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Probate & Property

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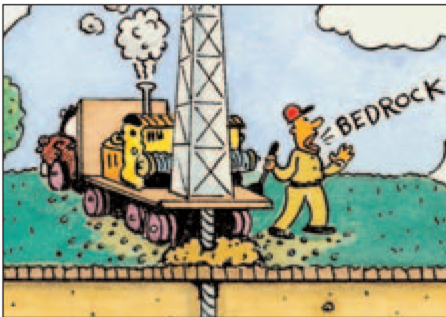

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Editorial Policy: *Probate & Property* is designed to assist lawyers practicing in the areas of real estate, wills, trusts, and estates by providing articles and editorial matter written in a readable and informative style. The articles, other editorial content, and advertisements are intended to give up-to-date, practical information that will aid lawyers in giving their clients accurate, prompt, and efficient service.

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Section News

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PROFILES IN MEMBERSHIP

Elwood F. Cahill Jr.

For virtually all of his 25 years of practice, Elwood Cahill has been an active member of the ABA. From his days as a young lawyer, Elwood realized that service to the profession and to the public were integral parts of the practice of law.

"I have been very fortunate to have had every opportunity to become involved in the ABA, and especially the Real Property Probate and Trust Law Section." As a liaison from the ABA/YLD, Elwood had the privilege of serving on the Section Council at a very young age. After serving in a variety of positions from vice-chair of the Surveys Committee, to chair of the Membership Committee, to most recently chair of the Diversity Committee, he now has come full circle to serve once again on the Section's Council.

The Section has allowed Elwood to give back to the profession and to the public in keeping with the Jesuit tradition of "men of service." "I am proudest of my involvement with the Diversity Committee of the Section. We were able not only to adopt the first formal Diversity Plan for the Section, but we actually implemented a number of important initiatives that were identified as priorities for the Section, including Manny Halper's Minority Outreach Project, the annual Diversity Luncheon, and the designation of two positions in the Section's Fellows Program being earmarked for minority lawyers. The work of the Diversity Committee reminds me that our quality of life depends on the quality of life of all around us. The privilege of practicing law comes with a responsibility to help improve the quality of life of not just all attorneys, but all humanity."

Elwood's service to the profession is not limited to the ABA. He has served as an adjunct professor at his alma mater, and he has presented at meetings of the American College of Real Estate Lawyers. He serves on the Board of Directors of the New Orleans Bar Association, and he was recently nominated as the secretary-treasurer of the Louisiana Bar Foundation. Even a fair amount of his spare time is devoted to community service in New Orleans.

Elwood is the proud father of three beautiful daughters, Erin, Kristen, and Abby. Each of his daughters has accompanied him on various Section trips. "My father instilled in me a strong sense of service and of community. I hope each of my daughters can also recognize that service to others is the best part of life." ■

Kalimah Z. White

Since being selected for the Section's Fellows Program in 2003, Kalimah White has been actively involved in the Section. Within the first few months of her fellowship, Kalimah collaborated with the Section's Membership Committee to establish a Young Lawyers Network (YLN) to improve young/new lawyer involvement, substantively and socially, in the Section. Currently, Kalimah works diligently with YLN leadership to bring substantive and professional development programming to young/new lawyers, including collaborating with the Community Outreach Committee to provide beginning level substantive programs in real estate and probate to young and minority lawyers. She works with the Section's Membership Committee to develop innovative recruitment initiatives. Recently, Kalimah was named vice-chair of the Fellows Program.

As a vice president and relationship manager at NatCity Trust Company of Delaware, Kalimah understands the advantages of active involvement in the Section. "In my position I have the opportunity to lecture on asset protection planning throughout the country. However, before I became involved with the Section, my lecturing experience was limited. My Section involvement has honed my speaking skills, which have been an asset to me and my organization." In addition, Kalimah recognizes the mentoring and networking opportunities available within the Section. "It is astounding to me that I can associate with asset protection gurus like Gideon Rothschild and Alexander Bove. In the probate area, this Section is the best place to gain knowledge, experience, and credibility."

Although Kalimah's Section activities keep her very busy, she still finds time to serve other important organizations. Currently, Kalimah chairs the Probate Committee of the Real Estate and Probate Section of the National Bar Association (NBA). In addition, Kalimah will be a lecturer on asset protection planning at the 2006 ALI-ABA Conference.

Kalimah enjoys spending time with her 10-year-old daughter, Kierra, her large family, and friends. "I have made many good friends in my short time with the Section. I look forward to continuing the friendships for many years to come!" ■

A project of the Section's Standing Committee on Membership

Welcome to Our New Fellows!

The Section of Real Property, Probate and Trust Law welcomes our new class of young lawyer fellows. They are Anta Cisse-Green of New York, New York, Elizabeth Lindsey-Ochoa of Aurora, Colorado, Julie Panero of Wilmington, Delaware, and Christopher Walker of Jackson, Mississippi. Each appointment is for a period of two years. The Section has designed the program to encourage minority participation in the Section by designating two of the fellowships for minorities. Funds have been allocated by the Section to cover expenses for the fellows to attend meetings of the Section during their fellowships.

Each fellow has been assigned to Section committees and will have a mentor to work with during the years as a fellow. Section leaders are charged with involving fellows in the substantive work of the committees, and the mentors will work to maximize the opportunities for participation and professional development on the part of their fellows. Each fellow will also work with his or her mentor to produce a significant written work for the Section magazine or journal.

Four fellows are selected each year. To be considered for selection, a candidate should have practiced in the probate or real property area for at least one year and be an active member of the YLD with demonstrated leadership initiative. Candidates may also be active members of the division who have aged out within the last three years.

For more information about the fellows program or nominations for next year's fellows class, please contact Steve Gorin at (314) 552–6151 or sgorin@thompsoncoburn.com or contact the Assistant Director for Technology, Marketing and Communications, Rob King, at (312) 988-5540 or kingr@staff.abanet.org. Or visit the Section web site at **www.abanet.org/rppt**. ■

Preventing the Loss of Property

The Property Preservation Task Force (PPTF) has been actively involved the last several years to identify the character, scope, and possible solutions to the loss of tenancy-in-common property throughout the United States including, without limitation, the southeastern United States. The PPTF has teleconferenced four times since November 2004, has met with Undersecretary Dorr of the USDA, and has communicated with the Joint Editorial Board of the National Council of Commissioners on Uniform State Laws. The general focus of the PPTF has been to identify the character, scope, and possible solutions to the loss of tenancy-in-common property. The key elements of the PPTF's focus at this time are

- to develop a coherent analysis of the nature of the problem to propose solutions for submission to the Joint Editorial Board of the NCCUSL,
- to prepare a symposium at the Fall Leadership Conference in early November 2005 in Colorado Springs,
- to become involved with the USDA to develop a method to allow a co-tenant to purchase with Rural Development loan proceeds, the remaining co-tenants' interests, and
- to coordinate with local bar associations for education of and delivery to members of the public who are vulnerable to tenancy-in-common land loss. ■

Section Nominations Committee

Pursuant to Section Bylaw § 6.1(f), following are the names of the Section 2005–06 Nominations Committee and the Section officer and council positions to be elected at the 2006 Section Annual Meeting. Any Section member wishing to suggest a nomination should send it to one of the Nominations Committee members listed below.

Nominations Committee

Chair: **Philip J. Bagley III**, Troutman Sanders LLP, P.O. Box 1122, Richmond, VA 23219-3531, phil.bagley@troutmansanders.com.

Vice-Chair: **Edward F. Koren**, Holland & Knight LLP, 100 N. Tampa Street, Suite 4100, Tampa, FL 33602-2644, ed.koren@hklaw.com.

Members: **Dennis M. Horn**, Holland & Knight, LLP, 2099 Pennsylvania Avenue N.W., Suite 100, Washington, DC 20006-6801, dennis.horn@hklaw.com; **David J. Dietrich**, Dietrich & Associates, P.O. Box 7054, Billings, MT 59103-7054, dietrichlaw@mcn.net; **Edward T. Brading**, Herndon Coleman Brading & McKee, 104 E. Main Street, Johnson City, TN 37604-5735, ebrading@lawyerfirm.com.

Positions to Be Elected, August 2006

Office	Incumbent	Eligible for Renomination?
Officers		
Chair-Elect	Christine L. Albright	No, automatic ascension to Section Chair
RP Vice-Chair	Kathleen M. Martin	Eligible to become Chair-Elect
PT Vice-Chair	Steve R. Akers	Yes
Finance & Corporate Sponsorship Officer	Roger D. Winston	Yes
Secretary	Tina Hestrom Portuondo	Yes
Section Delegate	Neal J. Fink	Yes
Council Members		
Real Property	Nancy J. Appleby	Yes
	Kenneth L. Samuelson	No
	Susan G. Talley	No
	David A. Thomas	Yes
Probate and Trust	Jo Ann Engelhardt	Yes
	Barbara A. Sloan	Yes
	William P. LaPiana	Yes
	Gideon Rothschild	Yes

USA PATRIOT Act and Gatekeeper Initiative

Concerns have arisen that legislation or regulations intended to curtail money laundering or the financing of terrorism may, among other things, impinge on important ethical rules governing our practices, such as the attorney-client privilege and duty of client confidentiality.

RPPT Section Chair Kevin Shepherd and *RPPT Bulletin* Editor Mark Mehlman are heading a task force appointed by the Executive Committee to attempt to communicate to the U.S. Department of Treasury the strongly held views of the Section and, if possible, to engage in an ongoing dialogue with Treasury regarding the potential impact on lawyers of any proposed legislation or regulations. Task Force members also include Section members Michael Goler, Neil Kessler, Timothy Powers, Shannon Skinner, and Susan Talley.

Kevin and Mark have met several times with senior Treasury staff members in Washington, D.C., to address issues of concern relating to the USA PATRIOT Act and the Gatekeeper Initiative.

Kevin reports that the meetings and discussions have been extremely productive, that Treasury appears sensitive to the concerns raised by the Section and other groups in attendance, and that Treasury seems favorably inclined to work with the Section and these groups in an effort to develop an approach to the issues that will not undermine any of the essential ethical underpinnings of our practices. ■

Letters to the Editor

A Loophole You Could Drive a Truck Through

Michael Whitty's article in the May/June 2005 issue of *Probate & Property* argues that the IRS is applying the wrong estate tax inclusion formula to a *Walton*-type GRAT and that a fixed-term interest should be treated differently from a lifetime interest. This is clearly not the law and should not be the law. Code § 2036 includes in the grantor's estate any trust in which the grantor retains an income interest for any period which does not in fact end before the grantor's death. If the grantor retains an annuity which is high enough that it must by definition include all of the income, that trust must also be includable. If, for example, the Code § 7520 rate assumes a 6% income return, then if I retain an annuity of 6% I will be receiving more than the amount of the income and if I die at any time during the trust, whether it is a term trust or a life trust, the trust should be includable in my estate. If I create a term income interest for, say, 15 years and I die the day before the trust term ends, Code § 2036 will include the entire trust in my estate. The rule can't be different if, instead, I retain an annuity as great as or greater than the income would be. Whitty argues for a loophole you could drive a truck through.

Lawrence P. Katzenstein
Thompson Coburn
St. Louis, Missouri

Professor Katzenstein was kind enough to correspond with me before writing to *Probate & Property* to critique my article "Repercussions of *Walton*" in the May/June 2005 issue. We had to agree to disagree on the extent to which Code § 2036 causes inclusion of a GRAT in the grantor's estate when death occurs during the annuity term. My position can be summarized as follows:

- Code § 2036(a) causes inclusion of principal only "to the extent" principal is subject to the grantor's retained "right to the income."
- In a pure GRAT, the grantor retains no express right to the income, but instead retains an annuity payment right—which is not the same thing.
- A pure GRAT is not simply a GRIT that has been modified to fix the payment. There are significant qualitative differences in the trustee's ability to amortize principal and the grantor's inability, in a pure GRAT, to cause the generation of income or the allocation of income to the payment when principal is available.
- Any implied income right contained in an annuity payment right is limited to that amount of income necessary to satisfy the payment right when principal is insufficient.
- The only principal necessary to generate that amount of income is the Annuity NPV, which is already included under Code § 2033.

I am developing an article for submission to *Real Property, Probate and Trust Journal* to further develop my analysis and to explain how it is supported by statutory and legislative history, relevant cases, and actual practice involving GRATs. In the meantime, I would suggest that planners avoid creating GRATs with the grantor as trustee or with a direction to pay the annuity from income first.

Michael D. Whitty
Winston & Strawn LLP
Chicago, Illinois

Departing Is Such Sweet Sorrow

GIVING UP U.S. CITIZENSHIP OR RESIDENCE

By G. Warren Whitaker and B. Dane Dudley

While millions of people around the world are trying to get into the United States by obtaining U.S. legal residence or citizenship, a few others are headed in the opposite direction. Those leaving are often U.S. citizens by birth or naturalization who have lived outside the United States for many years and have stronger connections to another country. They also include many U.S. permanent residents or "green card" holders who are returning to their home countries or moving elsewhere. According to the U.S. Treasury's own studies, the notion that thousands of wealthy Americans with no prior foreign ties suddenly pick up stakes and expatriate each year to avoid taxes is an urban myth. A few high-profile expatriates, however, including Campbell Soup heir John T. Dorrance III, who expatriated to Ireland in the early 1990s, prompted Congress to pass laws in 1996 to make it more difficult to expatriate.

Whatever mixture of human motivations may lead to this decision, giving up U.S. citizenship and residence can lead to the sweet result of escaping U.S. income, estate, and gift taxation. The sweetness may be tinged with sorrow, however, if the departing person is ensnared by the United States' Alternative Tax Regime. Although the United States does not have a formal exit tax like some other countries, including Canada, a series of complex provisions can trap a departing citizen or resident in the U.S. tax net for up to 10 years after departure. These rules were recently revised as part of the American Jobs Creation Act of 2004, H.R. 4520, Pub. L. No. 108–357, 118 Stat. 1569 (Oct. 22, 2004). The revised rules operate as follows.

General Rules

Income and Capital Gain Taxes

U.S. citizens and residents generally are subject to U.S. income taxation on their worldwide income. Nonresidents who are not U.S. citizens ("non-U.S. persons") are subject to U.S. income tax only on income from U.S. sources. (Keep in mind the definition of "resident" is different for estate and income tax purposes.) Non-U.S. persons are taxed at regular graduated rates on "active" income derived from a U.S. trade or business. Non-U.S. persons are taxed at a flat rate of 30% (or a lower treaty rate) on certain types of "passive" income derived from U.S. sources such as (1) dividends paid from U.S. corporations, (2) rents from U.S. real property, and (3) interest on debts of U.S. obligors (other than interest that qualifies as "portfolio interest," which includes bank interest and nearly all interest on publicly traded bonds). Non-U.S. persons pay no tax on gain realized on the sale of U.S. assets other than U.S. real property.

Estate and Gift Taxes

U.S. citizens and residents are subject to U.S. gift tax on transfers during life and estate tax at death on their worldwide assets. Non-U.S. persons are generally subject to U.S. gift tax only on gifts of real property and tangible personal property located in the United States and not, for example, on gifts of shares of U.S. corporations. Non-U.S. persons are subject to U.S. estate tax at death only on assets deemed to be situated in the United States, such as (1) real estate located in the United States, (2) tangible personal property located in the United States, and (3) shares of U.S. corporations (but U.S.-situs assets held by non-U.S. corporations are normally not subject to U.S. estate tax).

Alternative Tax Regime After Expatriation

Generally

An individual who relinquishes U.S. citizenship with the principal purpose of avoiding U.S. taxes is subject to an alternative method of taxation for 10 years after expatriation (the "Alternative Tax Regime"). See Code § 877. Persons who expatriate after June 3, 2004, are presumed to have expatriated with the principal purpose of tax avoidance and, therefore, generally are subject to the Alternative Tax Regime if (1) the individual's average annual net income *tax* for the period of five years ending before the date of the loss of the U.S. citizenship is greater than $124,000; (2) the individual's net worth as of the date of loss is $2 million or more; or (3) the individual fails to certify under penalty of perjury that she has met the requirements of the Code for the five preceding tax years or fails to submit evidence of her compliance as the IRS may require. The prior process by which expatriates could seek a ruling from the IRS that their action was not primarily motivated by tax considerations has been repealed.

A person who formally renounces her permanent work visa or green card after she has held it for part or all of at least 8 of the past 15 calendar years is subject to the same Alternative Tax Regime as one who has given up her U.S. citizenship. Persons in both categories will be referred to as "expatriates" in this article.

Income Tax

An expatriate subject to the Alternative Tax Regime is taxed on all U.S.-source income at the rates applicable to U.S. citizens (up to 35%), rather than the withholding rates applicable to non-U.S. persons. In addition, U.S.-source income has a broader definition under the Alternative Tax Regime for other nonresident aliens than it does for normal U.S. income tax purposes. It includes, for example, gain from the

An individual who relinquishes U.S. citizenship with the principal purpose of avoiding U.S. taxes is subject to an alternative method of taxation for 10 years after expatriation.

G. Warren Whitaker is a partner in the New York, New York, office and B. Dane Dudley is a partner in the West Hartford, Connecticut, office of Day, Berry & Howard LLP.

Richard Laurent

sale of U.S. corporate stock or debt obligations and interest on all U.S. government, corporate, or bank obligations. Accordingly, the Alternative Tax Regime generally applies to an exchange of property that produces U.S.-source income for property that produces foreign-source income. In addition, amounts earned by expatriates through controlled foreign corporations are subject to the Alternative Tax Regime, and the 10-year period is suspended during any time an expatriate's risk of loss on property subject to

the Alternative Tax Regime is substantially diminished. Another important change is that an expatriate will be treated as a U.S. citizen for a calendar year during the 10-year period following expatriation, fully subject to U.S. gift and estate taxes on worldwide assets and U.S. income tax on worldwide income, if she is present in the United States for any reason for more than 30 days in that calendar year. There are two narrow exceptions to this 30-day trap. A day of physical presence in the United States will be disregarded if the person is performing services for her employer and the employer is not related to her and meets all the requirements established by the Secretary of the Treasury. The other exception is when the expatriate became at birth a citizen of the United States and another country, continues to be a citizen of that country, and has no "substantial contacts" with the United States.

