the reduction in tax revenue that would result, and a lack of sufficient parking at the new location. The church sued the city in federal court, claiming, among other things, that the city's denial of the permit violated RLUIPA.

The court began by applying RLUIPA to the facts and concluded that the city had violated the Act by imposing a substantial burden on the church's religious exercise that was not in furtherance of a compelling interest and was not imposed in the least restrictive possible manner. This portion of the opinion adopts the framework of several of the other cases discussed above. But the court continued by finding RLUIPA's Section 2000cc(a) to be unconstitutional under both Section 5 of the Fourteenth Amendment and the Commerce Clause.

The court rejected the argument that RLUIPA simply codifies the "individualized assessment" doctrine previously set forth by the Supreme Court. In addition, the statute does not merely deter constitutional violations, as permitted by Section 5 of the Fourteenth Amendment, but also defines the substance of constitutional guarantees, which is the province of the courts. The court buttressed this argument by reviewing the legislative record and finding no evidence of a widespread and persistent deprivation of constitutional rights and no proportionality between the problem Congress sought to prevent and the method it adopted to address this problem. In summary, the court found that "the landscape is not so pervaded by religious bigotry that this blunderbuss of a remedy can be described as 'congruent and proportional' to the perceived injury." Id. at 1102. Finally, because RLUIPA regulates land use law rather than economic conduct, the court determined that Congress lacked legislative authority under the Commerce Clause.

Decisions considering the constitutionality of RLUIPA already are beginning to diverge, and the number of opinions addressing the application and validity of this new statute continues to grow. Like RFRA before it, RLUIPA appears to be headed for the Supreme Court. ■

LLC OPERATING AGREEMENTS

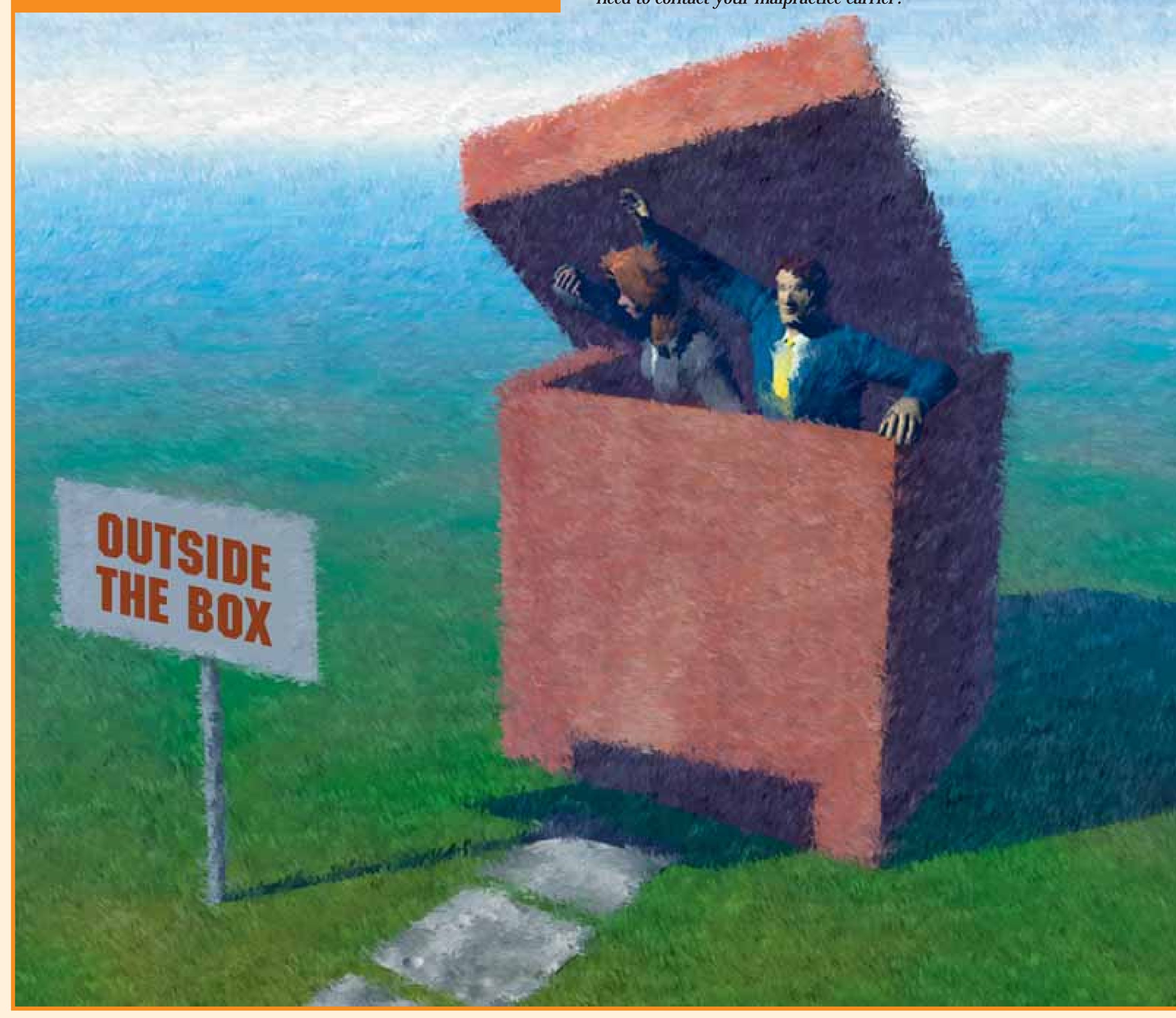
Drafting Tips and Traps for the Unwary

By Bradley R. Coppedge

John Doe comes to see you, his favorite attorney. “Mr. Esquire,” he says, “I’m going into a business with a couple of fellows, and we need some sort of legal company set up immediately.” “No problem,” you say, “what you need is an LLC.”

It just so happens you’ve created a few (or quite a few) LLCs in your career. You know you can reserve the name with the secretary of state and file articles of organization within a matter of minutes, so it shouldn’t be any problem for you to pull up an operating agreement from your document manager, make a few changes, and shoot a draft to the client within a day or so. You think to yourself how pleased the client will be to get a draft document so quickly.