Estate and Gift Taxes

In addition, the Alternative Tax Regime includes special estate and gift tax rules. Under these rules, certain closely held foreign stock owned by the expatriate is included in her gross estate to the extent that the foreign corporation owns U.S.-situs property if the expatriate dies within 10 years of expatriation. This rule prevents expatriates who are subject to the Alternative Tax Regime from avoiding U.S. estate tax by transferring U.S.-situs property to a foreign corporation. Moreover, under the Alternative Tax Regime, an expatriate is subject to gift tax on gifts of U.S.-situs intangibles, such as shares of U.S. corporations (and gifts of stock in some closely held foreign corporations that own U.S. assets), made during the 10 years following expatriation.

Reporting Requirements

To avoid being treated as a U.S. citizen, a person expatriating must give notice to the Secretary of State or the Secretary of Homeland Security of her renunciation of U.S. citizenship or residency. The expatriate also must file an information statement that includes (1) the mailing address of her principal foreign residence, (2) the foreign country in which she is residing, (3) her country of citizenship, (4) a complete list of her worldwide assets and liabilities, (5) information relating to her worldwide income for the year, and (6) the number of days that she was physically present in the United States during the year. The expatriate must file a detailed information statement similar to the one described above each year during the 10-year period, even if no U.S. tax is due. There is a $10,000 penalty for failing to file the annual information statement. See IRS Form 8854.

The Reed Amendment

In addition to the tax rules discussed above, Congress enacted the Reed Amendment in 1996 as part of the Illegal Immigration Reform and Immigrant Responsibility Act, Pub. L. No. 104–208, 110 Stat. 3009 (1996). This law allows the U.S. Attorney General to place tax-motivated expatriates on a list of undesirables who cannot reenter the United States for any reason, clumping them together with former Nazis, pedophiles, and international terrorists. Although to date no tax-motivated expatriate has been placed on this list, the possibility cannot be ignored.

The Not-So-Simple Solution

To avoid the continuing U.S. income, gift, and estate tax aspects of the Alternative Tax Regime, a person contemplating expatriation could sell all U.S.-situs assets, pay whatever U.S. capital gain tax is owed, and reinvest the net proceeds entirely in non-U.S. assets. In this way all of the person's ties to the U.S. tax would be cut. Besides the potentially prohibitive amount of capital gain tax that might be generated, this solution does not eliminate

- the 30-day limit on the number of days that can be spent in the United States during the 10-year period,
- the annual reporting requirements, or
- the risks associated with the Reed Amendment.

The person wishing to expatriate also must (1) have or acquire citizenship in another country, (2) physically move to another country and make that country her permanent home or domicile, and (3) go to the U.S. embassy or consulate in that country, present the information statement discussed above, and formally renounce U.S. citizenship or permanent residence status. Immigration and Nationality Act § 349(a), 8 U.S.C. § 1481 (2005).

In Summary

It is possible to leave the U.S. tax net, but the exits are not clearly marked and an informed guide is required. ■

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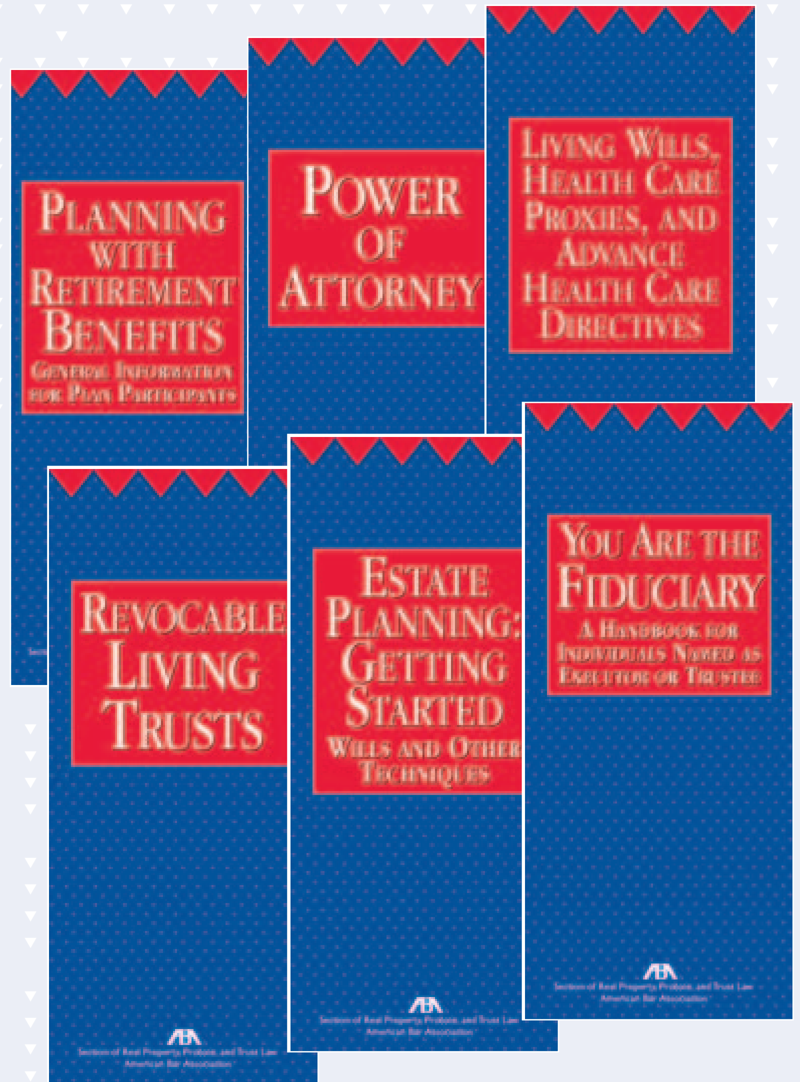

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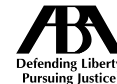

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Keeping Current

Probate

Keeping Current—Probate Editor: Prof. Gerry W. Beyer, Texas Tech University School of Law, Lubbock, TX 79409, gwb@ProfessorBeyer.com. Contributors include: Dave L. Cornfeld, Claire G. Hargrove, Christopher L. Harris, and Prof. William P. LaPiana.

Keeping Current—Probate offers a look at selected recent cases, rulings and regulations, literature, and legislation. The editors of *Probate & Property* welcome suggestions and contributions from readers.

CASES

CHARITABLE TRUSTS: Private party has standing. As part of the extensive litigation involving the Milton Hershey School, a sharply divided court held that the school's alumni association has a "special interest" that gives it standing to challenge agreements between the school and the state attorney general. *In re Milton Hershey School,* 867 A.2d 674 (Pa. Commw. Ct. 2005).

EXECUTORS: Executor cannot adversely possess realty against a will beneficiary. In *In re Estate of Seifert,* 26 Cal. Rptr. 3d 560 (Cal. Ct. App. 2005), the court reaffirmed the long-standing rule that the statute of limitations may not run for matters in which the parties are in a fiduciary relationship absent repudiation of the relationship. The court held an executor's possession of land could not be adverse to an estate beneficiary.

FUTURE INTERESTS: Express language creates vested remainder despite statutory presumption to the contrary. A father's will created a trust for his widow for life, remainder to his son "as an indefeasibly vested interest in fee" should the son survive the father, which he did. The son died before the life income beneficiary. Local law provides that a beneficiary's interest is contingent on surviving until the time of possession or enjoyment of the beneficiary's interest "unless otherwise specified by the terms of the trust." The court in *In re Will of Uchtorff,* 693 N.W.2d 790 (Iowa 2005), held that the remainder was vested in interest and therefore passed through the son's estate because the language creating the remainder overrides the statute.

GROSS ESTATE: Transfers of property to Delaware business trusts deemed to be bona fide sales for adequate and full consideration. The court in *Estate of Schutt v. Commissioner,* T.C. Memo. 2005–126, found that the stock the decedent transferred to revocable trusts for his children and grandchildren was not part of the decedent's gross estate because the transfers were true sales.

INDIVIDUAL RETIREMENT ACCOUNTS: U.S. Supreme Court rules that IRAs are exempt from the claims of creditors in bankruptcy. *Rousey v. Jacoway,* 125 S. Ct. 1561 (2005). This case resolved a split in authority among the various circuits.

INVESTMENT DUTIES OF TRUSTEE: Settlor bound by settlor's instructions regarding investments. The settlor created a revocable trust with a bank as the trustee and reserved to herself the power to direct investments. Months after she created the trust, the settlor sent the trustee a letter directing it to retain the shares of Enron the settlor had added to the trust and indemnifying the trustee for any loss, damage, or expense incurred because of such retention. After Enron greatly diminished in value, the settlor sued the trustee alleging violation of its fiduciary duties. In *McGinley v. Bank of America, N.A.,* 109 P.3d 1146 (Kan. 2005), the court held that the settlor was bound by the terms of the letter and had no recourse against the trustee.

MALPRACTICE: Failure to include power to create trusts in a durable power of attorney not deemed to be malpractice. *Thiel v. Miller,* 164 S.W.3d 76 (Mo. Ct. App. 2005).

NO CONTEST CLAUSE: Action to determine the time of death is not a contest. The decedent's trust required a beneficiary to survive the decedent by 120 days. The trust also contained a no contest clause specifically applying to challenges to the amendments to the trust that includ-

ed the survival provision. The beneficiary's widow filed an action asserting that the beneficiary actually survived for the required period. In *Estate of Davies*, 26 Cal. Rptr. 3d 239 (Cal. Ct. App. 2005), the court held that the action seeking clarification of whether the beneficiary survived did not invoke the no contest clause although challenges to the amendments themselves did.

PROFESSIONAL RESPONSIBILITY: Confidentiality not waived when the consultation did not result in an executed will. Like many jurisdictions, Connecticut makes an exception to the confidentiality of attorney-client communications relating to a will executed by the client. In *Gould, Larson, Bennet, Wells and McDonnell, P.C. v. Panico*, 869 A.2d 653 (Conn. 2005), the court held that this exception does not apply if the communications did not result in the execution of a will.

SATISFACTION: Gift adeemed legacy to donee. The court in *Yivo Institute for Jewish Research v. Zaleski*, 874 A.2d 411 (Md. 2005), held that the hearsay rule did not bar the admission of testimony about the testator's statements concerning an inter vivos gift to a charity that supported the lower court's conclusion that the legacy adeemed by satisfaction.

TRUSTS: Revocation by writing includes revocation by will. The settlor created a revocable trust with herself as trustee that provided for revocation by a writing signed by the settlor and delivered to the trustee. The settlor deeded real property to the trustee. The settlor then executed a will revoking all prior wills and stating her intention to dispose of all her property by the will. The court in *Gardenhire v. Superior Court*, 26 Cal. Rptr. 3d 143 (Cal. Ct. App. 2005), held that the subsequent will complied with the trust provision for revocation by a writing delivered to the trustee.

TRUSTS: Trust created by an agent cannot exculpate the trustees. The decedent's son held her power of attorney and used his authority to create a trust of her property with himself and his attorney as trustees. The principal never read the trust agreement. The trust document exculpated the trustees from liability except in cases of bad faith, intentional misconduct, or reckless indifference to the beneficiaries' interests. In upholding objections to the trustees' accounting and the imposition of surcharges, the court held that the exculpatory provision was ineffective because the nominal settlor never knew the terms of the trust agreement. *In re Dentler Family Trust*, 873 A.2d 738 (Pa. Super. Ct. 2005).

WILLS: A photocopy is not a "duplicate original." Under local law, if a will was last in the testator's possession and cannot be found after death, the testator is presumed to have destroyed the will with the intent to revoke it. The statute makes reference to the inability to find the will or a "duplicate original" of the will. In *Lauermann v. Superior Court*, 26 Cal. Rptr. 3d 258 (Cal. Ct. App. 2005), the court held that the term "duplicate original" does not include a photocopy that is not personally signed by the testator.

WILLS: Witness may sign after the testator's death. Under local law, based on UPC § 2–502, the witnesses must sign the will "within a reasonable time" of having witnessed the testator's signing or acknowledgment of the will. In *In re Estate of Jung*, 109 P.3d 97 (Ariz. Ct. App. 2005), the court held that the statute allows a witness to sign a will *after* the testator's death so long as the signature occurs within the prescribed reasonable time.

RULES AND REGULATIONS

ANNUITIES: Amounts received by a beneficiary in excess of the decedent's investment are considered income of the decedent if the owner of a deferred annuity dies before

the starting date. Accordingly, these amounts are includable in the beneficiary's gross income. Rev. Rul. 2005–30.

PROCEDURE: IRS issued guidance on the exhaustion of administrative remedies as a prerequisite to filing in Tax Court for Code § 6166 elections filed on or after May 20, 2005. Rev. Proc. 2005–33.

LITERATURE

Advance Directives. Morgan Morrison provides a client-friendly discussion of medical powers of attorney and living wills in *Ensuring Your End-of-Life Wishes Are Known and Followed*, 68 Tex. B.J. 460 (2005). The article focuses on Texas law and provides a useful checklist.

Advance Directives. In *Till Death Us Do Part?*, 93 Ill. B.J. 226 (2005), Helen W. Gunnarsson explores how the *Schiavo* case would have been resolved if she had been an Illinois resident. Ms. Gunnarsson also discusses the workings of Illinois law in *The Health Care Surrogate Act: A Physician's Finding Must [Be] in Writing*, 93 Ill. B.J. 229 (2005).

Family Limited Partnerships. The use of FLPs as an indiscriminate panacea in estate planning was brought to a halt by the *Strangi* and *Stone* cases. In the wake of these far-reaching decisions, Bradford Updike offers an organized explanation of important legal developments in FLP law in his article, *Making Sense of Family Limited Partnership Law after* Strangi *and* Stone: *A Better Approach to Planning and Litigation Through the Bona Fide Transaction Exception*, 50 S.D. L. Rev. 1 (2005). A further discussion of recent cases on FLPs is found in Wendy Gerzog's column *How Do* D'Ambrosio *and* Wheeler *Fit into the FLP Debate?*, 107 Tax Notes 387 (2005).

Fiduciary Duties. In his article, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 Am. U. L. Rev. 75 (2004), Arthur B. Laby contends that conflict of duty cases, regardless of the type of fiduciary involved, are coherent at their core by tracing the differences between the duty of loyalty and the duty of care and comparing them to Immanuel Kant's discussion of perfect and imperfect duties. Alyssa A. DiRusso and Kathleen M. Sablone discuss various legislative acts and why they are important in the context of current investment practices and laws as well as suggest a broadening of the application of these laws in their article, *Statutory Techniques for Balancing the Financial Interests of Trust Beneficiaries*, 39 U.S.F. L. Rev. 261 (2005). In *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 Yale L.J. 929 (2005), John H. Langbein argues that a transaction prudently undertaken to advance the best interest of the beneficiaries best serves the purpose of the duty of loyalty, even if the trustee also does or might derive some benefit.

Financial Planning. Grayson McCouch and Bill Turnier have authored an innovative law school text entitled *Family Wealth Management* (Thomson West 2005) that is "intended for teachers who wish to offer a basic course in financial investing and planning for law students. The materials range well beyond the conventional estate planning syllabus and cover topics such as housing, higher education, life and disability insurance, and retirement planning."

Flowcharts. Roger W. Andersen and Douglas Oliver offer a detailed proposal for using flowcharts as an effective method for explaining property distribution in their article, *Communicating Clearly: Showing Dispository Preferences with Flowcharts*, 29 Okla. City U. L. Rev. 559 (2004).

Inheritance Rights. R. Brent Drake provides a thorough analysis of the history and current status of nontraditional inheritance rights in Georgia, as well as a suggestion for future legislation, in his note, *Status or Contract? A Comparative Analysis of Inheritance Rights Under Equitable Adoption and Domestic Partnership Doctrines*, 39 Ga. L. Rev. 675 (2005).

Limited Liability Companies. David Berek explores the benefits and disadvantages of LLCs in *Is the Family LLC Still a Good Asset Protection Device?*, 93 Ill. B.J. 256 (2005).

Persona Rights. With advances in technology, facsimiles of celebrities are now being used to tout products even after their deaths. In his article, *Wills, Trusts, Schadenfreude, and the Wild, Wacky Right of Publicity: Exploring the Enforceability of Dead-Hand Restrictions*, 58 Ark. L. Rev. 43 (2005), William A. Drennan examines the balancing test applied in determining the enforceability of dead-hand restrictions that a celebrity might seek to impose on the use of her persona posthumously.

S Corporations. Steven Gorin discusses various estate and tax planning challenges related to S corporations in his article *Transferring Ownership of Stock in an S Corporation*, 61 J. Mo. B. 92 (2005).

Surrogacy Contracts. Nancy Ford provides a comprehensive analysis of *The New Illinois Gestational Surrogacy Act*, 93 Ill. B.J. 240 (2005).

Trust Investment. The effect that the Uniform Prudent Investor Act, as adopted in Oklahoma, has had on the duty of trustees is explored in detail by Mark R. Gillett in *Investing Trust Assets: Prudence Redefined*, 29 Okla. City U. L. Rev. 505 (2004).

Web-based Resources. Tom Mighell provides an overview of web-based estate planning resources, with emphasis on those for Texas practitioners, in *Estate Planning on the Web*, 68 Tex. B.J. 384 (2005).

Will Defects. In her comment, *Equitable Remedies for Nonconforming Wills: New Choices for Probate Courts in*

the United States, 79 Tul. L. Rev. 723 (2005), Leigh A. Shipp outlines the current remedies for defective wills and recommends that courts be allowed to use discretion on a case-by-case basis to determine whether the testator intended the document to be a will.

LEGISLATION

Arizona adopts Uniform Disclaimer of Property Interests Act. 2005 Ariz. Legis. Serv. 195.

Georgia declares the first week of April each year as "Living Will Week." 2005 Ga. Laws Act 307.

Indiana overhauls probate and trust law. Examples of the features of this comprehensive legislation include creation of a procedure for a testator, or anyone else in possession of an original will, to deposit the will with the clerk of the court for safekeeping; enactment of a savings provision for determining the validity of inter vivos trusts executed out-of-state; differentiation between the capacity a settlor must possess to execute a revocable as contrasted with an irrevocable trust; authorization of pet trusts and trusts for specific noncharitable purposes; protection of people who rely on the agent's authority under a power of attorney under specified circumstances; and codification of the court's ability to deviate from the terms of a trust. 2005 Ind. Legis. Serv. P.L. 238–2005.

Iowa expands automatic voiding of gifts on divorce to include relatives of the testator's ex-spouse and codifies the order of abatement. 2005 Iowa Legis. Serv. S.F. 379.

Minnesota modernizes pretermitted heir provisions. 2005 Minn. Sess. Law Serv. 26.

New Mexico enacts total return trust enhancements to Uniform Principal and Income Act. 2005 N.M. Laws 329.

New Mexico enacts Uniform Estate Tax Apportionment Act. 2005 N.M. Laws 143.

South Carolina enacts Uniform Trust Code effective January 1, 2006. 2005 S.C. Laws 66.

Virginia enacts Uniform Trust Code effective July 1, 2006. 2005 Va. Laws 935. ■

RECHARACTERIZATION ISSUES IN SALE-LEASEBACK TRANSACTIONS

BY JOHN C. MURRAY

Sale-leaseback transactions are subject, under certain circumstances, to recharacterization as either equitable mortgages or joint ventures (although to date no final, reported court decision has recharacterized a sale-leaseback transaction as a joint venture). In a sale-leaseback transaction, the seller-lessee may attempt to have the sale and leaseback recharacterized as an equitable mortgage to, among other things, provide it with an opportunity to "redeem" the property at a foreclosure sale. The courts (including bankruptcy courts) have applied a fact-based analysis to determine whether the substance of the transaction is in accord with its form and the expressed intent of the parties. Although the issue of whether a transaction is characterized as a sale or a mortgage depends to a great extent on the expressed intention of the parties, the economic substance of the transaction—and not its label—ultimately will determine whether it is a true sale-leaseback or a financing transaction. This article will examine the various factors considered, and tests used, by state and federal courts when determining whether to recharacterize a sale-leaseback transaction.

Factors Considered by Courts

Unfortunately, the courts are not consistent on the relevance and weight of the factors that determine whether a document designated as a lease will be recharacterized as a mortgage. The factors that the courts consider include

- the intent of the parties at the time of the execution of the documents, as determined by examining the language in the

Andrew O. Alcala

documents and (if there is an ambiguity) by the aid of parol evidence;
- whether there is continued evidence of a debt or liability;
- the relationship of the parties;
- prior unsuccessful attempts to obtain a loan;
- the circumstances surrounding the transaction;
- the sophistication and circumstances of the parties;
- the lack of legal counsel;
- whether the structure of the sale is unusual;
- the adequacy of consideration and whether the purchase price was related to the fair market value of the property;
- how the consideration was paid;
- whether there is written evidence of the debt;
- the belief that the debt remains unpaid;
- whether there is an option or agreement to repurchase;
- the continued exercise of ownership privileges, responsibilities, and/or possession by the seller-lessee, including the obligation to pay property taxes and insurance;
- whether there is a trading of tax benefits for a fixed return; and
- whether the rental payments were calculated to compensate the lessor for the use of the land or in actuality are structured as a return on an investment.

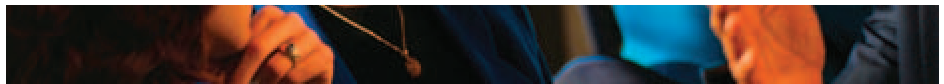
See, e.g., *Robinson v. Builders Supply & Lumber Co.*, 586 N.E.2d 316, 320–21 (Ill. App. Ct. 1992) (setting forth factors, including many of those listed above, considered in determining whether a conveyance should be recharacterized as a mortgage); *In re PCH Associates*, 804 F.2d 193, 200–01 (2d Cir. 1986) (setting forth several of the factors listed above).

Recharacterization is always an uphill battle—the party seeking to recharacterize the transaction is trying to argue that something is not what the parties said it is. Courts are not particularly fond of these cases; they are equitable proceedings and courts generally will hold the party seeking to recharacterize the document or transaction to a high standard of proof. The question of valuation of the property often is crucial. For example, in *U.S. Bank Trust N.A. v. Nielsen Enterprises Md., LLC*, 232 F. Supp. 2d 500 (D. Md. 2002), the plaintiff, a nonsignatory who was attempting to alter the terms of an agreement to which it was not a direct party, sought to have a ground lease transaction (not involving an option) recharacterized as an equitable mortgage. The court refused to recharacterize the transaction, for the following reasons:

> The Landlord has not received a windfall. As discussed previously, the discrepancy between the value of the land conveyed to the Landlord and the Landlord's consideration is too small to be considered unfair or unjust. Also, this was a transaction among sophisticated parties, which reduces the likelihood of surprise or mistake. Like many real estate deals, the transaction at issue has characteristics of both a land sale and a loan. There is ample evidence, however, that the transaction was a true sale to the Landlord and not just a security device. For example, the Landlord granted Nielsen a 98-year term precisely because a 99-year term, under Maryland law, would make the lease redeemable. See Md. Code Ann., Real Prop. § 8–110 (Michie 1996). Moreover, the absence of a right to prepay is evident from a review of the papers. Metropolitan [Bank & Trust Co., the leasehold lender] had full access to the transaction documents prior to the closing and raised no objection. Finally, the Landlord did not cause Metropolitan's financial predicament. Rather, Metropolitan's failure to perform proper due diligence and its haphazard acceptance of income predictions are to blame.

Id. at 529.

The court also stated, in a footnote, that an equitable recharacterization of the mortgage would pose practical difficulties, such as the issue of prepayment penalties.



Recharacterization is always an uphill battle—the party seeking to recharacterize the transaction is trying to argue that something is not what the parties said it is.

> For example, many commercial mortgages have prepayment penalties. To recharacterize the lease and allow the Bank to redeem it without paying a penalty would be to impose upon the Landlord a loan with commercially unreasonable terms. The Bank has not explained how this problem and others like it could be resolved.

Id. at 529 n.7.

The court distinguished the case from a transaction that was originally proposed as a loan but structured as a sale-leaseback. "In the instant case, the parties intended a lease from the beginning. Furthermore, there is nothing illegal about the transaction. . . . In short, there is no

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reason for equity to intervene and recharacterize the lease as a mortgage." Id. at 530.

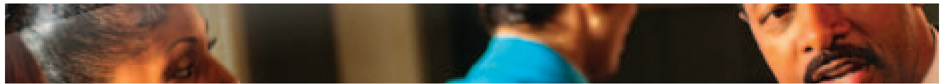
But other courts (especially in connection with bankruptcy proceedings involving the seller-lessee) have found that a purported sale-leaseback should be recharacterized as a mortgage. For example, *In re PCH Associates,* 949 F.2d 585, 603–04 (2d Cir. 1991), the court focused on the substance as opposed to the form of the transaction, which had been characterized by the parties as a sale-leaseback but that actually had all the economic features of a mortgage-financing transaction with the purchaser-lessor bearing few if any of the risks of ownership. The court held that the transaction was not a lease under Bankruptcy Code § 365 and the deed given to the purchaser-lessor was not an absolute deed but was instead an equitable mortgage. See also *In re Big Buck Brewery & Steakhouse, Inc.,* No. 04-56761-SWR, 04-CV-74771, 2005 WL 1320165 (Bankr. E.D. Mich. May 25, 2005) (ruling that property sale and ground-leaseback transaction was disguised financing agreement and not a bona fide lease under Bankruptcy Code § 365 because seller-lessee retained all the risks and rewards associated with ownership of the property and that the parties' intent would be discerned from totality of the circumstances).

Federal Tax Recharacterization

The IRS, when characterizing a transaction for tax purposes, considers the substance of the transaction, rather than its legal form, as controlling. See, e.g., *Helvering v. F&R Lazarus & Co.*, 308 U.S. 252 (1939). Whether a transaction is a sale or a lease for income tax purposes is a question of fact and depends on the intent of the parties as gathered from all the facts and circumstances and whether the benefits and burdens of ownership have passed to the purported purchaser. See *Larsen v. Commissioner,* 89 T.C. 1229, 1267 (1987). See also FSA 199920003, 1999 WL 319513 (May 21,1999) ("Where there is a genuine multi-party transaction with economic substance that is compelled or encouraged by business realities, contains tax-independent considerations, and is not shaped solely by tax avoidance features, the government should honor the allocation of rights and duties effectuated by the parties.").

Bankruptcy Recharacterization

The lessor in a sale-leaseback transaction should be aware that if a bankruptcy petition is filed by or against the seller-lessee after the inception of the lease, the bankruptcy court may under certain circumstances recharacterize the lease as a financing transaction and limit the rights and remedies of the lessor to the value of its collateral as a secured creditor (assuming that the lessor is deemed to have a valid, perfected security interest). Certain provisions of the Bankruptcy Code deal specifically with leasehold interests. Bankruptcy Code § 502(b)(6), which limits the lessor's claim for damages against the debtor-lessee, does not define "lease of real property" as used in that section, but the legislative history makes clear that it applies only to a true or bona fide lease. S. Rep. No. 95–989, at 64 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5850. Bankruptcy Code § 365(a) provides that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." Bankruptcy Code § 365(d)(3) and (d)(4), which delineate the rights of the bankruptcy trustee to assume or reject "any unexpired lease of nonresidential real property," apply only to true or bona fide leases. *In re PCH Associates*, 804 F.2d at 198.



The IRS, when characterizing a transaction for tax purposes, considers the substance of the transaction, rather than its legal form, as controlling.

The focus is on whether the parties intended to impose obligations and confer rights significantly different from those normally found in ordinary lease transactions. See, e.g., *Barneys, Inc. v. Isetan Co.* (*In re Barney's, Inc.*), 206 B.R. 328 (Bankr. S.D.N.Y. 1997). In this case the court held that whether an agreement constitutes a "true lease" for bankruptcy purposes must be determined by reference to federal law and stated that "[t]he appropriate inquiry is whether the parties intended to impose obligations and confer rights significantly different from those arising from the ordinary landlord/tenant relationship." Id. at 332. The court also noted that when the purported "lease" involves rental payments that are actually payments of principal and interest on a real estate loan, there is no "true" or "bona fide" lease, and Bankruptcy Code § 365(d)(3) and (d)(4), as well as Bankruptcy Code § 502(b)(6), do not apply. Id. at 333.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109–8, 119 Stat. 23 (2005), which was enacted into law on April 20, 2005 (and applies to all bankruptcy cases filed on or after October 17, 2005, with limited exceptions for certain provisions) has enacted changes in the law. To assume the lease and the right to continue as lessee, Bankruptcy Code § 365(b)(1), as amended, provides that the debtor-lessee must cure all

existing defaults (other than nonmonetary defaults) under the lease, including delinquent rent, and provide adequate assurance that it will perform its future lease obligations. Bankruptcy Code § 365(d)(3) requires timely performance by the trustee or debtor in possession under the lease until the lease is assumed or rejected. Before the 2005 changes in the Bankruptcy Code, section 365(d)(4) gave a debtor or trustee 60 days to reject or assume an unexpired lease. If the lease was not assumed within that time, it was "deemed rejected" and the property was surrendered to the lessor, thereby terminating all of the lessee's obligations for performance. This time frame was revised under the 2005 amendments to provide that the lease is deemed rejected (requiring surrender) if the lease is not assumed within 120 days after the filing of the bankruptcy petition or by the date of an entry of an order confirming a plan, whichever date occurs first.

Under Bankruptcy Code § 365(g)(1), rejection of a lease in bankruptcy constitutes a breach of the lease. Generally, the rejection gives rise only to a general unsecured claim for damages, which is subject to certain caps under Bankrutpcy Code § 502(b)(6), as discussed further below. 11 U.S.C. § 502(b), (g). Some damages may be recoverable as an administrative priority claim, however, if the trustee or debtor in possession initially assumed the lease but later rejected it. Before the 2005 amendments, a majority of courts had held that the lessor may collect the entire amount due for the assumed-then-rejected lease (including future rent) under Bankruptcy Code § 503(b)(1), which gives administrative priority to "the actual, necessary costs and expenses of preserving the estate . . . ." See, e.g., *Nostas Assocs. v. Costich (In re Klein Sleep Prods.)*, 78 F.3d 18, 26 (2d Cir. 1996) (reasoning that the initial assumption of the lease benefited the estate even though the "benefit turned to dust" when the lease was subsequently rejected). But see *In re Johnston, Inc.*, 164 B.R. 551, 555 (Bankr. E.D. Tex. 1994) (denying administrative priority to a claim for future rent under an assumed lease on the grounds that the estate derived no benefit from the lease once the debtor unconditionally vacated the space). In the 2005 amendments, Congress added a new Bankruptcy Code § 503(b)(7), which makes it clearer that the lessor is entitled to a priority claim for an assumed-then-rejected lease. The new provision limits the collection of future rent, however, to a period of two years following the rejection date or the date of surrender of the premises, whichever is later. Thereafter, the lessor's claim is unsecured (and subject to the Bankruptcy Code § 502(b)(6) caps discussed below).

Bankruptcy Code § 502(b)(6) limits the claim of a lessor for "rejection damages" arising from the termination of a lease of real property to an amount that does not exceed (1) the rent reserved in the lease, without acceleration, for the greater of one year or 15%, not to exceed three years, of the remaining term of the lease following the date the bankruptcy petition was filed or the date the leased property was repossessed or surrendered, plus (2) any unpaid rent due under the lease, without acceleration, on the earlier of such dates. This amount of the lessor's damages, as limited by new Bankruptcy Code § 503(b)(7), is ascertained by reference to the lease agreement and applicable state law. The case law is not consistent on whether the 15% limit on the landlord's damages under Bankruptcy Code § 502(b)(6) is a function of the remaining term of the lease or the amount of rent due. For example, compare *In re Gantos, Inc.,* 176 B.R. 793, 795 (Bankr. W.D. Mich. 1995) (holding that 15% cap refers to remaining rent due under lease), with *Sunbeam Oster Co. v. Lincoln Liberty Avenue, Inc.* (*In re Allegheny Int'l, Inc.*), 145 B.R. 823, 828 (W.D. Pa. 1992) (holding that 15% cap applies to remaining term of lease).

The bankruptcy process treats undersecured creditors differently from secured creditors. Under Bankruptcy Code § 506(a) and (b), an undersecured creditor (a creditor whose debt exceeds the value of the collateral) has two claims against the debtor's estate: (1) a secured claim in an amount equal to the value of the collateral and (2) an unsecured recourse claim for the remainder of the debt. Undersecured creditors have both of these claims under the Bankruptcy Code even if the loan is nonrecourse. If the lease is subsequently recharacterized as a secured financing transaction rather than a true lease, then the lessor-lienholder's claim will be secured as mortgage debt rather than as rent, and the claim can be restructured by the debtor-lessee, with the secured claim of the lessor-lienholder limited to the fair market value of the property. For example, in *In re Wilcox,* 201 B.R. 334, 336–37 (Bankr. N.D.N.Y. 1996), the bankruptcy court held that, because the "Land Contract" agreement between the debtor, as lessee-purchaser, and the lessor-mortgagor, which provided that the debtor was to lease the property for two years and then commence payments on the principal and interest accruing on the purchase price to be paid over the 18-year balance of the contract, was more like a mortgage than a lease, the debtor could "cram down" the claim of the lessor-mortgagor arising from the land contract. See also *United Air Lines, Inc. v. HSC Bank USA (In re UAL Corp.),* 307 B.R. 618, 632–34 (Bankr. N.D. Ill. 2004) ("landlord" under each lease was deemed to have only a secured claim based on a leasehold mortgage).

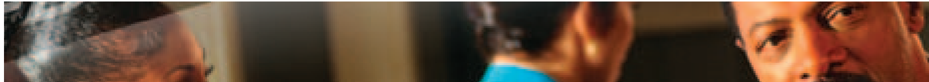
If all of the legal requirements of a reorganization plan are met, with the

exception of a successful confirmation by creditors, the plan may still be confirmed over the objection of a dissenting class. Under Bankruptcy Code § 1129(b)(1), if the plan does not discriminate unfairly and is fair and equitable to the dissenting class, it can be "crammed down" on the impaired class that votes against the plan. In a cramdown, the debtor, in accordance with Bankruptcy Code §§ 506(a) and 1123(a)(5)(F) and (H) may (1) reduce the principal amount of the secured claim to the value of the collateral, (2) reduce the interest rate, (3) extend the maturity date, or (4) alter the repayment schedule. The debtor also may make a minimal payment on the unsecured claim. The general rule of cramdown is that when a plan provides a dissenting secured class with consideration equal to the amount of its claim or when no class below that of the dissenting unsecured class is to participate under the plan, the plan may be confirmed notwithstanding the dissent. See 11 U.S.C. § 1129(b). If, on the other hand, the debtor's plan does not modify the loan terms in any way, Bankruptcy Code § 1124 provides that the creditor will not be an impaired class and, therefore, will not have the right to vote for or against a plan.

In *In re Waldoff's, Inc.*, 132 B.R. 325 (Bankr. S.D. Miss. 1991), the bankruptcy court held that the agreement between the debtor and an equipment financing company, although structured as a lease, was in fact a secured financing agreement. On the filing of a Chapter 11 bankruptcy petition by the lessee, the assignee of the lessor's interest (which argued that the transaction should be characterized as a true lease) was therefore secured only to the extent of the value of the collateral, based on its filing of UCC financing statements, and was an unsecured creditor for the balance of its claim. Id. at 329. The court stated that "whether a transaction qualifies as a security agreement must be determined from the intent of the parties" and found that the evidence presented to the court supported a finding that the agreement was a secured financing agreement. Id. at 328. When deciding how to classify the agreement, the court took into account the lessee's obligation for all repairs and replacements of the equipment and parts, payment of all taxes, insurance, license, registration fees, and other charges, and the fact that the debtor-lessee's accountant treated the transaction as a financing transaction for tax purposes. The court stated that:

> Whether or not an agreement is considered a lease or a security agreement will determine the type of treatment that may be given to the holder of the claim under the Bankruptcy Code. A lease [that was not terminated pre-petition] must be either assumed or rejected as specifically provided under 11 U.S.C. § 365. A creditor's secured claim may be subject to a modified treatment under a plan of reorganization.