All goes well for a year, or several, when major disputes arise between the partners regarding distributions, operations, and control. Your client comes to you and wants to know what his options are. Query: whether your client is quite so pleased at this point. Does your client really have any effective “out” provisions? Do you need to contact your malpractice carrier?



Choice of entity is an important decision in forming any new business. This is true regardless of whether it is an active operating business or merely a family estate planning tool. With all of the entity options today, and with the (generally) nominal differences in LLPs, LLCs, and even S corporations to some degree, many attorneys take this decision for granted. The decision about the choice of entity is much more complicated than in the above scenario. But if an LLC is in fact the correct choice once the attorney has listened to the client's concerns, he nonetheless does the client a great disservice if he simply throws together an operating agreement with no more thought than he would put into drafting a statutory health care power of attorney. When possible, it is advisable for the client, the attorney, and the CPA to initially meet to discuss choice of entity. Often it will be the CPA who has more in-depth knowledge of the client's goals and financial forecasts, which are critical factors in choice of entity.

Most law firms have a basic "form" operating agreement that was either acquired from a form manual or that one of the partners painstakingly drafted from scratch back when LLCs were first authorized under state law. But has anyone taken the time to update the form? There have been significant changes in statutory law in the last several years in the LLC arena in several states. Has the attorney thoroughly read the operating agreement and does he really understand all of its provisions? Does it cover the myriad of problems that can arise down the road? Has the attorney considered whether there are any estate planning concerns?

Ownership—Defined

Many "form" operating agreements define ownership in terms of relative capital account balances. Although this may be an acceptable method in some circumstances, structuring ownership as a definition of capital accounts should generally be avoided. Consider the following example:

> A and B form LLC, each contributing $10,000 for a 50% interest each. LLC buys an asset for $20,000. Assume it produces little or no income and has generated few expenses, such as raw land held for investment or future development. After 5 years, the asset has appreciated to $100,000. A and B now wish to admit C for a 1/3 interest, perhaps to help develop the land, with A and B each retaining a 1/3 interest. (Remember, assume A and B still have capital account balances of $10,000 each.) What amount should C contribute? If C contributes $10,000, then A, B, and C each will have a $10,000 capital account balance and each will own a 1/3 interest. This results in an incredibly good result for C. C has contributed only $10,000 and received a 1/3 interest in a $100,000 asset. By the same token, if C contributes $33,333 (1/3 of the value of the property), a "bad" result is also reached. He now owns:
>
> $\frac{\$33{,}333}{\$53{,}333}$ (roughly 3/5) or a 62% interest.

This problem can usually be remedied by defining ownership in terms of percentage ownership, largely ignoring capital accounts for ownership purposes. So long as allocations and distributions are made in accordance with ownership interests and liquidating distributions are made first in accordance with positive capital account balances, the allocations should still have "substantial economic effect," a requirement under the Code § 704 regulations. (Note there are several methods for allocations to have substantial economic effect under the regulations.) Of course, state law should be checked to determine whether voting is per capita or pro rata based on ownership interests and whether the attorney wishes to provide a different vote under the agreement. Often members will wish to have an equal vote (per capita) even when ownership is unequal. In such event, the attorney may need to override default state law in the operating agreement.

Granted, a good CPA or an astute partnership tax attorney will say that there are ways to remedy the inequitable result from the above example through optional elections under the partnership provisions of the Code. These are generally rather complex provisions, however, that are difficult for most practitioners and many accountants to follow, although following certain of these partnership Code provisions is a requirement. As such, it is often more practical simply to avoid structuring ownership in terms of capital account balances and thereby reduce administrative complexity.

Structuring ownership in terms of capital account balances can be particularly problematic with family LLCs and family partnerships, particularly if non-pro-rata distributions of income are made to certain members. In such event, the capital accounts will be adjusted, which may cause unintended shifts in ownership. This is especially true if income is disproportionately allocated and distributed to the senior generation. This results in increased capital accounts, and thus increased ownership, which is generally contrary to most estate planning goals in family partnerships.

Quorum and Voting

Quorum is an issue that should be given more than mere passing consideration, especially if the LLC operating agreement involves a number of individuals with minority interests. All too often the basic form provision requires a quorum of 100% of the members. So what happens when there is a dispute? A disgruntled member who is quick-witted and realizes what the provision does (or one who is represented by counsel) will simply not allow a quorum to be established, effectively locking down the operation of the company and perhaps forcing a judicial dissolution. At the same time, a quorum of too few members can be equally problematic, unless the "manner of

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acting" provisions are also tightly drawn to prohibit a minority of owners from establishing a quorum and then acting on behalf of the company. Admittedly, there may be circumstances when the clients genuinely want to require a quorum of 100% or unanimous agreement. In such cases, the buy–sell provisions addressed below become all the more important.

One alternative is to provide for a quorum at some amount between 51% and 80%. In that case, the "manner of acting" provision should provide for action by members holding at least 51% of all membership (voting) interests. Note the difference here as compared to most corporate quorum provisions. In a corporation, a quorum may be as little as 50%, but once a quorum is established action may generally be taken *by a majority of those present,* or as few as 26% of the corporate shares!

Buyouts: Right of First Refusal and Put Provisions

Right of First Refusal

Most LLC operating agreements have a basic "right of first refusal" (ROFR) provision. Is this alone sufficient? It is often advisable to add a "put" provision that guarantees that a severance of ownership can and will occur if an irreconcilable dispute arises.

The ROFR provision provides that if any member receives an offer from a prospective third-party purchaser to buy any portion of his or her membership interest, he or she must first offer that interest to the remaining members on the same terms and conditions as received from the third-party purchaser. The remaining members then have a set time period in which to determine whether to exercise their right of first refusal and purchase the selling member's interest or allow the sale to go through to a third party. (Keep in mind that any such third-party purchaser would not be a "member" but would rather be only an "economic interest owner" unless and until all of the remaining members approve of the purchaser's becoming a member.)