Id.



Title insurance insures against defects in title or in the mortgage itself; it does not insure against problems arising from or relating to the underlying debt or the relationship between the insured and other parties to the transaction.

Focusing on the substance of the transaction, not the form, bankruptcy courts will disregard the characterization or label that the parties have used to describe the agreement and the nature of their relationship and often will employ an "economic realities test" to determine whether the transaction should be characterized as a true lease or as a financing transaction. This test requires the court to determine whether "the parties intended to impose obligations and confer rights significantly different from those arising from the ordinary landlord/tenant relationship." *In re PCH Associates,* 804 F.2d at 199–201. In *Steele v. Gebetsberger (In re Fashion Optical, Ltd.),* 653 F.2d 1385 (10th Cir. 1981), the court stated that, under the "economic realities" test, "where the terms of the lease and option to purchase are such that the only sensible course for the lessee at the end of the lease term is to exercise the option and become the owner of the goods, the lease was intended to create a security interest." Id. at 1389 (internal citation and quotations omitted).

The following factors are commonly considered to be relevant in determining whether the agreement constitutes a true lease under the economic realities test:

- whether the amount of rental payments was calculated to compensate the lessor for the use of the land, as opposed to being structured for some other purpose, such as ensuring a particular return on an investment;
- whether the purchase price is related to the fair market value of the property, or is calculated as the amount necessary to finance the transaction;
- whether the property was purchased by the lessor specifically for the lessee's use;
- whether the transaction was structured as a lease to secure certain tax advantages;
- whether the lessee assumed the obligations normally associated with outright ownership of the

property, including the payment of taxes and insurance; and
- whether the agreement permits or requires the lessee to purchase the property at the expiration of the lease term for a nominal consideration. See, e.g., *Barneys, Inc.*, 206 B.R. at 332–33.

Title Insurance for Recharacterization Issues

Will (and should) the title insurance company that is asked to insure a sale-leaseback transaction create a special exception in the title insurance policy as the result of any subsequent recharacterization of the interest of the insured party in the land described in Schedule A? Or is it unnecessary to raise any exception in the first place because the risk of recharacterization is excluded from coverage under the policy exclusions in any event because it is a matter "created, suffered, assumed or agreed to" by the insured, or "[d]efects, liens, encumbrances, adverse claims or other matters . . . attaching to or created subsequent to Date of Policy" (based on the conduct of the parties after the transaction has closed), as set forth in Exclusions 3(a) and 3(d), respectively, of the ALTA Loan Policy (Oct. 17, 1992)?

Title insurance insures against defects in title or in the mortgage itself; it does not insure against problems arising from or relating to the underlying debt or the relationship between the insured and other parties to the transaction. In *Lawyers Title Ins. Corp. v. JDC (America) Corp.*, 52 F.3d 1575 (11th Cir. 1995), the Court of Appeals for the Eleventh Circuit held that the title insurer had no duty to defend a claim that the insured's mortgage was unenforceable because of the insured mortgagee's status as a partner in a joint venture for which the mortgaged property was held in trust, because the exclusion in the mortgagee's title insurance policy for matters "created, suffered, assumed or agreed to" by the insured applied to the claims of the lender and involved actions of the insured in entering into various relationships with the borrower. The court further held that the provision of the policy providing coverage against the "invalidity and unenforceability of the insured mortgage" did not apply because "the provision insures against defects in the mortgage itself, but not against problems arising from or related to the underlying debt." The court noted that "[t]he defenses asserted by [the insured] on behalf of the joint venture . . . all explicitly related to the effect of the parties' relationship on the collectability of the debt underlying the mortgage rather than the validity of the mortgage itself." Id. at 1583. Similarly, in *Ticor Title Ins. Co. of California v. FFCA/IIP 1988 Property Co.*, 898 F. Supp. 633, 640–41 (N.D. Ind. 1995), the federal district court held that, in a sale-leaseback transaction, the seller-lessee's claim that the purchaser-lessor's ownership interest in the property was in fact a mortgage security interest necessarily required proof of the insured party's intent and was therefore not a matter covered by title insurance because of the policy exclusion for matters "created, suffered, assumed or agreed to by the insured claimant."

If the title insurer is aware of the nature of and the facts surrounding a sale-leaseback transaction, is this enough to cause it to be deemed to have provided coverage to the insured under a title policy against the risk of recharacterization unless the title insurer has raised a specific recharacterization exception? It has been suggested that, in connection with recharacterization issues involving sale-leaseback transactions, an investigation by the insurer of the facts surrounding a sale-leaseback transaction may create a sufficient level of knowledge through which the insurer would be deemed to have assumed the obligation to insure or defend against loss from a recharacterization, whether the inquiry was undertaken voluntarily by the insurer or in response to a request by the insured that the policy expressly insure against loss from a sale-leaseback recharacterization. See Thomas C. Homburger & Brian P. Gallagher, *To Pay or Not to Pay: Claiming Damages for Recharacterization of Sale Leaseback Transactions Under Owner's Title Insurance Policies,* 30 Real Prop. Prob. & Tr. J. 443, 488–89 (1995). The title insurer may, therefore, be well advised to disclaim specifically any obligation to indemnify the insured against loss from a sale-leaseback transaction recharacterization. Id. at 489.

Title insurers are justifiably reluctant to issue policies in sale-leaseback transactions without a specific recharacterization exception.

Title insurers are justifiably reluctant to issue policies in sale-leaseback transactions without a specific recharacterization exception. The insured parties in such transactions commonly agree to an exception in the owner's title policy containing language similar to the following:

> Any defect in, or lien or encumbrance on, the title resulting from an allegation or determination that the interest of the insured as evidenced by any or all of the following documents, either jointly or severally, should be or has been recharacterized in any manner.

Or,

RECHARACTERIZATION ENDORSEMENT
ATTACHED TO POLICY NO. ______
ISSUED BY

First American Title Insurance Company

Notwithstanding exception _______ of Schedule B, the Company hereby assures the insured that, in the event of a final determination by a court of competent jurisdiction that the deed dated ___________________and recorded as Instrument No. ________________ and the lease shown as exception____ of Schedule B, create a mortgage as of Date of Policy from the lessee in favor of the lessor under the lease with a priority date as of Date of Policy, the insured shall have (in place of and instead of the rights and obligations under this policy) all of the rights and obligations of an insured under an ALTA Loan Policy (Rev. 10-17-92), insuring said mortgage as a lien against the land as of Date of Policy with an amount of insurance of $_______, subject to no exceptions other than those set forth in Schedule B and any statutory lien or right to a lien for services, labor or material heretofore or hereafter furnished for an improvement or work related to the land.

This endorsement is made a part of said policy and is subject to all of the terms and provisions thereof and of any prior endorsements thereto. Except to the extent expressly stated, it neither modifies any of the terms and provisions of the policy and any prior endorsements, nor does it extend the effective date of the policy and any prior endorsements, nor does it increase the face amount thereof.

First American Title Insurance Company

BY: ____
AUTHORIZED SIGNATORY

FA Special Recharacterization Endorsement (2-2-98)
ALTA Owner's Policy (10-17-92)

> Any assertion or determination that the vesting of title in [the insured] is, or is part of, a loan transaction, including without limitation any assertion or determination that all or any of the following documents, either jointly or severally, constitute a mortgage or other security device(s) or instrument(s).

The purchaser-lessor in a sale-leaseback transaction may request a "recharacterization" endorsement to the owner's policy, which may or may not be available depending on the particular facts of each transaction and applicable legal and regulatory restrictions. The title insurer may, under certain circumstances, be persuaded to issue such an endorsement. The recharacterization tests applied by federal and state courts (including bankruptcy courts), as set forth above, can serve as a useful guideline for title insurers when analyzing the risks of the transaction and evaluating whether and under what circumstances, if any, to issue a recharacterization endorsement and evaluate claim exposure. If the title insurer agrees to issue such an endorsement, it would need to closely investigate and analyze the facts of the transaction and also the underlying documentation. The level of inquiry would depend on factors such as the identity of the parties and the authorization of designated individuals to act on behalf of those parties, the size and scope of the transaction and amount of the policy (or policies) to be issued, and any unusual risks inherent in the transaction. The parties would need to supply the title company with written statements, certifications, and/or affidavits that fully disclose and explain all of the details and risks of the transaction. Written indemnifications in favor of the title insurer may also be required. As mentioned earlier, the recharacterization tests applied by the bankruptcy courts can serve as a useful guideline for title insurers when analyzing the risks of the transaction.

Conclusion

The expressed intention of the parties still is one of the most important (if not the single most important) factor in determining whether a court will recharacterize a sale-leaseback transaction. When the seller-lessee is a sophisticated and experienced real estate developer or investor and is represented by sophisticated legal counsel, and the documents negotiated and drafted by the parties (and their actions and conversations in connection with them) expressly refer to the transaction as a sale-leaseback and make no mention, express or implied, of any other characterization (and in fact specifically disclaim any construction of the transaction as a security agreement or equitable mortgage or any intention to create any relationship between the parties other than as expressly stated), the seller-lessee (or a bankruptcy trustee) likely will face an uphill battle in meeting its burden of proof that the transaction is something other than a sale-leaseback. The parties must document the transaction carefully to avoid recharacterization, and the lease terms (including the rental) should reflect a true market lease and not a disguised financing transaction. Appraisal testimony (including the credibility of the individual appraiser) also can be crucial in determining the value of the property in these types of transactions, which in turn is crucial to the issue of whether the consideration for the transaction is fair and sufficient to prevent recharacterization. ■

Keeping Current
Property

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Keeping Current—Property offers a look at selected recent cases, literature, and legislation. The editors of *Probate & Property* welcome suggestions and contributions from readers.

CASES

CONDOMINIUMS: Association must impose special assessment to pay judgment creditor. The 1994 Northridge earthquake damaged the common areas of a condominium project. The condominium association hired an insurance adjuster, agreeing to pay him 10% of the proceeds received from the association's insurer. After the insurer paid $1.4 million, the association refused to pay the adjuster. The adjuster obtained a judgment, which he sought to collect from the assessments paid by the unit owners to the association. A California statute exempts regular assessments from execution "to the extent necessary for the association to perform essential services." Cal. Civ. Code § 1366(c). The court agreed that all the association's regular assessments were needed for essential services, but it directed the association to impose a special emergency assessment to pay the judgment. The members met, but did not vote for an assessment. The court appointed a receiver for the purpose of imposing the assessment. The appellate court affirmed, interpreting the state's convoluted assessment statute as authorizing the remedy. The result contravenes the general principle that members and shareholders of a corporation are not personally liable for the entity's debts, notwithstanding the court's disavowal that the special assessment "will not transform the homeowners into judgment debtors or otherwise make them personally liable for the debts of the Association." Suppose all or most of the condominium owners refuse to pay the special assessment. Almost certainly, then, the court will authorize the receiver to take enforcement measures, including use of the association's lien powers. Perhaps the real reason for the result is an unspoken sense that the creditor was defrauded when the member assessments are the sole source of association revenue and the members refuse to assess themselves enough to cover the association's debt. *James F. O'Toole Co., Inc. v. Los Angeles Kingsbury Court Owners Ass'n*, 23 Cal. Rptr. 3d 894 (Cal. Ct. App. 2005).

COVENANTS: Covenant in gross excluding church use is enforceable. Mobil Oil Corporation, in settling litigation before a state environmental commission, agreed to a pollution remediation plan for an oil pipeline terminal. Mobil also agreed to impose a restrictive covenant to bar uses that could create environmental risks before selling the property. In 1997, it sold the property subject to a covenant requiring use of the property "for commercial/light industrial purposes only" and specifically prohibiting use "for residential purposes, health-care facilities, daycare facilities, schools, playgrounds." Three years later the buyer resold the property to a church. The church renovated an old industrial warehouse, making it a church sanctuary where it held worship services. It also opened a kitchen, printing press, appliance repair shop, and retail store on the property. Mobil (now ExxonMobil) obtained an injunction prohibiting use of the property for "church services and related fellowship and worship activities." The appellate court affirmed, conclusorily rejecting the church's argument that the covenant, properly interpreted, did not bar church uses. Although the court gave the "brownfield-redevelopment context" as a reason for broadly construing the covenant, it did not ask whether environmental risks for church patrons were as great as those presented for residential users, or akin to those presented for commercial and industrial users. The court rejected the church's second principal argument—that enforcement of the covenant violated

the church's constitutional rights to religious freedom—because the covenant was facially neutral. This holding is consistent with a line of authority excluding churches from residential neighborhoods that have residential-use-only covenants. The church also argued that ExxonMobil lacked standing to enforce the covenant because it did not own land benefited by the covenant. Traditional law, followed up until now by Texas courts, requires that both ends of a covenant touch and concern parcels of land. Benefits in gross are prohibited. The new *Restatement* partially rejects this position. *Restatement (Third) of Property (Servitudes)* §§ 2.6, 8.1 (2000). The church may not have fully developed this argument. The court rejected it summarily, without discussing Texas precedents or the *Restatement*. *Voice of the Cornerstone Church Corp. v. Pizza Property Partners*, 160 S.W.3d 657 (Tex. Ct. App. 2005).

DEEDS: Specifying the grantee's town, county, and state complies with a statutory address requirement. In a foreclosure proceeding, an Idaho court adjudicated the validity of a quitclaim deed made by a successor to the original mortgagor. The deed conveyed a 245-acre tract to Walter and Mary Barton, stating their address as "Carmen, Lemhi County, Idaho." An Idaho statute mandates, "The name of the grantee and his complete mailing address must appear on [the] instrument." Idaho Code § 55–601. The court upheld the deed on the ground that the given address was sufficient to allow the post office to deliver tax notices, sent by the assessor, to the addressee. The court noted that Carmen was sparsely populated. The party attacking the deed also noted that the grantees had divorced before delivery of the deed, and that the husband then had an out-of-state address. The court rejected this claim without analysis. Presumably, whenever a deed has multiple grantees, furnishing the "complete address" of one grantee complies with the statute. *KEB Enterprises, L.P. v. Smedley*, 101 P.3d 690 (Idaho 2004), review denied (Apr. 6, 2005).

EASEMENTS: Brief physical interruptions of use prevent prescriptive easements. In 1975, a homeowner began using a plantation road across a neighbor's tract for access to his home. Seven years later, the neighbor sought to stop the use by setting posts and cables across the road. This triggered a neighborhood feud, which lasted for more than a decade. The owner drove around the obstacles and subsequently destroyed them. The neighbor installed new barriers and complained to the police. The neighbor also plowed the road every year and planted the road with rye for several years. The owner uprooted a couple of small trees and scraped the road with his tractor. The trial court granted the owner a prescriptive easement based on continued and uninterrupted use for twenty years. In a case of first impression for South Carolina, the court reversed, holding that a prescriptive use is interrupted by overt acts of the servient owner that cause a discontinuance of the use, no matter how brief. The court rejected a North Carolina case holding that ineffective interruptions do not prevent the creation of a prescriptive easement. The court grounded its holding on the old acquiescence element of prescriptive easement, which proceeded from the lost grant theory. It quoted a Holmes opinion from 1898, which reasoned that a landowner "is not required to battle successfully for his rights. It is enough if he asserts them [through] an overt act [that] interrupts the would-be dominant owner's impression of acquiescence." *Pittman v. Lowther,* 610 S.E.2d 479 (S.C. 2005).

ESCROWS: No attorney malpractice liability for failure of bank that holds deposit. An elderly widow contracted to sell two Manhattan cooperative apartments. Her attorney, acting as escrow agent, deposited down payments of $1.45 million and $1.28 million in the Connecticut Bank of Commerce, where his firm maintained an Interest on Lawyer Account (IOLA). Before closing, the bank closed, with the FDIC named as receiver. The buyers sued the seller and her attorney for their down payments. In a cross claim, the seller asserted malpractice against her attorney on the ground that he should have deposited the funds in a manner providing for greater protection than the FDIC insurance coverage for $100,000. Reversing the trial court, the appellate court dismissed the malpractice claim, because the attorney did not violate the escrow instructions and did not know that the bank was in danger of closing. The outcome is questionable. The attorney should have advised his client of the risk that small banks are more likely to fail than large banks and that he could take other steps to reduce the risk of loss. Moreover, the attorney's deposit of the funds into a non-interest-bearing IOLA account presents a conflict of interest. *Bazinet v. Kluge,* 788 N.Y.S.2d 77 (N.Y. App. Div. 2005).

LANDLORD-TENANT: Grantee under deed from landlord has right to collect rent notwithstanding lack of express assignment of lease. Three months after entering into a five-year lease, the landlord conveyed the real property by quitclaim deed to a partnership. The tenant subsequently defaulted, and the partnership brought an action for unpaid rent. The tenant's defense was that the grantee lacked the right to collect rent, because the lease was personal property (a chattel real) and was not properly assigned to the grantee. The court rejected the defense, relying in part on a statute providing, "A person to whom any real property is transferred . . . upon which rent has been reserved . . . is entitled to the same remedies for recovery of rent . . . as his grantor . . . might have had." S.D. Codified Laws § 43–8–7. The common law rule is the

same. All jurisdictions appear to reach the same result. When a deed is silent on the treatment of an existing lease, the grantee becomes the new landlord by privity of estate. The grantee is entitled to enforce all real covenants, including the rent covenant. *MHW Ltd. Family Partnership v. Farrokhi*, 693 N.W.2d 66 (S.D. 2005).

PUBLIC HOUSING: Landlord's refusal to rent to tenant with Section 8 voucher does not violate Equal Credit Opportunity Act (ECOA). A federal housing program, known as Section 8, provides subsidies for low-income families to rent dwelling units from private landlords. Federal housing legislation does not require private landlords to participate in the Section 8 program. A Chicago apartment complex, which did not accept Section 8 vouchers, rejected a tenant who tendered a voucher. She sued under the federal ECOA, which prohibits discrimination against credit applicants based on public assistance as the source of the applicant's income. In a case of first impression, the court held that the typical residential lease is not a credit transaction, because it involves a contemporaneous exchange of consideration—monthly rent is paid in advance for the right to occupy premises for the coming month. This decision adopts the position of the Federal Reserve Board, which repudiated an earlier Ninth Circuit case, holding that the ECOA applies to a consumer lease of an automobile. *Laramore v. Ritchie Realty Management Co.*, 397 F.3d 544 (7th Cir. 2005).

REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA): Arbitration clause in promissory note covers RESPA claims. A promissory note secured by a mortgage on Florida real property called for binding arbitration of "[a]ll disputes, claims or controversies arising from or relating to this contract." Husband executed the note, but husband and wife executed the mortgage. The lender's bankruptcy resulted in a transfer of the loan to a new entity, Green Tree. Husband and wife brought a RESPA action for the failure to provide notice of a change in the loan servicer. The district court refused Green Tree's motion to compel arbitration, but the circuit court reversed. The court rejected plaintiffs' argument that their claim was independent of the note, reasoning that there could be no statutory servicer liability if there were no note. It also pointed to a "strong federal policy favoring arbitration" reflected by the Federal Arbitration Act. The court applied the doctrine of equitable estoppel to bind the wife to arbitration. Even though she did not sign the note, her RESPA claims rested on her status as a borrower, and thus she was claiming the benefits of the note. *Blinco v. Green Tree Servicing LLC*, 400 F.3d 1308 (11th Cir. 2005).

SALE CONTRACTS: Representation that lot is buildable survives "no representations" contract clause. During negotiations, the buyer of a vacant lot stated that he wanted to build a seasonal home. The town zoning board had previously denied the seller's application to build a seasonal home on the lot. The seller nevertheless represented that the buyer "could build a house on the property." Immediately after closing, the buyer learned the truth from a town official and stopped payment on his check given for the purchase price. When the seller sued for the price, the buyer counterclaimed for fraud, misrepresentation, abuse of process, and malicious prosecution. Trial resulted in a jury verdict for the buyer, with an award for the buyer's attorney's fees but with no damages on the counterclaims. On appeal, the seller claimed he should have received summary judgment based on a contract clause providing, "Seller makes no representations as to land use law or regulations." The court rejected seller's claim on two grounds. First, the court stated the disclaimer's language was not specific enough to exclude reliance on a representation that the lot was buildable. Second, the court held that no contract language can ever insulate a party from liability for "positive fraud." In some other states, the seller would have prevailed on the ground that it is impossible for a buyer justifiably to rely on the seller's representation when the contract has an express disclaimer. The appellate court remanded for reconsideration of the attorney's fees award. The trial court had awarded attorney's fees based on a finding that the seller acted in bad faith, which was not sufficient by itself. *Van Der Stok v. Van Voorhees*, 866 A.2d 972 (N.H. 2005).

SPECIFIC PERFORMANCE: Buyer may enforce contract despite seller's "time of the essence" notice. A contract of sale required the seller to terminate a tenancy before closing. Unforeseen difficulties ensued. Because the tenant refused to leave, the seller prosecuted litigation, which took over two years. Then the vacant building contained substantial debris. The buyer insisted that the seller remove it, relying on a contract provision requiring that the premises be "broom clean." The seller refused, relying on another contract provision stating the property was being sold "as is." The seller sent the buyer a "time of the essence" closing date, which the buyer ignored. After that date passed, the parties negotiated, agreeing to a new closing date with an escrow to handle debris removal. Before that new date arrived, the seller sold the property to a third party. The original buyer sought specific performance. The appellate court reversed a summary judgment for defendants. Although one party can make "time of the essence" by sending a reasonable notice of a closing date to the other party, the seller's notice was ineffective, because the seller was unwilling to remove the debris. The contract's "broom clean" clause took precedence over the "as is" clause. Moreover, the seller waived its right to insist on a timely closing by subsequently agreeing to a later closing date. The third-party buyer did not qualify as a bona fide purchaser. He had actual knowledge of the prior contract, having earlier inspected the property to bid on doing restoration work for the original

buyer. *Marioni v. 94 Broadway, Inc.*, 866 A.2d 208 (N.J. Super. Ct. App. Div. 2005).

LITERATURE

9/11 Ongoing Thoughts; Commercial Leasing. The destruction of the Twin Towers continues to occupy the minds of property law lawyers and professors. John B. Wood and Alan M. Di Sciullo recently updated their well-crafted and very useful two-volume treatise, *Negotiating and Drafting Office Leases* (Law Journal Press 2005). The revised treatise continues to treat each aspect of the commercial office lease, providing clear explanations, sample provisions, negotiating and fallback positions, and a general statement of reasonable positions that parties might pursue. The authors speak with evident and thorough knowledge of the substantive law. The authors have added new material to the treatise specifically evaluating the commercial office lease in light of 9/11. In particular, the treatise regards insurance needs of landlord and tenant and the effect of the Terrorism Risk Insurance Act (2002). The authors also pay close attention to the requirement of landlords to provide building safety in the aftermath of 9/11. Di Sciullo had his office on the 65th floor of Tower 2 and was on his way to the building when the planes struck. See Alan M. Di Sciullo, *A Personal Perspective*, Prob. & Prop. 16, Sept./Oct. 2002. His preface to the treatise makes it clear that the events of 9/11 raise more than merely legal and negotiating interests for this attorney, as they should for us all.

9/11; Commercial Development. The prior summary reveals that commercial office space can become more than a fungible commodity in the minds of the people who occupy the space. In the words of Alan M. Di Sciullo, "the World Trade Center was as much a home for many of us as our family residences." In her recent article, *Reconstructing the World Trade Center: An Argument for the Applicability of Personhood Theory to Commercial Property Ownership and Use,* 109 Penn. St. L. Rev. 815 (2005), Professor Mary L. Clark explores this relationship, and its implications. Professor Clark first explains the "personhood theory of property" developed by Professor Margaret Jane Radin. Professor Radin argued that certain types of property deserved special protection under the law "in recognition of the roles these classes of things play in our self-constitution and expression." The personhood theory of property suggests that, to some extent, we are what we own. Property that helps define an individual therefore should be entitled to greater legal protection. Professor Radin argued that personal property, such as wedding rings, and real property, such as private residences, fall into this category. As an example, Professor Radin suggested that family homes should be essentially "immune" from eminent domain actions. This theory, although intellectually interesting, has not had a significant effect on eminent domain, so far as Professor Clark can discern. Although Professor Radin apparently found few "personhood" attributes in commercial property, Professor Clark sees this as a significant omission. She points to the landowner's decision, in the face of significant community concern, *not* to develop the "footprint" of the Twin Towers as proof that commercial property has significant aspects of personhood property.

Eminent Domain and Public Use; Taking Ongoing Businesses. Professor Shelley Ross Saxer raises concern that government may be overextending its takings power in *Government Power Unleashed: Using Eminent Domain to Acquire a Public Utility or Other Ongoing Enterprise,* 38 Ind. L. Rev. 55 (2005). Professor Saxer's point of departure is "the City of Corona [California]'s exercise of eminent domain power to acquire Southern Edison in order to provide less expensive rates and more reliable electricity service to residents." As Professor Saxer notes, municipalities are now reacting to the California energy shortages and "the Enron mess" by following the lead of Corona. Although the article focuses on the power of state and local government to employ takings powers to acquire utilities, "an overriding concern remains—what is the limitation on government power after a municipality or state condemns a private business it determines can be run more efficiently as a public function?" The author examines both the narrow and broader issues in light of the "Dormant Commerce Clause, the Commerce Clause, the Tenth Amendment, the Supremacy Clause, antitrust laws, and the Contract Clause." Although the author accepts that there are compelling reasons for employing the Takings Clause to take utilities, Professor Saxer nevertheless worries that this "opens the door to a myriad of condemnation actions converting private free enterprise to municipal ownership." Because the courts have been historically deferential to the condemnation decisions, Professor Saxer argues that this power must be legislatively or constitutionally limited. This article is timely, especially given the recent Michigan Supreme Court decision to overrule *Poletown Neighborhood Council v. Detroit* and the U.S. Supreme Court opinion in *Kelo v. City of New London*, 125 S. Ct. 2655 (2005)(see below).

Eminent Domain and Public Use; *Poletown*. Timothy Sandefur is a staff attorney for the Pacific Legal Foundation and the author of an amicus curiae brief in *County of Wayne v. Hathcock*, 684 N.W.2d 765 (Mich. 2004). In *Hathcock,* which was the subject of article summaries in the July/August installment of "Keeping Current—Property," the Michigan Supreme Court discarded the very broad definition of "public use" adopted in its earlier case of *Poletown Neighborhood Council v. City*

of Detroit, 304 N.W.2d 455 (Mich. 1981). Sandefur's article is titled *A Gleeful Obituary for* Poletown Neighborhood Council v. Detroit, 28 Harv. J. L. & Pub. Pol'y 651 (2005). Sandefur argues that *Poletown* is just one example in a pattern of judicial abuse of the takings power provided by the Constitution. The *Poletown* application of public use permitted the City of Detroit to take property from one set of private parties (neighbors in a blue-collar area of the Motor City) to be redistributed to another private party (General Motors). According to the author, the power of government to redistribute private property on the premise that it will benefit the public creates a "public choice problem." In other words, "it is in the interest of those parties to lobby the government to do so on their behalf." The takings power therefore, arguably, becomes a captive to the financial resources and lobbying prowess of significant individuals or entities with a need to obtain particular real property. Sandefur would like the U.S. Supreme Court to follow the example of the Michigan Court and redraw the limits of public use. According to the author, this would necessitate overruling key aspects of *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984). After publication of the article, however, the U.S. Supreme Court reaffirmed its support of a broad reading of "public use" in *Kelo v. City of New London*, 125 S. Ct. 2655 (2005). The editor (in this case, Professor Bogart) is pleased to note that Sandefur, his former student, has involved himself in property law on a constitutional level and has taken the time to defend his views in legal scholarship.

Materialman's Liens; the Status of the Architect. Steven J. Kuhn looks at the occasionally precarious position of the unpaid architect when the developer abandons the property before construction. In his article, *The Noble Architect, the Heartless Landowner and an Ambiguity in Oregon's Construction Lien Statutes*, 41 Willamette L. Rev. 95 (2005), Kuhn asks whether, under Oregon's statute, the architect is entitled to a construction lien. The Oregon statute provides a lien to architects for work that relates back to the date construction commences on a project (or, presumably, when the property is abandoned in lieu of construction). The statute provides that the lien covers work "intended for use" in development of property. Architects have argued, and some Oregon courts have agreed, that this language should protect the architect if no construction work actually begins. Yet, Oregon courts have been inconsistent in their holdings. Kuhn capably explains the ambiguities inherent in the Oregon statute. Kuhn then looks to similar statutes of other states and examines the application of the rules by courts of these other jurisdictions. This article

will be of interest to attorneys with construction lien questions involving architectural work, regardless of the jurisdiction of that lawyer's practice.

LEGISLATION

Alaska criminalizes the false filing of a Notice of Pendency. A notice of pendency that is filed with "reckless disregard" constitutes the crime of filing a false instrument. 2005 Alaska Sess. Laws 27.

Arizona adopts the Timeshare Owners' Association and Management Act. Regulation of timeshares is separated from planned communities and condominiums. The Act provides a detailed scheme for the development, sale, and operation of timeshares. 2005 Ariz. Sess. Laws 132.

Arizona enacts the Uniform Real Property Electronic Recording Act. Electronic signatures, filing, recording, and storage are authorized by the Act. 2005 Ariz. Sess. Laws 109.

Arizona requires updated maps be maintained by the state land department for public use in determining whether seller disclosure is required relative to property located within noise or clear zone of a military airport. 2005 Ariz. Sess. Laws 153.

Arkansas adopts the Real Estate Lien License Act. Real estate brokers are granted a lien in commercial real estate transactions to aid in the collection of fees. 2005 Ark. Acts 1944.

Arkansas authorizes beneficiary deeds that are effective on the death of the grantor. The deed is revocable until the death of the grantor. A beneficiary deed is a countable asset under Medicaid. 2005 Ark. Acts 1918.

Arkansas enhances the marketability of title of tax deeds. Fifteen years after the tax deed is recorded, the title becomes marketable on meeting the requirements of the Act. 2005 Ark. Acts 2270.

Arkansas regulates reverse mortgages. The Reverse Mortgage Protection Act substantially increases the disclosures required by the lender and the rights of the borrower. 2005 Ark. Acts 2166.

Delaware enacts the Uniform Real Property Electronic Recording Act. Electronic signatures, filing, recording, and storage are authorized by the Act. 75 Del. Laws 23 (2005).

Florida validates mortgage releases executed by a title insurer. In the battle to secure and record releases for mortgage loans, this Act allows a valid mortgage release to be recorded without the signature of the record mortgage holder as long as the record owner affirms that the debt has been paid. The Mortgage Certificate Release is signed by an agent of a title insurer. Although the Act contains stringent requirements to avoid fraud, it seems to open the door to that very problem. 2005 Fla. Laws ch. 122.

Florida adopts the Uniform Disclaimer of Interests Act. 2005 Fla. Laws ch. 108.

Idaho authorizes electronic indexes and storage of documents related to real property transactions. The recorder is no longer required to maintain physical records or indexes. 2005 Idaho Sess. Laws 243.

Iowa enacts the Iowa Cemetery Act that imposes substantial requirements for interment, along with regulation of fees and management. 2005 Iowa Legis. Serv. H.F. 836.

Iowa enacts the Uniform Environmental Covenants Act. Environmental covenants are established as an interest in real property. The covenants arise as a result of environmental remediation or mitigation that imposes activity and use limitations on the property. Such covenants must be recorded and are subject to other requirements. 2005 Iowa Legis. Serv. S.F. 375.

Kansas adopts the Commercial Real Estate Broker Lien Act. Real estate brokers are granted a lien in commercial real estate transactions to aid in the collection of fees. 2005 Kan. Sess. Laws 179.

Maryland enacts the Uniform Environmental Covenants Act. See Iowa, above. 2005 Md. Laws 229.

Maryland expands the protection of homeowners in mortgage foreclosure. 2005 Md. Laws 509.

Montana adopts the "Uniform Commercial Code—Documents of Title." This Act modifies and supercedes the federal Electronic Signatures in Global and National Commerce Act. 2005 Mt. Laws 575.

Nebraska adopts the "Uniform Commercial Code—Documents of Title." See Montana, above. 2005 Neb. Laws 570.

New Mexico adopts the "Uniform Commercial Code—Documents of Title." See Montana, above. 2005 N.M. Laws 144.

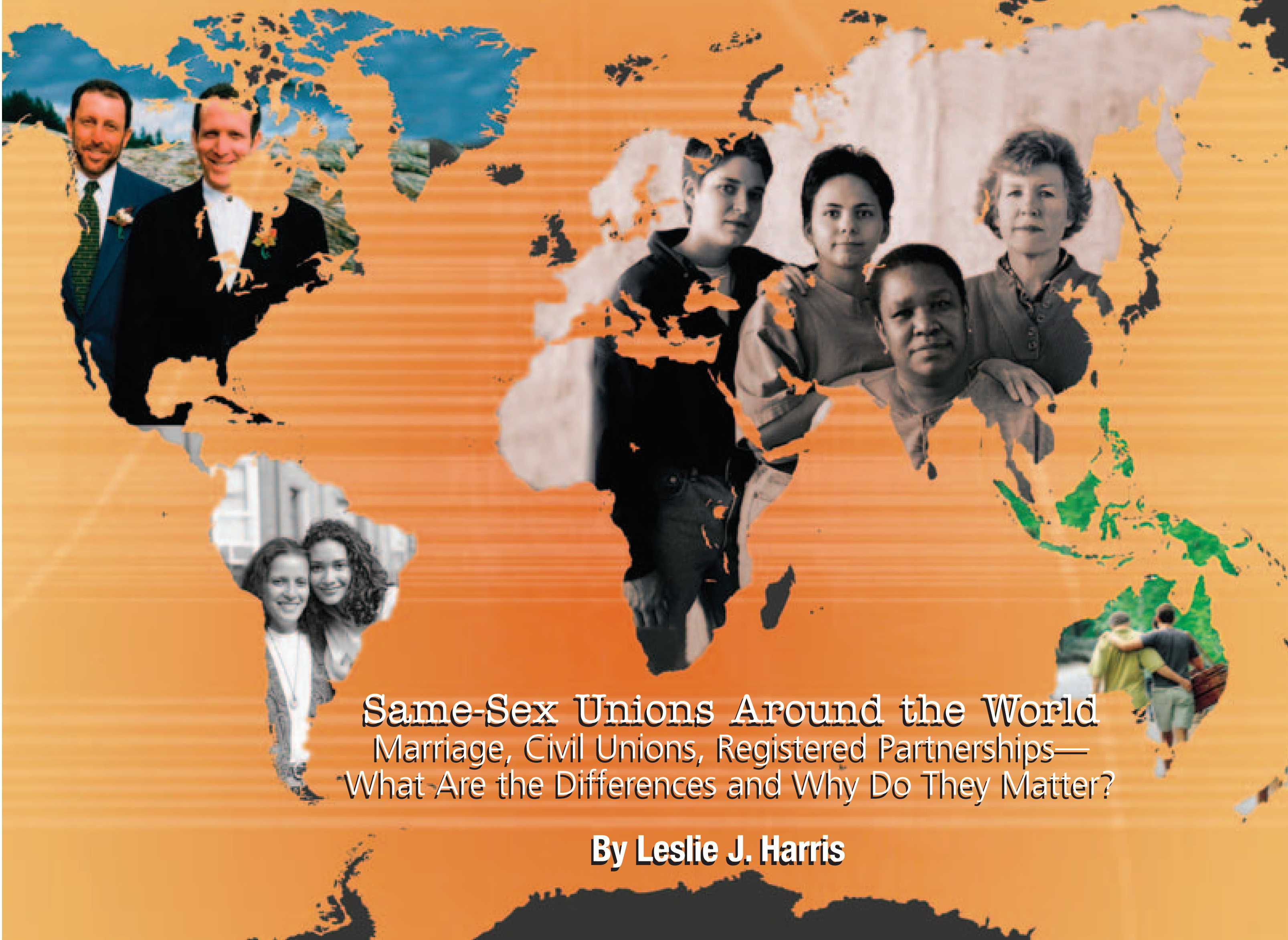
North Dakota limits deficiency judgments in the foreclosure of mortgages secured by agricultural land. 2005 N.D. Laws 302.