Most LLC operating agreements have a basic "right of first refusal" provision.

Put Provisions

The "put" is a fallback provision when a member has not received an offer from a third party yet wishes to either (1) sell his or her interest to the remaining members or (2) purchase all of the remaining members' interests. This provision is often called a "Russian roulette" provision. A put provision is merely a fallback provision when no other agreement can be reached to settle a severance of ownership amicably.

The put provision provides that a member may, at any time, "put" his interest to the other members. In this instance, the selling member would notify the remaining members that he or she wishes to buy or sell at a given price. The remaining members then have a set period of time in which to exercise their options. These purchasing or remaining members have only two options: (1) they may sell their interests to the "selling" member at the pro rata price at which the selling member has put the interest to them; or, alternatively, (2) they may purchase the selling member's interest at the price at which it was put to them. If the remaining members have not taken any action within a defined period of time, the remaining members are deemed to have accepted and at that point must purchase (rather than having the option to sell their interest) the selling member's interest.

Bear in mind that a put provision can run afoul of estate planning purposes. An LLC is often an ideal way to transfer assets (or value) to a descendant while effectively maintaining control in the senior generation for a period of time. If a black sheep child has sufficient individual assets, however, the child can use such a provision to force the senior generation into an uncomfortable position—having to either buy out the child or be forced to sell the entirety of his or her ownership to the child. The same is true even when there is no familial relationship. The party putting his or her interest may end up being the one bought out, even if the intent was to acquire the interest of the other members.

Forced-Out Provision

As mentioned above, one problem with a put provision is that the member wanting to buy out another member may wind up finding himself bought out by exercising his put provision. It is easy enough to see why a put provision is often called Russian roulette. This can be particularly problematic when a member owns a majority interest or is one of the larger percentage owners. Often these members wish to have a method to force out a minority owner. This can be accomplished in part by having a separate provision for a forced sale. One option, particularly in multiple-member LLCs, is to provide that any member may be bought out by affirmative vote of some percentage of the remaining members. For example, 80% of the membership interests may vote to buy out a minority member. In such event, it would be best to have an agreed-on value of a 1% membership interest determined annually by a super-majority vote and reflected in annual minutes. Such a value should probably be used only for purposes of a forced sale provision, although it could also be used for the purchase price in the event of death (although that may interfere with estate planning discounts).

In drafting such a provision, especially if the attorney is working with a member who will own a majority interest, the attorney needs to be very careful and clear at the beginning of the representation as to whom he represents. The engagement letter in such cases should probably reflect that the majority owner is the client, not the

entity itself. In any event, the minority owners need to be advised clearly that the attorney is not representing them.

Buyout at Death

What happens at the death of a member? One option is to provide for authorized transfers to defined "permitted transferees" (a spouse, children, or other family members). Similar provisions are found in most well-drafted family partnership agreements. Under this option, a member has an absolute right to transfer his interest to the permitted transferees without triggering the ROFR provisions. The primary drawback to this option is that the other members may end up with partners not of their choosing. It is at this point that a put or forced sale provision can be important.

A second option is to give the LLC itself or the other members a limited window of opportunity in which to elect to exercise a right of first refusal. If not exercised, the transferee could either become a substitute member or merely an economic interest holder. If exercised, at what price? Should it be the pro rata share of the value of the LLC assets? Perhaps, but if so, there might not be any discount available for estate tax purposes. Alternatively, it could be valued at the value of the membership interest reflecting discounts for lack of marketability or minority interest. These discounts can be significant (as much as 40% or higher), so it is essential that the issue be discussed with the initial members up front and an informed decision made. Or it could be an agreed value that would be determined each year by the members as to a 1% interest.

Another option is to require repurchase at the death of a member. This raises the same issues as the second option above and will nullify any estate tax discounts unless the purchase price is defined as the value of the interest being purchased rather than the pro rata value of the underlying assets. The purchase price will be the value included in any estate tax return. In addition, a required buyout at death can cause cash flow problems in many LLCs. The attorney may wish to provide structured terms for such a buyout (secured or unsecured promissory note at market rate of interest paid over some period of years).

Allocations and the Code § 704 Regulations

Several key provisions should appear in the operating agreement relating to allocation of items of income and loss and liquidating provisions.

Three accounting mechanisms relate to basis in an entity taxed as a partnership: inside basis, outside basis, and capital accounts. Generally, a member's basis in his membership interest equals the sum of his capital account and his share of company liabilities, subject to limited exceptions dealing with certain liabilities.

The regulations provide that an allocation under an operating agreement is

valid if it satisfies any one of three tests:

1. if it has substantial economic effect (this is basically a safe harbor),
2. if it is in accordance with membership interests under Code § 704(b) and Treas. Reg. § 1.704–1(b)(3), or
3. if it is "deemed" to be in accordance with membership interests.

The first two tests share the same premise, that income and loss should be allocated to the members who bear the correlative economic benefits and burdens of the allocation.

For an allocation to satisfy the first test (the substantial economic effect test), it must meet two requirements:

1. It must have "economic effect" under the capital account analysis regulations, and
2. The effect must be substantial.

The regulations further say that in order to have "economic effect," (1) capital accounts must be maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv), (2) liquidating distributions must be in accordance with positive capital account balances, and (3) there must be an obligation to restore deficit capital account balances. Once the economic effect test has been satisfied, the allocation must also be determined to be substantial under Treas. Reg. § 1.704–1(b)(2)(iii) (generally not a problem). If these requirements are met, allocations will generally be respected as meeting the "substantial economic effect" safe harbor test.

If an operating agreement has no provision to make up deficit capital accounts (a "deficit restoration obligation" or "DRO"), the allocation provisions will fail the safe harbor test of substantial economic effect. But the second test, that allocations "be made in accordance with membership interests," will be met so long as either (1) no special allocations are made, or, (2) if any special allocations are made, they are reflected in the members' capital accounts. Under the alternate test for economic effect (Treas. Reg. § 1.704–1(b)(2)(ii)(d)), an allocation is valid, even without a DRO, if income and losses are charged to properly maintained capital accounts and any loss does not result in a deficit capital account. To prevent deficit capital accounts, a "qualified income offset and minimum gain chargeback" provision is required.

In summary, if the attorney is going to have a provision that specifically does not require the makeup of deficit capital accounts (which should almost always be specifically included in an operating agreement), certain additional provisions are necessary. These include a qualified income offset and minimum gain chargeback provision and a provision specifying that liquidating distributions be made first in accordance with a positive capital account balances and then in accordance with the membership interests. These provisions operate to ensure that no member maintains a deficit capital account.

> An operating agreement is a flexible document and can be drafted with as much or as little authority to any management committee as the client wishes.

Distributions

Distributions under the operating agreement may be either required or made at the members' discretion. If discretionary, consider adding a provision to require distributions to pay tax liabilities. But this method has two potentially negative effects. First, it reduces the bargaining power to freeze out a creditor and so makes an LLC assignee interest unappealing. It also reduces the effectiveness of keeping a black sheep child in line when used for estate planning purposes. It does reflect, however, a fiduciary duty and helps to counter some of the arguments raised in *Hackl v. Commissioner*, 118 T.C. 279 (2002), aff'd, 335 F.3d 664 (7th Cir. 2003), and other recent IRS attacks on family LLCs and family partnerships. A sample provision is as follows:

> *Distributions to Pay Tax Liabilities.* In no event will Reserves be set at such a level so that distributions will not be available to at minimum satisfy each Member's tax liability on such Member's share of Company taxable income. At minimum, the Company shall:
>
> (a) distribute to each Member on or prior to the fifteenth (15th) day of each April, June, September, and January an amount equal to twenty-five percent (25%) of the Company's taxable income attributed to each such Member during the preceding taxable year of the Company multiplied by the sum of the maximum federal and State of _______ income tax rates in effect for an individual taxpayer filing as a single person for such taxable period; and
>
> (b) distribute to each Member within sixty (60) days after the close of the taxable year of the Company, an amount equal to that portion of the Company's taxable income attributed to each such Member during the prior taxable year of the Company multiplied by the sum of the maximum federal and State of ______ income tax rates in effect for an individual taxpayer filing as a single person for such taxable income during such taxable period, reduced by that amount paid under Subsection (a) above during such taxable period.

Day-to-Day Management, Authority, Limitations

An LLC can be managed in two ways: (1) member-managed; or (2) manager-managed, reserving to the members collectively only certain decision-mak-

ing rights (such as liquidation, admission of new members, and so on). An operating agreement is a flexible document, however, and can be drafted with as much or as little authority to any management committee as the client wishes. If a management committee is appointed, care should be taken to provide for appointment of successors, terms of office, resignation and removal procedures, and the like. In addition, a properly drafted operating agreement should clearly set forth both quorum and voting procedures not only for members but also for managers. Any limitations on the authority of the managers and members should be both addressed in the operating agreement and recited in the articles to be effective against third parties. In fact, to avoid apparent authority concerns, it is essential that such limitations be in the articles to be effective against third parties. Otherwise, each member will have apparent authority to bind the LLC.

A sample provision to limit the authority of members in a manager-managed LLC is as follows:

> Unless duly authorized in writing to do so by the Managers of the Company and recorded in the Minute Book of the Company, no attorney in fact, Member, employee or other agent of the Company shall have any power or authority to bind the Company in any way, to pledge its credit or to render it liable pecuniarily for any purpose. No Member shall have any power or authority to bind the Company unless the Member has been duly authorized by the Managers in writing to act as an agent of the Company in accordance with the previous sentence.

Limitations may also be placed on the managers' authority to bind the LLC; for example:

> *Contracts and Leases; Limitations.* Except as limited herein, the Company may enter into such leases and contracts (employment, supply, distributor, etc.) as the Managers deem to be in the best interests of the Company, upon such terms and conditions as the Managers determine.
>
> Notwithstanding the foregoing, NO:
>
> (i) contract for goods or services with anticipated or actual total annual payments in excess of $50,000;
>
> (ii) lease or purchase of equipment, machinery, or assets with
>
> (a) a one-time payment of over $20,000,
>
> (b) total annual or annualized payments over $50,000,
>
> (c) cumulative payments over $100,000, or
>
> (d) a lease term (original term or as extended via renewals) in excess of 12 months;
>
> (iii) employment contract with annual or annualized compensation in excess of $40,000;
>
> (iv) bonus or incentive to any employee, whether or not a Manager;
>
> shall be binding upon the Company unless approved in writing and signed by all Managers. In addition to the foregoing, all matters required to be approved by the Managers (and all actions by the Members) shall be in writing and recorded in the Minute Book of the Company.
>
> Should any such contract, lease, or agreement be entered into without the requisite approval and signatures of the Managers, such contract shall be voidable by the Company at the discretion of the nonsigning Manager; and in the event the Company is held pecuniarily liable for the rescission or voidance of any such agreement, the Manager so responsible for its execution shall be personally liable to the Company for such amount of pecuniary liability.

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Each member's authority can be limited in any manner as the members may agree. The foregoing is but one example of an area in which authority may be specifically limited.

Capital Calls

A "capital call" provision is an essential provision that is often paid little heed. Most operating agreements provide that additional capital contributions may or shall be made if approved by the membership. The problem arises with the next common sentence: "In such event, the Members shall have the opportunity (but not the obligation) to participate in such contributions pro rata in accordance with their ownership interests."

When ownership is defined in terms of capital account balances, no problems arise. Noncontributing members end up with proportionately reduced capital accounts, and thus, reduced ownership.

When ownership is not based on capital accounts, however, a fairness issue is raised. Granted, if the Code § 704 regulations are followed, fairness may prevail in the end (on dissolution) because liquidating distributions will be made in accordance with positive capital account balances. But during the short term, other members may not see it that way. For example, suppose an LLC has four equal members, and a capital call of $100,000 is approved. If all members contribute, the contribution is $25,000 each. If, however, one does not contribute, the remaining three members would need to contribute $33,333 each. In such event, the three contributing members would likely want increased ownership to reflect their new contributions.