Oklahoma adopts the "Uniform Commercial Code—Documents of Title." See Montana, above. 2005 Okla. Sess. Laws 139.

Tennessee enacts the Residential Closing Funds Distribution Act of 2005. Funds are required to be disbursed in accordance with the Act. 2005 Tenn. Pub. Acts 273.

Washington imposes Medicaid liens on life estates. The life estate is valued immediately before the death of the life tenant (decedent). 2005 Wash. Laws 292.

West Virginia enacts the Uniform Environmental Covenants Act. See Iowa, above. 2005 W. Va. Acts 406. ■



Same-Sex Unions Around the World

Marriage, Civil Unions, Registered Partnerships—What Are the Differences and Why Do They Matter?

By Leslie J. Harris

In most states, a survivor has statutory rights in the estate of his or her deceased mate only if the two were married; similarly, only a surviving spouse, not other committed partners, can claim preferential estate and inheritance tax treatment. Because same-sex couples cannot marry in any state except Massachusetts, it seems that these benefits are not available to same-sex partners. But in five states in addition to Massachusetts and in more than a dozen countries, recent legislation extends estate rights to committed same-sex partners. This legislation is part of a worldwide trend toward giving legal recognition and protection to same-sex familial relationships. The legislation varies in three important respects: the extent to which it gives the partners familial rights in their dealings with third parties, the extent to which it gives the partners rights and duties between each other, and the extent to which the legislative scheme is available to opposite-sex as well as same-sex couples. A fourth important variation among jurisdictions is whether adult partners who can legalize their relationships have only one option (marriage or a civil union, for example), or whether they have a choice, such as between marriage and and as a civil union.

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Andrew O. Alcala

Rights and duties vis-à-vis third parties include rights to preferential intrafamilial income and estate tax treatment; family benefits related to the employment of one partner, such as health insurance and family leave; the right to make health-care decisions for incompetent partners; and so on. Familial rights between the parties typically include property rights when the relationship ends because the parties break up or one partner dies and support and property rights during the relationship; they may include rights and duties regarding children.

In the United States, third-party rights and duties have received more attention than have rules regarding the relationship between the partners for two reasons: employment-related benefits, such as health insurance and pensions,

are such an important part of people's financial security, and almost all states allow cohabitants to make some kind of claim against each other when the relationship ends, based on contract or equitable principles. These so-called *Marvin* remedies, named after *Marvin v. Marvin*, 557 P.2d 106 (Cal. 1976), the most well-known early case extending these remedies to unmarried cohabitants, are often available to same-sex couples as well. U.S. courts have also been relatively open to same-sex couples' consensual arrangements to share parenting of children, at least if the nonbiological parent wishes to adopt the child. Most of the states that have addressed the issue of adoption by a same-sex partner have approved it. See, e.g., *Sharon S. v. Superior Court*, 73 P.3d 554 (Cal. 2003), and cases cited therein. In contrast, relatively more emphasis is placed on familial rights between the parties in many countries, especially in Western Europe, where the employment-related benefits are less important because the countries have extensive universal health and retirement programs.

Three of the countries that currently allow same-sex marriage also have comprehensive domestic partnership laws that apply to both same- and opposite-sex couples.

Generally, marriage is the legal arrangement that provides the most complete access to both types of legal protection, and other statutory schemes are usually compared to marriage. Four countries—the Netherlands, Belgium, Spain, and Canada—permit same-sex marriage. The Netherlands was the first country to recognize same-sex marriage. Title 5, Article 30(1), of the Dutch Civil Code was amended in 2000, effective April 1, 2001. Belgium followed suit in 2001. Spain's legislation was enacted in 2005. The Canadian federal government enacted legislation in July 2005 that permits same-sex marriage after courts in most of the provinces held that the Canadian Charter of Rights and Freedoms requires that same-sex couples be allowed to marry and that a statutory domestic partners law that provides almost all the benefits of marriage did not satisfy the Charter. *Halpern v. Canada (A.G.)*, [2003] 215 D.L.R.4th 223, aff'd, [2003] 225 D.L.R.4th 529, is the leading Canadian case. Legislation allowing same-sex marriage is expected to be proposed in South Africa.

Three of the countries that currently allow same-sex marriage also have comprehensive domestic partnership laws that apply to both same- and opposite-sex couples and that provide rights and duties between the parties and vis-à-vis third parties that are similar to marriage. The Netherlands and Belgium have permitted opposite and same-sex couples to enter registered partnerships since 1998 and 2000, respectively. The Canadian Modernization of Benefits and Obligations Act provides that all unmarried couples, opposite- and same-sex, who have lived together for at least one year are entitled to the same benefits and are, for purposes of federal law, under the same obligations as married couples. In these three countries, all otherwise eligible couples, of the same or opposite sex, have a choice between marriage and some form of domestic partnership.

A number of countries have registered partnerships, civil unions, or domestic partnerships. In some countries, including France, New Zealand, and some Australian states, the partnership is open to both same- and opposite-sex couples. Couples who register under the French Pacte Civil de Solidarité (PCS), created in 1999, "obtain most of the rights and obligations traditionally associated with marriage in the fields of social welfare, housing, tax law and property rights, but a few significant distinctions will remain in the areas of inheritance and children, as well as in the event of a possible breakdown of the relationship." Eva Steiner, *The Spirit of the New French Registered Partnership Law—Promoting Autonomy and Pluralism or Weakening Marriage?*, 12 Child & Fam. L.Q. 1 (2000). In December 2004, the New Zealand parliament enacted a civil union law for same-sex couples that gives partners the same rights and duties that married opposite-sex couples have. Legislation in Australian states and territories provides for property distribution at the end of de facto relationships. In the Northern Territories, South Australia, and Tasmania, only heterosexual cohabitants are covered, while statutes in Victoria, Western Australia, the Australian Capital Territory, New South Wales, and Queensland apply to same- and opposite-sex couples. In these countries opposite-sex couples have the same kind of choice of family form that all couples in the Netherlands, Belgium, and Canada do, but same-sex couples are limited to the statutory alternative.

Other countries, including England and Wales, all the Scandinavian countries, and Germany, offer registered partnerships only to same-sex couples, leaving marriage exclusively for and the only option available to opposite-sex couples. In most of these countries, the legal effects of entering into a registered partnership are similar to those of marriage, though a number of them provide that certain aspects of the law of marriage, often pertaining to children, do not apply to the partnership.

In one American state, Massachusetts, same-sex couples, like opposite-sex couples, can marry,

at least for the time being. The Supreme Judicial Court held in *Goodridge v. Department of Public Health*, 798 N.E.2d 941 (Mass. 2003), that denying the benefits of marriage to same-sex couples violates the state constitution and, in *Opinions of the Justices to the Senate*, 802 N.E.2d 565 (Mass. 2004), that civil union statutes do not solve the constitutional problem. Therefore, Massachusetts law does create an intermediate institution such as the domestic partnership or civil union. A constitutional amendment to overturn *Goodridge* and *Opinions of the Justices* has been proposed but cannot be voted on until 2006 at the earliest.

Six states have legislation that provides some of the legal benefits of marriage to same-sex couples. The legislation in one state, Maine, is limited. It permits same-sex couples and opposite-sex couples to register as domestic partners, thereby obtaining intestate succession rights equal to those of a surviving spouse. Other sections of the legislation give domestic partners, even if they have not registered, spouse-like rights in guardianship and other protective proceedings, rights to control the remains of a deceased partner, and spouse-like rights to employment-related health insurance. 2003 Me. Laws 672, codified in scattered sections of the Maine code.

The legislation in the other five states is more comprehensive. In two states, Vermont and Hawaii, the statutes were enacted in response to decisions from the highest state courts that denying same-sex couples the benefits of marriage violates their state constitutions. *Baker v. Vermont*, 744 A.2d 864 (Vt. 1999); *Baehr v. Lewin*, 852 P.2d 44 (Haw. 1993); *Baehr v. Miike*, No. 91–1394, 1996 WL 694235 (Haw. Cir. Ct. Dec. 3, 1996), aff'd, 950 P.2d 1234 (Haw. 1997). Vermont's civil union legislation, which applies only to same-sex couples, provides all of the benefits of marriage that are available under state law. Vt. Stat. Ann. tit. 15, § 1201 et seq. (2000). The most distinctive feature of Hawaii's reciprocal beneficiaries relationship is that it is open to any couple legally ineligible to marry each other, including not only same-sex couples but also, for example, closely related relatives. Hawaii's legislation does not address the parties' relationship to each other but provides limited rights against third parties, including hospital visitation, health-care decision-making, inheritance, and the right to bring wrongful death actions. Haw. H.B. 118 (1997), codified as Haw. Rev. Stat. ch. 572c and in scattered sections of the rest of the code.

The remaining three states, California, New Jersey, and Connecticut, have enacted legislation without the spur of a judicial decision. 2003 Cal. Stat. 421 (A.B. 205), effective Jan. 1, 2005, codified as sections of the California Family Code; New Jersey Domestic Partnership Act, Pub. L. 2003, ch. 246 (2004), codified at N.J. Stat. Ann. § 26:8a-1 et seq.; An Act Concerning Civil Unions, Conn. Pub. Act No. 05-10 (2005) (effective Oct. 1, 2005). The California domestic partnership and the Connecticut civil union are very similar to the Vermont civil union; partners have virtually all the duties and benefits of marriage that the state can bestow. The New Jersey legislation is more limited, providing that the partners are jointly responsible for common living expenses but are not liable for each other's debts and do not automatically have rights in each other's property; it also provides protection against discrimination on the basis of familial status, hospital visitation rights, health-care decision-making rights, and treatment as spouses under state tax law. Only same-sex couples may enter into a civil union under the Connecticut legislation. In contrast, the California and New Jersey laws allow opposite-sex couples in which at least one is older than 62, as well as same-sex couples, to enter into domestic partnerships. These opposite-sex couples are the only ones in the United States who currently have a choice between marriage and another legally recognized familial status.

This brief review highlights the important distinctions among marriage, civil unions, registered or domestic partnerships, and reciprocal beneficiary relationships. Some advocates of same-sex marriage have also argued that in terms of legal consequences marriage is preferable to an alternative form in two additional ways, but in the United States today these differences are not significant. The first distinction pertains to whether a relationship is "portable," that is, whether it will be recognized and given legal effect in jurisdictions other than the one in which the parties entered into it. Generally, marriages valid where entered into are valid everywhere unless recognizing a marriage would offend a strong public policy of the jurisdiction asked to recognize the relationship. *Restatement (Second) of Conflict of Laws* § 283(2) (1971). Most states, however, have enacted statutory or constitutional provisions that deny recognition within that state to same-sex marriages entered into elsewhere. Constitutional challenges to these laws have begun to come before the courts, with mixed results. *Morrison v. Sadler*, 821 N.E.2d 15 (Ind. Ct. App. 2005) (state defense of marriage act does not violate the equal privileges and

In the United States, third-party rights and duties have received more attention than have rules regarding the relationship between the partners.

immunities clause of the state constitution); *Castle v. State of Washington*, No. 04–2–00614–4, 2004 WL 1985215 (Wash. Super. Ct. Sept. 7, 2004) (state defense of marriage act violates the state privileges and immunities clause).

Because registered partnerships, civil unions, and other alternate forms are new and statutory, there is no common law rule regarding interjurisdictional recognition, and the limited case law is, again, mixed. *Rosengarten v. Downes*, 806 A.2d 1066 (Conn. 2002); *Burns v. Burns*, 560 S.E.2d 47 (Ga. Ct. App. 2002) (refusing to recognize Vermont civil unions); *Langan v. St. Vincent's Hospital of New York*, 765 N.Y.S.2d 411 (N.Y. Sup. Ct. 2003) (recognizing civil union). Two states with domestic partnership laws also have statutes recognizing similar relationships from other states, N.J. Stat. Ann. § 26:8A–6; Cal. Fam. Code § 299.2. A Massachusetts case says that civil unions entered into in other states will be recognized there. *Salucco v. Alldredge*, 17 Mass. L. Rep. 498 (Mass. Super. Ct. 2004). Thus, interstate recognition of any kind of same-sex union within the United States is quite limited, at least for the near future.

The second claim in favor of marriage over domestic partnerships or civil unions is that only marriage qualifies people for a host of federal benefits. It is true that federal law treats married couples differently from unmarried couples for many purposes, including income and estate taxes, Social Security, ERISA (pertaining to pension rights), and so on. And it is also true that generally federal law refers to state law to determine whether any couple is validly married. But the federal Defense of Marriage Act (DOMA) provides:

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or wife.

Pub. L. No. 104–199, 110 Stat. 2419 (1996), codified at 1 U.S.C. § 7. Unless Congress repeals the DOMA or it is held unconstitutional, only heterosexual couples can be married for purposes of federal law. The only courts that have heard constitutional challenges to the federal DOMA to date have rejected them. *Wilson v. Ake*, 354 F. Supp. 2d 1298 (M.D. Fla. 2005); *In re Kandu*, 315 B.R. 123 (Bankr. W.D. Wash. 2004).

Thus, the important distinctions among the statutes that have recently been enacted in the United States and in other countries with legal and cultural systems similar to those of the United States concern how closely the relationship approximates marriage, whether the relationship created by statute is open to all couples or only to same-sex pairs, and, related to that issue, whether the jurisdiction's statutes as a whole create alternative legal structures from which couples may choose. What then justifies these distinctions? Preserving marriage as a separate institution is often used as the justification for denying same-sex couples the right to marry in the United States, and this rationale has been accepted in some other countries. For example, registered partnerships under German law are considered not only different from but in some sense inferior to marriage. The German Constitution obliges the state to promote marriage and the family—a provision that is understood to be limited to opposite-sex marriage and as making it inappropriate to place a same-sex relationship on the same level as a "true" marriage. The legislative history of some of the Scandinavian registered partnership laws also indicates that marriage occupies a preferred position.

In contrast, courts in Canada and the Massachusetts Supreme Judicial Court have held that privileging traditional marriage is not a constitutionally sufficient rationale for denying same-sex couples access to marriage while granting it to opposite-sex couples. These opinions recognize that "marriage" is unique because of the social and personal significance attached to the relationship. In *Goodridge*, the Massachusetts court said,

> Civil marriage is at once a deeply personal commitment to another human being and a highly public celebration of the ideals of mutuality, companionship, intimacy, fidelity, and family. . . . Because it fulfils yearnings for security, safe haven, and connection that express our common humanity, civil marriage is an esteemed institution, and the decision whether and whom to marry is among life's momentous acts of self-definition. . . .
>
> Without the right to marry—or more properly, the right to choose to marry—one is excluded from the full range of human experience and denied full protection of the laws for one's "avowed commitment to an intimate and lasting human relationship."

Goodridge, 798 N.E.2d at 954, 957. Explaining its conclusion that a civil union law would not solve the constitutional problem identified in *Goodridge,* the Massachusetts court said,

> Because the proposed law by its express terms forbids same-sex couples entry into civil marriage, it continues to relegate same-sex couples to a different status. The holding in *Goodridge*, by which we are bound, is that group classifications based on unsupportable distinctions, such as that embodied in the proposed bill, are invalid under the Massachusetts Constitution. The history of our nation has demonstrated that separate is seldom, if ever, equal. . . .
>
> The bill's absolute prohibition of the use of the word "marriage" by "spouses" who are the same sex is more than semantic. The dissimilitude between the terms "civil marriage" and "civil union" is not innocuous; it is a considered choice of language that reflects a demonstrable assigning of same-sex, largely homosexual, couples to second-class status. The denomination of this difference by the separate opinion of Justice Sosman (separate opinion) as merely a "squabble over the name to be used" so clearly misses the point that further discussion appears to be useless. . . . If, as the separate opinion posits, the proponents of the bill believe that no message is conveyed by eschewing the word "marriage" and replacing it with "civil union" for same-sex "spouses," we doubt that the attempt to circumvent the court's decision in *Goodridge* would be so purposeful.

Opinions of the Justices to the Senate, 802 N.E.2d at 569, 570. Similarly, in *Halpern v. Canada (A.G.)*, [2003] 215 D.L.R.4th 223, aff'd, [2003] 225 D.L.R.4th 529, the highest Ontario provincial court held that excluding same-sex couples from the fundamental social institution of marriage perpetuates the view that same-sex relationships are less worthy of recognition than opposite-sex relationships, violating the Canadian Charter of Rights and Freedoms.

The European countries that open registered partnerships to opposite- and same-sex couples and that also allow same-sex marriage deliberately create a range of legal alternatives for organizing relationships from which couples may choose. The Law Commission of Canada in a report called *Beyond Conjugality* (2001) (see accompanying box) recommended that Canada take the same path. In the United States local domestic partnership laws that are available to opposite- as well as same-sex couples move toward this approach, but because of the limited authority of local governments they do not have a substantial practical effect. At the statewide level legal recognition of alternatives to marriage is largely limited to case law that provides for rights of unmarried cohabitants between themselves at the end of their relationships. This case law serves the salutary purpose of protecting weaker parties who have not thought to, or who have been unable to, protect their own interests by marrying (when that is possible) or entering into a contract, but its limits are also apparent. First, the case law solutions deal with rights between the parties; very few cases address the relationship of the couple to third parties. Second, because the case law solutions are after-the-fact, they do not facilitate planning and are unpredictable.

A number of countries have registered partnerships, civil unions, or domestic partnerships.