The attorney should consider this issue carefully when drafting the operating agreement. Provisions could be drafted to trigger a forced sale from the noncontributing member for a portion of his ownership. Another option would be to provide a formula that would reduce ownership of noncontributing members. Or disproportionate allocations could be made until the investment is recouped.

Officers

Most LLC statutes do not specifically provide for officers, but provisions for officers may be made in the operating agreement. If officers are designated, their duties and authority should be clearly delineated in the operating agreement. In addition, any restrictions on their authority should be recited in the articles of organization, even if it is a general statement that provides the officers' authority is limited "as set forth in the company's written Operating Agreement, as may be amended from time to time." Otherwise, a member/officer of an LLC will have apparent authority to bind the LLC, and recitals in the articles of organization are the best, if not only, way to adequately negate apparent authority as to third parties.

Amendment

Many operating agreement forms require unanimous consent for amendments. Is this really wise? It may become particularly problematic when the LLC involves multiple members. There are two competing issues in analyzing the proper percentage vote to require: (1) ensuring that a large enough vote is required to avoid unfairness or blatant bias against an out-of-favor minority member and (2) ensuring that there is, in fact, some flexibility in the agreement. A range of 75–90% approval for amendments to the operating agreement is often ideal; this ensures some amount of flexibility. If desired, a higher percentage or unanimous vote could be required for "major" amendments (such as amendments that alter distributions or change management structure or functions).

LLCs Used for Estate Planning—Drafting Around *Hackl* Concerns

Beware *Hackl*! In 2002, the Tax Court issued an opinion in *Hackl v. Commissioner,* 118 T.C. 229 (2002), aff'd, 335 F.3d 664 (7th Cir. 2003), that has caused much concern among estate planners. If anything could go badly for the taxpayer, it did in *Hackl.* In *Hackl,* the family patriarch established an LLC with significant amounts of timberland. He subsequently made numerous annual exclusion gifts over several years. The IRS challenged the gifts and their valuations, resulting in significant tax. Some key provisions of the operating agreement, as focused on by the IRS, included:

- a family patriarch appointed manager for life, with 80% vote required for removal,
- a manager who had no fiduciary duty to the other members,
- distributions that were in the sole discretion of the manager, and
- very limited transferability without manager approval.

In addition, the LLC had significant losses and was expected to continue in the red for several years. The IRS determined the provisions of the operating agreement, coupled with the losses, meant that there was no "present interest." The Tax Court agreed.

How does one avoid a *Hackl*-type argument? Several steps can be taken:

1. Do not appoint a manager for life. Some clients will, however, insist on as much control as possible. If sole authority has to be vested in a senior generation family member, provide a reasonable mechanism whereby the other members may remove the manager, preferably by majority vote.

2. Include recitals of fiduciary duties to the other members.
3. Ideally, provide members with an unrestricted right to withdraw, although this runs contrary to many estate planning goals. Alternatively, consider requiring distributions quarterly or annually, at least in an amount sufficient to cover tax liabilities for pass-through income on the members' K-1s.
4. Provide for some transferability of interests. If the LLC is primarily for estate planning, avoid a forced put or required buyout provision, because this can effectively kill any discount for estate tax purposes unless the strike price is based on discounted value. Include a section in the operating agreement that defines "permitted dispositions" to certain classes of individuals or charities, which rights may be exercised without the consent or approval of any other member. Such a transferee would not have to be accorded voting rights, but could rather be an economic interest owner. Alternatively, a *Crummey*-type provision could be included, arguably the best alternative. In addition, a transferability subject to a right of first refusal provision could be provided, though this could affect the discount to some degree.

Notwithstanding the foregoing, it is important to bear in mind the client's specific estate planning purposes while drafting the agreement. For example, if the intent in *Hackl* had been to make unified credit gifts, the document would have been very beneficial, because the present interest issue would not have mattered. If the estate planning purpose is to make annual exclusion gifts, however, *Hackl* should be carefully considered.

Summary

Choice of business entity is one of the most important decisions an attorney can help a new business client make. If an LLC is selected as the entity of preference, the work and analysis do not stop with the selection. Rather, an in-depth analysis must begin regarding buy–sell provisions, management authority, and the other key issues presented herein. The additional time spent on the front end of the representation will often be much less time than would otherwise be spent helping the client extricate himself or herself from a loosely drafted LLC and will make for a much happier client. ■

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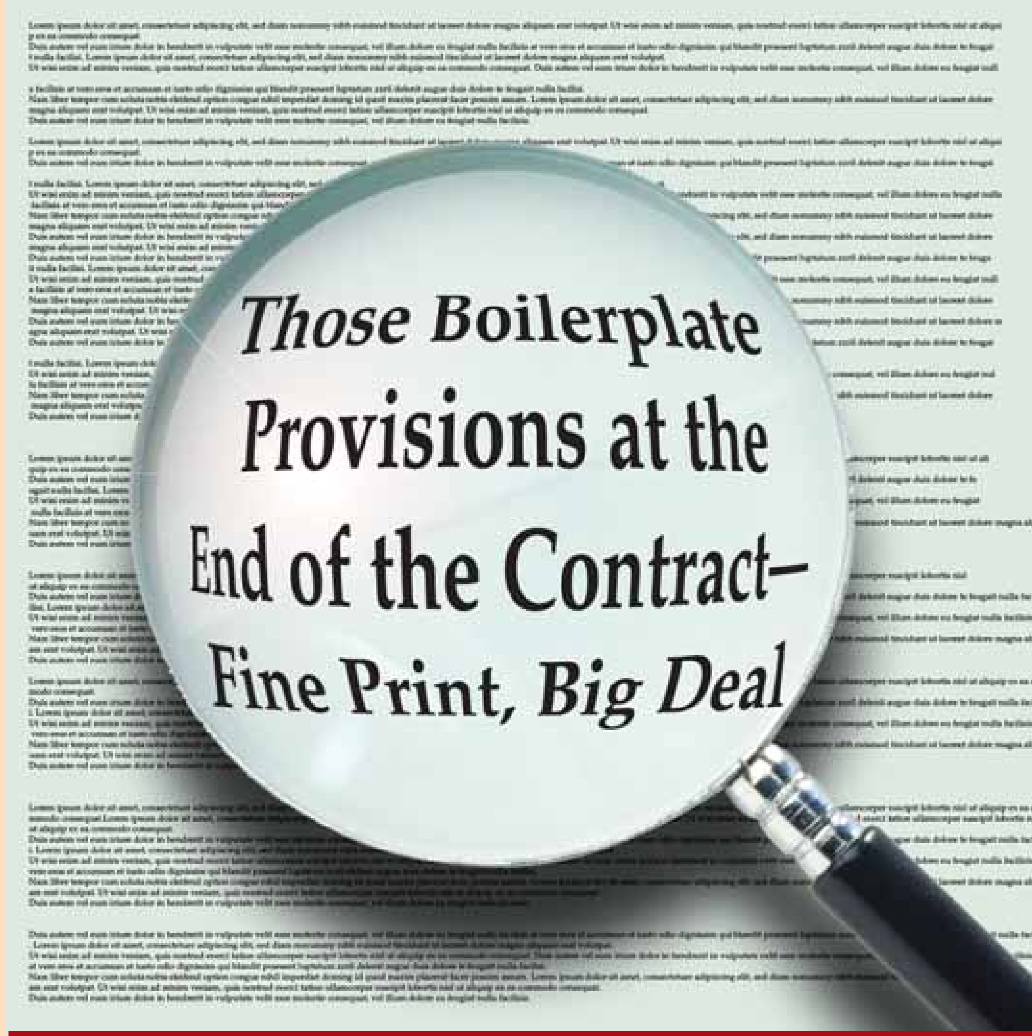

Those Boilerplate Provisions at the End of the Contract—Fine Print, Big Deal

By Tina L. Stark

It's 11:00 p.m. and finally the agreement is almost done. A quick cut-and-paste of the boilerplate provisions from the firm's precedent files and then time to head home.

Dangerous. Very dangerous. Traps lurk within each of these provisions.

Classic examples of boilerplate provisions are choice of law, waiver of jury trial, assignment and delegation, severability, and amendments. These provisions supply a road map, telling the parties how to govern their relationship and administer the contract. They are said to serve housekeeping functions—arguably, matters of secondary importance. The placement of these provisions toward the end of the contract, as "Miscellaneous" or "Administrative Provisions," furthers the impression that they are but an afterthought. Drafters perceive them as no-brainers. They are boilerplate—standardized, one-size-fits-all provisions that can be plunked down into the contract and forgotten. "Boilerplate," however, is a misnomer. Within each provision are significant business and legal issues.

The remainder of this article highlights a few of the business and legal issues that should be considered in drafting these provisions. But beware—the various provisions suggested here are only a starting place. Each provision must be tailored to the contours of the particular transaction.

Choice of Law

A drafter of a commercial contract should anticipate (unfortunately) that disputes between the parties may later arise. In addressing how these disputes will be adjudicated, one provision to include is a choice-of-law provision—one that specifies which state's substantive law governs the contract's interpretation.

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Several factors should be considered. First, the lawyer should evaluate whether the law of the jurisdiction under consideration is well-developed and affords predictability. Delaware and New York, for example, have well-developed bodies of corporate law, making an agreement's interpretation far more predictable than would be true under the law of other jurisdictions. In addition, a drafter should consider the substantive leanings of the jurisdictions under consideration. Finally, a drafter should evaluate whether the particular body of state law is hostile or friendly to the type of client (and the type of cause) being represented. For example, although California courts have upheld significant punitive damages awards for bad-faith denials of insurance coverage, New York courts, as a general matter, prohibit such awards.

Now, as to the provision itself. The following choice-of-law provision is a time-honored version, straight from the precedent files:

> The laws of Illinois, without giving effect to its choice-of-law principles, govern all matters with respect to this Agreement.

Who would have thought that this provision fails to cover all matters? Excluded, however, are tort claims such as fraudulent inducement. See *Caton v. Leach Corp.*, 896 F.2d 939, 943 (5th Cir. 1990). To embrace these claims, the provision must be restated in one of two ways:

> The laws of Illinois, without giving effect to its choice of law principles, govern all matters with respect to this Agreement, *including all tort claims.*

Andrew O. Alcala

or

> The laws of the State of Illinois, without giving effect to its choice-of-law principles, govern all matters *arising under or relating to* this Agreement.

The second version may be particularly startling because it uses a couplet—"arising under or relating to." Generally couplets should be banished from contracts as legalese. This couplet, however, serves a purpose. Who knew? Other boilerplate provisions have different surprises.

Waiver of Jury Trial

Another dispute resolution provision that must be carefully drafted is the waiver of jury trial. Because the right to a jury trial is a constitutional right, the party claiming that the waiver is enforceable has a high burden to bear. U.S. Const. amend. VII. Indeed, there is a presumption against the enforceability of a jury-waiver provision. See *Aetna Ins. Co. v. Kennedy,* 301 U.S. 389, 393 (1937). Courts, therefore, insist that any waiver must be knowing, intentional, and voluntary. See *Connecticut Nat'l Bank v. Smith,* 826 F. Supp. 57, 59 (D.R.I. 1993).

The trick is to be able to demonstrate that the waiver was knowing, intentional, and voluntary.

The trick, of course, is to be able to demonstrate that the waiver was knowing, intentional, and voluntary. To do this, make the waiver conspicuous and prominent by doing the following:

- Put the jury waiver as the last provision immediately before the signature line.
- Increase the size of the font.
- Put the provision in bold.
- Precede the provision with a caption that is appropriately titled.
- Include the provision in any table of contents.