Thus, in most states, cohabitants, including same-sex couples, have no readily accessible way of entering into a legal status that defines and protects their relationship, and all but heterosexual couples older than 62 in California and New Jersey have no choice between marriage and an alternative such as a civil union or domestic partnership. But until the question of whether to recognize same-sex relationships at all has played out more fully in the United States, it seems unlikely that legislatures will turn their attention to the broader question of whether society would be best served by creating a range of family status relationships from which partners can choose. ■

The Law of Same-sex Relationships on the Web

Kavan Peterson, *50-State Rundown on Gay Marriage Laws*, Feb. 9, 2005, available at www.stateline.org/live/ViewPage.action?siteNodeId?136&languageId?1&contentId?15966.

Halpern v. Canada, available at www.ontariocourts.on.ca/decisions/2003/june/halpernC39172.htm.

Law Commission of Canada, *Beyond Conjugality* (2001), available at www.lcc.gc.ca/research_project/cpra-en.asp.

Kees Waaldjik, *Chronological Overview of the Main Legislative Steps in the Process of Legal Recognition of Homosexuality in 36 European Countries*, available at http://athena.leidenuniv.nl/rechten/meijers/index.php3?m?10&c?128, last updated April 2003.

The Civil Partnership Act of 2004 (England and Wales), available at www.womenandequalityunit.gov.uk/lgbt/partnership.htm.

New Zealand civil union legislation, available at www.civilunions.org.nz.

Fourie and Bonthuys v. Minister of Home Affairs, available at wwwserver.law.wits.ac.za/sca/judgment.php?case_id?12942.

RECHARACTERIZATION ISSUES in PARTICIPATING LOANS

By John C. Murray

A "lead" or "agent" bank often will agree with another bank or financial institution, or several banks or financial institutions, to "participate" the loan, that is, to transfer an interest in a portion of the mortgage loan and the underlying debt obligation either before the closing of the loan or after the loan has closed. The lead lender commonly will retain a portion of the loan and be the mortgagee of record, hold the debt instrument (or instruments) in its possession, and be responsible for maintaining and servicing the loan, collecting the debt payments, and enforcing the terms of the loan documents. The lead lender also will be responsible for delivering to each participant its proportionate share of the loan payments that it collects from the borrower and will assume certain disclosure and other obligations to the participants, all as contained in the participation agreement between the lead lender and the participants.

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Relationship Between Co-lenders

The relationship between the lead lender and the participating lender or lenders may involve an underlying loan that is either secured or unsecured. Lenders should be aware

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that the characterization of a participation interest may affect the ability of the lead lender or a participant to deal with the collateral when the loan is in fact secured by an interest in real property.

A loan participation agreement generally is construed as an arm's-length commercial contractual relationship that will be enforced in accordance with its terms. See, e.g., *In re Colocotronis Tanker Securities Litigation,* 449 F. Supp. 828, 833 (S.D.N.Y. 1978) ("[Participation] agreements are arms-length contracts between relatively sophisticated financial institutions and do not establish fiduciary relationships."); *Natwest USA Credit Corp. v. Alco Standard Corp.*, 858 F. Supp. 401, 407–08 (S.D.N.Y. 1994) ("A participation is not a loan. . . . To the contrary, a participation is a contractual arrangement between a lender and a third party whereby the third party, labeled a participant, provides funds to the lender. . . . The participant is not a lender to the borrower and has no contractual relationship with the borrower").

There are several other possible characterizations of the relationship between a lead lender and a participating lender (or lenders), and one or more of the following characterizations may be determined to exist by a court as a result of the contractual or other relationship of the parties:

- A loan of a portion of the loan proceeds by the participant to the lead lender, which is secured by an unperfected transfer of the underlying loan. See *Came Realty LLC v. DeMaio,* 746 N.Y.S.2d 555 (N.Y. Sup. Ct. 2002), which held that "fractional assignments of mortgage" issued to investors did not entitle them to proceeds from foreclosure sale and gave them only an unperfected security interest in the mortgagor's note; the court stated that "[a] guaranteed return of investment, participation that lasts for a shorter period of time than the underlying obligation, different payment arrangements between borrower and lead lender and lead lender and participant, and a discrepancy between the interest rate in the underlying note and the interest rate specified in participation, are the factors indicating an intention to create a loan instead of a mortgage participation plan." Id. at 556 (citations omitted).
- A sale and purchase of an interest in the loan, in which the participant would have acquired an undivided interest in the loan (including the security for the loan).
- A trust relationship between the lead lender and the participant, whereby the lead lender holds title in trust for the participant as a "beneficiary," to the extent of the interest transferred.
- A joint venture, tenancy-in-common, or partnership.
- An agency relationship, whereby the participant is deemed to be the principal and the lead lender an agent of the participant for (at a minimum) collecting payments due under the loan.
- The sale of a security (that is, the participation interest).

See Dennis B. Arnold, *Loan Participations: A Conceptual Overview and Intercreditor Conflicts Among Loan Participants in the Context of Troubled Debt*, American College of Real Estate Lawyers Annual Meeting, Scottsdale, Arizona (April 4–5, 1997), available at www.acrel.org/Public/Publications.

Characterization of Participation Agreements in Bankruptcy

Although bank groups (especially groups involving both foreign and domestic banks) usually execute an agency agreement, the agent or lead lender may not always be acting (or be obligated to act) in the best interests of, or at the direction of, each of the participants. Such agency agreements commonly provide for a majority vote as opposed to a unanimous vote. If the agent votes the claims of the members of the group in a bankruptcy proceeding, a dissenting member conceivably could claim that the voting of its individual claim was impermissible under the Bankruptcy Code and the Bankruptcy Rules. This tactic could result in extensive litigation and possible objection to confirmation of the plan based on the placement of several banks' claims and interests into one class of creditors.

The success of this argument may depend on whether the loan participants are in fact deemed by a bankruptcy court to have discrete claims that may be asserted separately from the claim asserted on behalf of the group by the agent or lead lender. See, e.g., *In re 203 N. LaSalle St. P'ship,* 246 B.R. 325 (Bankr. N.D. Ill. 2000). In this case, the bankruptcy court rejected the bank's requested relief for voting the claim of a subordinated lender in accordance with the subordination agreement between the parties. The court found that 11 U.S.C. § 510(a) (Bankruptcy Code), which provides that a subordination agreement is enforceable in bankruptcy to the same extent it is enforceable under nonbankruptcy law, "does not allow for waiver of voting rights under § 1126(a)." Id. at 331. Bankruptcy Code § 1126(a) provides that "[t]he holder of a claim" may vote to accept or reject a plan under Chapter 11. According to the court, because voting is covered explicitly by Bankruptcy Code § 1126(a), its provisions trump contrary provisions in private pre-petition agreements—much like the Bankruptcy Code does not permit a debtor to contract away its discharge—and "[s]ubordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights." Id. The court further stated that "it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the

Code should not apply." Id. The court also held that Bankruptcy Rule 3018(c) does not allow the secured creditor to vote a subordinated creditor's claim. This rule provides that "the creditor or equity security holder or an authorized agent" must sign an acceptance or rejection of a Chapter 11 plan. The court dismissed the bank's argument that it was an "agent" of the general partner under the written agreement, because in voting the claim it would be acting in its own interests and not the general partner's. The court looked to the substance of the relationship and found that the parties cannot contract in advance for this status consistent with either Bankruptcy Code § 1126(a) or Bankruptcy Rule 3018.

But the bankruptcy court's refusal to enforce the consensual transfer of the subordinate lender's voting rights in *203 N. LaSalle* is problematical and does not appear to be warranted by either the facts of this case or other case law in this area. Unlike pre-petition agreements between the debtor and a secured creditor providing for an automatic lift of the stay or the waiver of other rights by the debtor or the consent to certain actions of the first mortgage lender by the debtor (to not oppose a reorganization plan submitted by the secured creditor, for example), the agreement in *203 N. LaSalle* was voluntarily entered into solely by creditors of the bankruptcy estate, which is to say, the debtor was not a party to the agreement. No public policy is violated in this factual situation, especially because there is no expectation of any recovery for the subordinate lienholder. (In *203 N. LaSalle,* the bank's first-position secured lien was valued at $54.5 million, and the indebtedness owed to the bank by the debtor was $93 million.)

The trading in and assignment of claims among creditors is common and is supported by case law, as well as the Bankruptcy Code and Bankruptcy Rules. Although a bankruptcy court may invalidate a vote that was not made or obtained in good faith, a creditor is not prohibited from assigning or transferring its vote, or right to vote, to another person or entity after a bankruptcy petition has been filed by or against the debtor. Bankruptcy Code § 1126(e) (permitting a court to disqualify the votes of any entity whose acceptance or rejection of a plan was not incurred in good faith). Under the Bankruptcy Rules, the courts are authorized and empowered to resolve disputes and enter appropriate orders in connection with such transfers and assignments. Fed. R. Bankr. P. 3001(e). For the most part, if the transferor does not object, then the transfer is automatically approved without a court order. Bankruptcy Rule 3001(e) is not intended either to encourage or discourage post-petition transfers of claims or to affect any remedies that are otherwise available to a transferor or transferee under nonbankruptcy law, such as the remedy for misrepresentation in connection with the transfer of a claim. In general, purchasing claims is permitted if full and proper disclosure is made and if the purpose of the purchase is not to increase the creditor's recovery at the expense of the other creditors.

The trading in and assignment of claims among creditors is common and is supported by case law, as well as the Bankruptcy Code and Bankruptcy Rules.

Although case law is sparse in this area—probably because most disputes are resolved through voluntary and consensual compromises on the respective positions and recoveries of the parties to prevent costly and time-consuming litigation—other bankruptcy court decisions generally have held that voting rights may be transferred to another creditor as part of an intercreditor or subordination agreement and that such assignments are valid and enforceable as bargained-for contractual rights. In *In re Curtis Center Ltd. Partnership,* 192 B.R. 648, 659–60 (Bankr. E.D. Pa. 1996), the subordinate lienholder had entered into a subordination agreement with language remarkably similar to that contained in the intercreditor agreement executed by the first and second lienholders in *203 N. LaSalle* (providing that the first lienholder was authorized, on behalf of the junior lienholder, to file all claims and proofs for the full outstanding amount of the junior debt and to "prove and vote or consent in any proceedings with respect to [the junior] debt"). The court ruled that the junior lender could not vote on the debtor's plan because of the "plain and unambiguous" language in the subordination agreement, the clear language of Bankruptcy Code § 510(a) for the validity and enforceability of intercreditor agreements, and the inapplicability and irrelevance of the junior lienholder's implied argument that it could ignore the plain language of the subordination agreement because it was to be paid, as part of the debtor's plan, from some "source other than the Debtor." See also *In re Itemlab, Inc.,* 197 F. Supp. 194, 197–98 (E.D.N.Y. 1961) (holding that when senior creditor would not recover full amount of its claim and junior creditor would therefore receive nothing, junior creditor was deemed to have made an equitable assignment of its claim and senior lender was entitled to vote junior lender's claim even though subordination agreement was silent on voting of claims in bankruptcy proceedings); *In re Inter Urban Broadcasting of Cincinnati, Inc.,* Nos. 94-2382, 94-2383, 1994 WL 646176

(E.D. La. Nov. 16, 1994) (approving assignment of vote in subordination agreement); *In re Southland Corp.*, 124 B.R. 211, 225–27 (Bankr. N.D. Tex. 1991) (holding that notwithstanding Bankruptcy Rule 3018, which grants record holders of claims right to vote on Chapter 11 reorganization plans, beneficial owners of securities, not record holders, were actual "holders" of right to vote within meaning of Bankruptcy Code § 1126(b)).

Other courts, however, have refused to enforce provisions in intercreditor or subordination agreements that permitted the senior lender to vote the bankruptcy claim of a junior lender, or have strictly construed the language in such agreements to prevent the senior lender from exercising the junior lender's right to vote. See, e.g., *In re Alda Commercial Corp.*, 300 F. Supp. 294, 296 (S.D.N.Y. 1969) (permitting junior creditors to vote for trustee at first meeting of creditors, before determination of whether some creditors were subordinated for eventual payment); *In re Hart Ski Mfg. Co., Inc.*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980) (stating, in dicta, that regardless of subordination, the subordinate lender retains the right to "to assert and prove its claim" and to "participate in the voting for confirmation or rejection of any plan of reorganization"); *First Nat'l Bank of Hollywood v. American Foam Rubber Corp.*, 530 F.2d 450, 454–56 (2d Cir. 1976) (upholding right of subordinated creditor to discharge an unmatured subordinated indebtedness without consent of senior creditor, and stating that "if the senior creditor would prohibit a discharge because of such remote contingencies, he should so provide in the subordination agreement").

In *In re Sentry Operating Co. of Texas, Inc.*, 264 B.R. 850 (Bankr. S.D. Tex. 2001), the debtors had entered into a $20 million credit facility with two banks for the acquisition and operation of several small-town funeral homes. The banks held liens and security interests against the properties under a credit agreement with the debtors. In addition, certain other bank equity investors had purchased $2 million worth of senior subordinated notes issued by the debtor (Notes). The Notes contained an explicit provision stating that during the continuance of any default in payment of the senior secured indebtedness, the noteholders would subordinate their right to payment until the senior lienholders were paid in full. The Notes also contained a provision that if the borrower-debtors were liquidated, any payment otherwise due to the subordinate lienholders would be paid to reduce the senior indebtedness. The Notes further provided that the noteholders would not vote their claims "in a manner inconsistent with the terms of this Section . . . ." Notwithstanding this express language, the subordinated investors voted against the Chapter 11 bankruptcy plan approved by the senior lienholders. The senior lienholders filed a motion to disqualify the votes of the subordinated investors, alleging that the clear language of the subordination provision in the Notes prohibited them

from voting against the plan so long as the senior indebtedness had not been paid in full. The court acknowledged that subordination agreements are enforceable in a bankruptcy case and that the subordinate noteholders had clearly subordinated their claims.

But the court noted that the proposed plan provided for greater payment to trade creditors (who were placed in their own class and would receive 100% of their claims, as opposed to the subordinate noteholders who were placed in a separate class and would receive 1% of their claims). The court found that the subordination provision in the Notes only provided for subordination to payment of the senior indebtedness, not to a plan that allowed payment of trade debt in preference to payment of the subordinated investors; that is, the subordination provision in the Notes explicitly provided that the claims of the subordinated noteholders were not subordinated to other unsecured claims. Therefore, the court ruled, the subordinated noteholders were "not prohibited from voting against a plan that subordinates them to trade creditors of equal rank." Id. at 858. Because the plan provided for greater payment to trade creditors than to the subordinate investors, the court held that "[t]his violates the [the subordination section] of the Notes. Consequently, a vote against such plan is in accordance with [the subordination section of the Notes], not violative of it." Id. The court acknowledged that the subordinate investors would be prohibited from voting against a plan that provided for payment of all funds to the secured senior lenders or that provided for equal payment to trade creditors and other secured creditors. This case clearly illustrates the importance (as noted earlier in this article) of drafting clear and comprehensive language in subordination agreements to reflect the intent of the parties.

In *In re Okura & Co.*, 249 B.R. 596 (Bankr. S.D.N.Y. 2000), the bankruptcy court held that the participation agreement between the lead or "agent" bank and another lender was a "true loan participation," which did not result in a partial assignment of the lead lender's right to payment from the debtor or otherwise give the participating bank lender any right to payment from the debtor. The court ruled that the participating bank was entitled only to share in the proceeds on the debtor's repayment of the loan and that the participating bank did not have any "claim" against the debtor that would give it "creditor" status in the debtor's Chapter 11 bankruptcy proceeding. The court noted that the participation agreement between the lead lender and the participating bank contained language stating that the lead lender retained the exclusive right to assert a claim against the debtor and that the participating bank would have no interest in the collateral for the loan. According to the court, "One aspect of loan participations that makes them

attractive is the delegation of administrative tasks, like origination costs and servicing responsibilities to a lead lender." Id. at 608 (citations omitted). The court further ruled that the loan participation agreement did not constitute a tenancy in common under New York law, because only the lead lender had entered into the underlying loan agreement with the debtor.

The *Okura* case contains a discussion of the law of participation agreements in general, including the difference between participation agreements (which the court characterized as "true participations"), interbank loans, and syndication agreements. According to the court:

> The most common multiple lending agreement is the loan participation which involves two independent, bilateral relationships: the first between the borrower and the lead bank and the second between the lead bank and the participants. . . . As a general rule, the participants do not have privity of contract with the underlying borrower. . . . In an interbank loan, one bank lends the funds of another bank which, in turn, lends to the borrower. In a syndication agreement, the banks jointly lend money.

Id. (citations omitted). See also *In re Autostyle Plastics, Inc.*, 269 F.3d 726, 737–40 (6th Cir. 2001) (stating that "[t]he facts indicate that the parties intended the transactions to be true participation agreements," and that the participation agreements were valid, legal, and enforceable and gave the lead lender "the sole right to seek legal recourse against the borrower").

Uniform Commercial Code Issues

Effective July 1, 2001, the rules regarding interests in promissory notes under the Uniform Commercial Code (UCC) dramatically changed. This was done in an attempt to accommodate asset securitization; the asset-based commercial-paper market currently holds $708 billion in assets (up from $517 billion in 1999) and is by far the most rapidly growing segment of the U.S. credit markets. See Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 Cardozo L. Rev. 1655, 1656 (2004) ("Securitization is one of the most significant legal and business innovations of the last 30 years. Securitization transforms receivables . . . into securities that can be sold in capital markets. As of the end of 2002, there were more than 6 trillion dollars of outstanding securities issued in securitizations. Securitization has been the fastest growing form of capital formation . . . .").

Former Article 9 of the UCC classified a promissory note as an instrument, and the sale of an instrument was outside the scope of Article 9. In 2001, revised Article 9 ("Revised Article 9") of the UCC was enacted into law in every state. Revised Article 9 expressly includes the sale of promissory notes within its scope. See UCC § 9–109(a)(3). (Further references to specific UCC sections will be to Revised Article 9, unless otherwise indicated.) But there are some limitations:

- sales of promissory notes as part of the business from which they arose,
- assignments of promissory notes for collection only, and
- assignments of promissory notes to an assignee in satisfaction of indebtedness.