Although the enumerated steps go a long way, the knowing-intentional-voluntary standard is more difficult to meet if the waiver is by an individual rather than a corporation. The concerns are twofold: first, the individual may be unsophisticated and not understand his or her rights, and second, the relative bargaining power of the parties may be unequal. In *Malan Realty Investors, Inc. v. Harris*, No. WD 52294, 1997 WL 10272 (Mo. Ct. App. Jan. 14, 1997) (not released for publication), the Missouri court upheld a clear, conspicuous waiver after considering whether the landlord and tenant had equal bargaining power, whether the provision was negotiable, and whether the tenant was sophisticated. In addition to those just enumerated, the following steps can further buttress a claim that the jury waiver was voluntary:

- Have the individual initial the provision.
- Include in the provision a statement that the individual has read the waiver and that the waiver is made knowingly, intentionally, and voluntarily.
- Assuming that the individual has counsel, have the individual state in the contract that he or she has received the advice of competent counsel about the waiver.
- Obtain an acknowledgment from the individual's counsel that he or she has explained the meaning of the waiver.
- Make the waiver bilateral.

Assignment

Anti-assignment provisions appear in almost every contract. They are, however, often misdrafted.

Virtually all courts recognize the enforceability of anti-assignment provisions, but their recognition is more in form than in substance. Although cases give lip service to the principle of enforceability, the bottom-line holding of many cases is that, for whatever reason, the anti-assignment provision does not prohibit the particular assignment. See John D. Calamari & Joseph M. Perillo, *The Law of Contracts* 684 (4th ed. 1998). Indeed, courts practically turn themselves inside out to find anti-assignment provisions unenforceable. The courts' bias stems from the view that such provisions interfere with the free flow of commerce and for that reason should almost always be narrowly construed. See *First Bank & Trust v. Novak,* 747 P.2d 850, 855 (Kan. Ct. App. 1987). Note also that provisions of the Uniform Commercial Code (UCC) render anti-assignment provisions unenforceable in contracts subject to the UCC. See, e.g., UCC § 9–406(d).

The following is a classic example of an anti-assignment provision that does not work. It is short but not sweet.

> No party may assign this contract.

Courts have variously construed this provision to forbid solely an assignment of rights, solely a delegation of duties, or both an assignment of rights and a delegation of duties. See *Cedar Point Apartments, Ltd. v. Cedar Point Investment Corp.*, 693 F.2d 748, 753 (8th Cir. 1982), cert. denied, 461 U.S. 914 (1983).

To bring order to this issue, both the UCC and the *Restatement (Second) of Contracts* include interpretive provisions providing that a promise not to "assign a contract" generally prohibits only the delegation of duties and not the assignment of rights. *Restatement (Second) of Contracts* § 322(1) (1981); UCC § 2–210(3). Most courts have followed their lead: they have taken what appears to be a straightforward anti-assignment provision and turned it on its head to create an anti-delegation provision. See *Charles L. Bowman & Co. v. Erwin,* 468 F.2d 1293, 1297–98 (5th Cir. 1972).

To prohibit an assignment of rights, an anti-assignment provision needs to prohibit specifically not an assignment of the contract but *an assignment of rights under the contract:*

> No party may assign any of its rights under this Agreement.

There are more traps in the anti-assignment provision. A provision that merely prohibits an assignment of rights does not prohibit assignments by merger or by operation of law. See *Winchester Constr. Co. v. Miller County Bd. of Educ.,* 821 F. Supp. 697, 702 (M.D. Ga. 1993). To do that, the provision must explicitly refer to those assignments. In addition, a change of control must be explicitly prohibited. See *Alabama Vermiculite Corp. v. Patterson,* 124 F. Supp. 441, 445 (W.D.S.C. 1954). Finally, the provision must state that any assignment in violation of the provision is void. See *Bel-Ray Co., Inc. v. Chemrite Ltd.,* 181 F.3d 435, 442 (3d Cir. 1999). If this language is omitted, the assignment is enforceable, and the nonassigning party's only recourse is a cause of action for damages—often an empty right, because often there are no damages. The following provision solves each of the problems discussed in this section.

> No party may assign any of its rights under this Agreement, voluntarily or involuntarily, whether by merger, consolidation, dissolution, operation of law, or any other manner. For the purposes of this provision, a change of control is deemed an assignment of rights. Any assignment in violation of this provision is void.

Other issues to consider when drafting an anti-assignment provision are whether a party will consent at the time of contracting to a specific future assignment and the parameters of that consent. In addition, a drafter should consider whether either party may delegate its performance. If not, a specific prohibition should be included.

Severability

There is an often-stated legal maxim: illegal agreements are void, and the courts will not enforce obligations arising out of an illegal agreement or transaction. A contract that contains one illegal provision, however, may also contain completely legal, enforceable provisions. In such situations, a refusal to enforce the entire contract might prove unduly harsh. So courts often seek to enforce a contract in part by striking the offending provisions and allowing the remainder of the agreement to stay in force.

The purpose of a severability provision is to express the parties' intent that the court enforce the valid provisions of a contract, even if it finds one or more other provisions to be illegal or unenforceable. The following is a typical provision.

> If any provision of this agreement is held invalid, illegal, or unenforceable, the validity, legality, and enforceability of the remaining provisions of this Agreement are not affected or impaired in any way.

Unfortunately, this typical provision rarely reflects the parties' actual intent. For example, imagine a noncompete agreement that requires an employer to pay an employee $3 million, in return for which the employee agrees not to compete anywhere in the world for 10 years. Imagine further that the court holds that the noncompete agreement is overly broad and unenforceable. Did the drafter really understand the import of the severability provision that states if one provision is unenforceable the others remain intact? Imagine how unhappy the employer/client will be when he or she learns that he or she must pay $3 million even though the employee is not bound by the noncompete agreement. Now imagine the complaint and the allegations of malpractice. Probably a more accurate expression of the parties' intentions under these circumstances would be the following:

> If any provision of this Agreement is determined to be invalid, illegal, or unenforceable, the remaining provisions of this Agreement remain in full force, if the essential provisions of this Agreement for each party remain valid, binding, and enforceable.

Although this rewriting of the more standard formulation is probably insufficiently specific to preclude all disputes (for instance, would a radius restriction or an exclusive use provision be deemed essential in a lease?), at least it explicitly expresses the idea that there are some provisions the parties cannot do without. It affords them the opportunity to make their case for which provisions are essential in the context of any later dispute.

There is one other thing to keep in mind when drafting severability provisions: how the provision is drafted should reflect whether the governing law is that of a state that follows the *blue-pencil rule* or that of a state that follows the *rule of reasonableness.*

Under the traditional blue-pencil rule, a court will delete portions of an otherwise unenforceable provision if the deleted portions can be clearly—and grammatically—separated from the remainder of the provision (that is, if the provision will still be grammatically correct after the offending terms have been deleted). See Richard A. Lord, 6 *Williston on Contracts* § 13:21, at 785–90 (1995). For example, an overbroad covenant forbidding future employment "in the State of Connecticut" could not be reduced to cover an enforceable geographic area in a blue-pencil jurisdiction. By contrast, that result could be reached if the covenant had separately listed each county in the State of Connecticut. Then a court could salvage the noncompete agreement by deleting specific counties until the list was no longer

overbroad. See *Beit v. Beit,* 63 A.2d 161 (Conn. 1948). States that have adopted this approach include Colorado, Connecticut, Indiana, and North Carolina.

The *Restatement* has rejected the traditional blue-pencil approach in favor of the more flexible rule of reasonableness, under which a court may reform an unenforceable provision to the extent reasonable under the circumstances and enforce it as so reformed. *Restatement (Second) of Contracts* § 184 (1979). States that have adopted this approach include Delaware, Florida, New Jersey, New York, Pennsylvania, and Tennessee. Courts have sought to limit the risk of overreaching that this approach might entail by requiring proof that the offending provisions were drafted in good faith and in accordance with standards of fair dealing at the time the contract was made. See Richard A. Lord, 6 *Williston on Contracts* § 13:22 (1995). See also the case citations in *Restatement (Second) of Contracts* § 184 (1981 and Supp. 2004).

Amendments

The no-oral-amendments provision is classic boilerplate—always present, rarely negotiated. It is also generally unenforceable under the common law. In a Texas case, *Mar-Lan Industries, Inc. v. Nelson,* 635 S.W.2d 853, 855 (Tex. App. 1982), the court stated that a written contract "is of no higher legal degree than an oral one, and either may vary or discharge the other." Similarly, in *Beatty v. Guggenheim Exploration Co.,* 122 N.E. 378, 381 (N.Y. 1919), Judge Cardozo said: "Those who make a contract may unmake it. The clause which forbids a change, may be changed like any other. . . . What is executed by one act is restored by another. . . . Whenever two [persons] contract, no limitation self-imposed can destroy their power to contract again."

To bring greater predictability to contractual relations, at least two states have enacted laws providing that no-oral-amendment provisions are enforceable. See, e.g., Cal. Civ. Code § 1698 and N.Y. Gen. Oblig. Law § 15–301. The courts, however, have undermined these statutory provisions by finding that underlying agreements can be modified by an executed oral amendment, a course of conduct, or estoppel. See *Wechsler v. Hunt Health Systems, Ltd.,* 186 F. Supp. 2d 402 (S.D.N.Y. 2002).

A nationwide solution has also been attempted through UCC § 2–209(2), which specifically provides that no-oral-amendment provisions are enforceable in contracts governed by UCC Article 2. Unfortunately, this solution is not bulletproof. Specifically, under UCC § 2–209(4) a purported amendment that does not satisfy the requirements of the statute of frauds can operate as a waiver. The rationale is that the course of performance during the term of the contract is relevant to determine whether a particular act sheds light on the meaning of the agreement or represents a waiver. In essence, UCC § 2–209(4) codifies the estoppel theory under which courts have enforced oral amendments despite contractual prohibitions against them.

With all these obstacles to an enforceable no-oral-amendments provision, the obvious question is whether it makes sense to try to include one. This author believes that the answer is "yes." These provisions evidence the parties' agreement and their intent at the time the contract was executed. Many parties use them as guideposts for their actions during the life of the contract. If there is a dispute as to whether a purported amendment is enforceable, these provisions set the starting point for a court's analysis because they reflect the parties' understanding when they made their agreement.

The following is a basic no-oral-amendments provision. The bracketed language might be useful in New York, where the highest state court held that the minutes of a board of directors meeting, signed by the corporate secretary, were a sufficient writing to constitute execution of an amendment. See *DFI Communications, Inc. v. Greenberg,* 363 N.E.2d 312, 314–15 (N.Y. 1977).

> The parties may amend this Agreement only by a written agreement of the parties [that identifies itself as an amendment to this Agreement].

This provision may be tailored to specify who must sign on behalf of each party and to include as a condition precedent to the enforceability of the provision that each party must deliver to the other a board resolution authorizing the amendment.

When drafting amendment provisions for a shareholders' agreement, the drafter should recognize that the shareholders' interests may differ if one shareholder owns or controls more than 50% of the shares. In that case, the majority shareholder controls any vote of the shareholders, and the minority shareholders are effectively cut out from the decision-making process. To prevent this situation, a majority shareholder sometimes agrees to what is known as a *supermajority provision*: a vote that requires some percentage greater than 50%. Such a vote gives the minority shareholders a voice. The percentage is a matter of negotiation and takes into account the distribution of the shares. The minority shareholders generally want the percentage to be high enough to require the assent of a significant percentage of the minority shareholders. The majority shareholder, however, wants to keep the percentage lower so that it will need to sway only a small number of the minority shareholders.

Conclusion

A final thought. The mere fact that a provision has become boilerplate is not a reason to use it or scrap it. The task is to determine how to take advantage of the benefits of a boilerplate provision while protecting the client from its pitfalls. A drafter must understand each provision—its history, business purpose, and variations. Only then can the drafter make a considered business and legal judgment and craft an appropriate provision. ■