Id. § 9–109(d)(4), (5), (7). These exclusions typically do not affect securitization transactions.

Section 9–109(b) of Revised Article 9 provides (as did former Article 9) that "[t]he application of this article to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this article does not apply." But Comment 7 to this section makes clear the views of the drafters that a recorded assignment of a mortgage has no bearing on whether a security interest in the mortgage is created or perfected and that any cases to the contrary are overruled. According to Comment 7,

> an attempt to obtain or perfect a security interest in a secured obligation by complying with non-Article 9 law, as by an assignment of record of a real-property mortgage, would be ineffective. . . . [O]ne cannot obtain a security interest in a lien, such as a mortgage on real property, that is not also coupled with an equally effective security interest in the secured obligation.

A buyer of an interest in a promissory note should enjoy automatic perfection under Revised Article 9 but should also file a UCC-1 Financing Statement in case the seller-originator's bankruptcy trustee subsequently alleges that the transaction was really a loan and not a sale. Methods of perfection can create problems for the escrow holder and the borrower-debtor. The method of perfection of a security interest in a promissory note depends on whether the transaction involves a "sale" of that type of property or a "loan" secured by that type of property. To perfect an interest in the note, the buyer-lender should, if the interest is a

- "*Loan secured by interest in promissory note*": Perfect by possession or filing. See UCC §§ 9–312(a) and 9–313(a). Because possession of the note is not always practical, in many instances filing of a UCC-1 may be the only way to perfect. A bona fide purchaser, however,

who takes possession in good faith and without knowledge, will achieve priority over a security interest that was perfected by filing. See UCC § 9–312 cmt. 2 and UCC § 9–330(d). This represents a significant change from former Article 9–304, which provided that taking possession of the instrument was the only method of achieving long–term perfection. See UCC § 9–312 cmt. 2.

- *"True sale" of an interest in a promissory note*: Be aware that neither filing nor possession is necessary or effective to perfect the security interest. Perfection is *automatic* on attachment if the "security interest" results from the sale of the promissory note. See UCC § 9–309(4). Once perfected, the security interest takes priority over the interest of a subsequent lien creditor and the originator-debtor's bankruptcy trustee. See UCC § 9–317(a)(2); 11 U.S.C. § 544(a)(1).

In addition, to accommodate the practice of warehouse lending, Revised Article 9 provides that a secured party does not relinquish possession of the mortgage if a mortgage warehouse lender delivers the original note to prospective purchasers. It need only instruct the third party that it is to hold for the benefit of the secured party and to redeliver the collateral to the secured party. See UCC § 9–313(h) cmt. 9.

Because perfection can be done without filing, and possession of the instrument is not determinative of ownership, and because UCC § 9–203(g) provides that the mortgage follows the note, the original maker of the note and an escrow holder cannot rely on the public records to determine who owns the note and who can sign a reconveyance or release of the mortgage. Revised Article 9 neither protects the original maker nor provides advice on how to determine whom to pay. Although UCC § 9–308(e) provides that perfection of a security interest in a promissory note also perfects a security interest in a supporting mortgage, Comment 6 to this section states that attachment and perfection of a security interest in a secured right to payment do not of themselves affect the obligation to pay, nor do they determine who has the power to release or reconvey a mortgage (instead "that issue is determined by real-property law").

Comment 7 to UCC § 9–109 of Revised Article 9 states that any attempt to obtain or perfect a security interest in a mortgage by complying with non–Article 9 law (such as recording an assignment of the mortgage or a collateral assignment of the beneficial interest) would be ineffective. (This comment also states that one cannot obtain a security interest in a mortgage that is not also coupled with an equally effective security interest in the secured obligation.) Purchasers of interests in promissory notes and the underlying debtors must rely on representations and the financial stability of originators-sellers to determine who really owns the interest. See UCC § 9–308 cmt. 6.

Some commentators, viewing this phenomenon from the maker-account debtor's perspective, refer to this set of facts as an "invisible lender scenario" because the debtor under the mortgage-secured note will not be able to ascertain what has occurred through examination of the public records (including who has the right to execute a reconveyance or release of the mortgage).

If the maker of the note cannot determine whom to pay, and recording of a collateral assignment of the beneficial interest is ineffective and not indicative of ownership, failure to rely on the public records by the escrow holder should not be the basis of a cause of action for breach of fiduciary duty. Reliance on the public records would be foolhardy and may even be actionable negligence.

As noted above, an absolute assignment of a promissory note carries with it the securing mortgage without the requirement of physical delivery of either the note or mortgage. Under UCC § 9–309, a security interest in a sale of a promissory note is perfected when it attaches. Attachment of a security interest in a promissory note (which automatically includes the attachment of a security interest in the securing mortgage) requires either a security agreement authenticated by the debtor or possession of the collateral by the secured party under an agreement. See UCC §§ 9–309(4) and 9–203. Under the "principal/incident" view of the note/mortgage relationship, UCC §§ 9–203(g) and 9–308(e) provide that attachment of a security interest in a promissory note is also attachment of a security interest in a securing mortgage, and the perfection of a security interest in a promissory note is also perfection of a security interest in a securing mortgage.

It should be noted that Revised Article 9 ostensibly makes it easier for a secured party with a security interest in a promissory note to foreclose a mortgage securing the note. After the debtor-mortgagee's default, the secured party may exercise the debtor-mortgagee's rights in any property that secures the debtor-mortgagee's obligations. See UCC § 9–607(a)(3).

Effective July 1, 2001, the rules regarding interests in promissory notes under the Uniform Commercial Code dramatically changed.

The secured party does not have to foreclose on the promissory note to foreclose on the mortgage. Of course, the secured party cannot foreclose or exercise the debtor-mortgagee's foreclosure or other remedies unless the debtor-mortgagee is entitled to do so under the mortgage. This raises the possibility that, although the debtor-mortgagee may not be in default under its obligation to the secured party, the obligor-mortgagor is in default under its note to the debtor-mortgagee. If the debtor-mortgagee is not in default, the secured party cannot foreclose on the mortgage. (The agreement between the debtor-mortgagee and the secured party should address this situation.)

Title insurers may have some concerns about these particular revisions to Article 9. For the secured party to have insurable title following a foreclosure, the secured party will need to have a good chain of title to the mortgage. (In some states, a secured party cannot foreclose unless it has a recorded chain of title.) This is why the secured party usually will require that an assignment of the mortgage from the debtor-mortgagee to the secured party be properly recorded in the applicable land records at the time of the grant of the security interest in the note to the secured party. If this has not occurred, the debtor-mortgagee may subsequently be unwilling to cooperate in the secured party's request for an assignment to assist the secured party (especially if the debtor-mortgagee is in default under the security agreement or other loan documents).

Section 9–607(b) of Revised Article 9 provides a way for the secured party to document its interest in the mortgage in the land records without the debtor-mortgagee's involvement. Under this section, the secured party is authorized to file in the land records a copy of the security agreement and a sworn affidavit that states that a default has occurred and that the secured party is entitled to foreclose nonjudicially. Commentators W. Rodney Clement Jr. and Baxter Dunaway, however, have noted some problems with this procedure:

Title insurers may have some concerns about these particular revisions to Article 9.

- A conflict may arise with state laws that require an acknowledgment or other conditions to recording a document in the land records (which are usually not found in a security agreement);
- Neither Revised Article 9 nor the Official Comments provide that a memorandum of the security agreement (as opposed to the entire agreement) is sufficient for recording, and there is uncertainty about whether other loan documents referenced in the security agreement must also be recorded (most debtor-mortgagees would not want the entire document recorded); and
- A filed security agreement will (as noted above) establish a chain of title only if the debtor named in the security agreement is in fact the mortgagee in the mortgage and the secured party named in the security agreement is the secured party that proposes to foreclose. If there have been further assignments of the note, these further assignments also would have to be documented. See UCC § 9–619 (explaining the transfer statement). As one commentator recently stated: "Title insurance companies presumably will develop underwriting guidelines for determining when a foreclosure by a secured party that has established its chain of title by filing its security agreement is enforceable."

See W. Rodney Clement Jr. & Baxter Dunaway, *Revised Article 9 and Real Property*, 36 Real Prop. Prob. & Tr. J. 511, 570–71, n.275 (2001). This procedure does not appear to be available in those states that do not permit nonjudicial foreclosure proceedings.

Section 9–109(d)(11) of Revised Article 9 continues to exclude from its coverage "the creation or transfer of an interest in or lien on real property," with certain limited exceptions. This language, but for the exceptions (which do not affect this analysis), is identical to former Article 9. This language is not entirely accurate, however, because, as noted above, Revised Article 9 *does* provide for transfers of mortgages (which clearly are "liens on real property").

If there was intent to transfer a promissory note when an assignment of mortgage was executed, the plaintiff-lender should prevail. See UCC § 3–110(a) ("The person to whom an instrument is initially payable is determined by the intent of the person, whether or not authorized, signing as, or in the name or behalf of, the issuer of the instrument."). Revised Article 9 and Article 3 of the UCC (Negotiable Instruments) allow enforcement when the note has been lost, before or after the transfer to an assignee, or is simply unavailable. See UCC § 3–301(iii) (stating that a "[p]erson entitled to enforce an instrument" includes "a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3–309 or 3–418(d). A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument"). UCC § 3–309(a) provides that a person not in possession of an instrument is nonetheless entitled to enforce it if the

instrument was destroyed, was lost, or is in the wrongful possession of an unknown person. Under UCC § 3–309(b), however, the person seeking enforcement, if not the holder of the note, must prove the terms of the instrument and the person's right to enforcement and also must provide "adequate protection" (by "any reasonable means") to the debtor-borrower to prevent the debtor-borrower from paying the same debt twice. If there was no intent to transfer, and the assignee of the mortgage was simply a "servicer"-agent for the holder of the note (which is common in connection with securitized loan transactions), general agency law may still protect the lender. See also UCC § 3–110(c)(2)(ii) (providing that if an instrument is payable to "a person described as agent or similar representative of a named or identified person, the instrument is payable to the represented person, the representative, or a successor of the representative").

In a decision by the South Carolina Court of Appeals, the court dealt with an issue involving the interplay between Article 3 and Article 9. *Swindler v. Swindler*, 584 S.E.2d 438 (S.C. Ct. App. 2003). Although acknowledging that the UCC excludes from its application the creation or transfer of an interest in or lien on real estate, the court held that Article 3 clearly applies to negotiable instruments and that the negotiability of a note is not altered by the execution of a related real estate mortgage. The court noted that Article 3 does not distinguish an unsecured note from a note secured by a real estate mortgage and that Article 9 does not exclude a note secured by a real estate mortgage from the application of Article 3. According to the court, "nothing in Article 9 provides a limitation on the applicability of Article 3 to notes secured by mortgages on real estate." Id. at 252. The court stated further that "Article 9 controls over Article 3 only where some conflict between the applicable provisions of Articles 3 and 9 exists. Here, no conflict exists because Article 9 does not address the underlying indebtedness of a security interest." Id. See also *Broward Title Co. v. Matrix Capital Bank (In re AppOnline, Inc.)*, 321 B.R. 614, 623–25 (E.D.N.Y. 2003), rehearing denied, 2004 U.S. Dist. LEXIS 27069 (E.D.N.Y. Mar. 16, 2004). In the *AppOnline* case, the federal district court held that the mortgage notes were negotiable instruments under UCC Article 3 because they contained an unconditional promise to pay a sum certain, and references in the notes to the mortgages were solely to provide the creditors with additional security. The court reasoned that Article 9 did not apply in the case because Article 9 applies only when a mortgagee pledges a note or mortgage to secure his own obligation to another party; in this case, the notes were assigned to creditors as part of a purchase agreement (and not to secure any obligation). Therefore, according to the court, because the creditors, as assignees, had possession of the notes and took them in good faith and without notice of any claims, they were holders in due course and took the mortgages free of all claims and defenses available against the notes.

To summarize, under the UCC possession is not an indication of ownership of the note; recording of collateral assignments is not required under Revised Article 9; enforcement of the debt without the note is allowable under Article 3; and equitable arguments are available to prevent a borrower from benefiting from the industry's inability to keep track of its documents.

Conclusion

As highlighted in this article, many practical and legal issues arise in connection with participating loans, including the nature and scope of the relationship between the lead lender and co-lenders, the form and substance of the documentation entered into by the parties, the risk of recharacterization of the relationship between the parties (especially if a bankruptcy petition is filed by or against the borrower), and the exercise of remedies (including UCC remedies). Counsel for the lead lender and each of the loan participants must address and resolve each of these issues before entering into the transaction. For an analysis and discussion of the nature of the relationship between a lead lender and its participant or participants, the law on the characterization of such a relationship, and the rights and obligations of the respective parties (all of which are beyond the scope of this article), see generally Richard D. Jones, *Loan Participations, Syndications and Co-Lending,* Finance Topics, American College of Real Estate Lawyers Annual Meeting (Apr. 4–5, 1997), available at www.acrel.org/Public/Publications; Dennis B. Arnold, *Loan Participations: A Conceptual Overview and Intercreditor Conflicts Among Loan Participants in the Context of Troubled Debt,* American College of Real Estate Lawyers Annual Meeting (Apr. 4–5 1997), available at www.acrel.org/Public/Publications; Lester Bliwise, Norman Gutmacher & Edward A. Peterson, *The Relationship Amongst Co-Lenders—Identifying the Different Policies and Approaches of Co-Lenders Before a Deal Goes Bad,* American College of Real Estate Lawyers Annual Meeting (Apr. 4–5, 1997), available at www.acrel.org/Public/Publications; Kenneth A. Rogers, *Lender Liability Concerns in Participation Agreements,* in Commercial Real Estate Finance: A Current Guide to Representing Borrowers and Lenders (Sidney A. Keyles ed., ABA 1993), at 393; James E. Lilly, *Loan Participation from the Participant's Perspective,* in Commercial Real Estate Finance: A Current Guide to Representing Borrowers and Lenders (Sidney A. Keyles ed., ABA 1993), at 409; Eric M. Schiller, Scot A. Lindquist & Christopher Q. King, *Current Issues in Loan Participation and Co-Lending Agreements,* Real Property Programs, Third Annual Spring CLE and Committee Meeting, American Bar Association, Section of Real Property, Probate and Trust Law (May 7–9, 1992), at F-3, available at www.abanet.org/rppt/meetings_cle/1992/home.html; and Billie J. Ellis Jr. et al., *"Easy Street" or "Risky Business?"—Why Loan Participants Can't Afford to Be Passive Investors,* SC78 ALI-ABA 547, 550 (1998). ■

Surviving the Internal Revenue Code's Partnership Distribution Rules

By Bruce J. Belman

> The distressingly complex and confusing nature of the provisions of Subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field.
>
> *Foxman v. Commissioner,* 41 T.C. 535, 551 n.9 (1964).

Business entities taxed as partnerships have become much more popular since the advent of the limited liability company and the promulgation of the "check-the-box" regulations. Also, family limited partnerships have served as a popular estate planning tool over the last decade by providing taxpayers valuation discounts, creditor protection, ownership continuity, and family wealth management opportunities. At inception, many business owners or families do not consider the tax traps waiting for them when the inevitable occurs: the day when members or partners want to withdraw from the entity and take a portion of the business's assets with them. When this happens, avoiding tax can be surprisingly complex, and the entire transaction requires careful analysis.

Most estate advisors know that partnership contributions and distributions usually occur tax-free. Code § 731 generally allows a current or liquidating distribution to a partner to be tax-free unless it receives money that exceeds the tax basis of its partnership interest. Money, as discussed below, may sometimes include marketable securities. If the distribution consists solely of property other than money, the partner will not recognize taxable income. See Code § 731(a)(1) and (c)(1).

The key difference between a current and a liquidating property distribution is the partner's tax basis in the asset or assets received. In a current distribution, an asset has the same basis as it had in the hands of the partnership. In a liquidating distribution, the asset has a basis equal to the partner's basis in his or her partnership interest less any money received plus any income recognized under Code § 731.

Thus, generally, only money distributions can create gain or loss. Property distributions result in no immediate income or loss. Any inherent gain or loss will be recognized on subsequent sale of the property by the recipient partner. But several complex rules, popularly known as the mixing bowl rules, need to be navigated when making property distributions. Each of them may require a partner to recognize taxable income, even in a family context. This article will attempt to explain the intricate and arcane workings of three of those rules:

- A property distribution to one partner can create taxable income for another partner who contributed the property. See Code § 704(c)(1)(B).
- A distribution of marketable securities can create taxable income for the partner who receives the securities. See Code § 731(c).
- A distribution of property can create taxable income for a distributee partner if the partner previously contributed other property. See Code § 737.

Applicable Internal Revenue Code Provisions

Code § 704(c)(1)(B)

Code § 704(c)(1)(A) requires a partnership to allocate income and deductions for contributed property among the partners to take into account the value/basis difference of the property on contribution in a manner that assures the contributing partner will ultimately realize the economic gain or loss attributable to that difference. This difference is known as net precontribution gain or loss. Code § 704(c)(1)(B) was enacted in 1989 to keep partners from avoiding their Code § 704(c) gain or loss by having the partnership distribute its contributed property to another partner within seven years of its initial contribution. Originally, the tainted period was five years, but it was changed to seven years by the Taxpayer Relief Act of 1997 for all property contributed after June 8, 1997. Under Code § 704(c)(1)(B), if Code § 704(c) property is distributed to any partner other than a contributing partner within seven years of the original contribution, the contributing partner must recognize gain or loss in the amount and character that it would have been allocated under Code § 704(c)(1)(A) had the property been sold to the recipient partner at its fair market value on the date of the distribution. Waiting longer than seven years to distribute the property will avoid this result.

When a partner transfers its interest, the recipient of the interest inherits the tax attributes associated with the interest, including the Code § 704(c) taint. In other words, the transferee partner "steps into the shoes" of the transferring partner. On receipt of the partnership interest, the transferee partner becomes the contributing partner for its percentage interest in any Code § 704(c) property that includes the seven-year distribution rule under Code § 704(c)(1)(B). See Treas. Reg. § 1.704–4(d)(2). As will be seen, this rule can come into play in the FLP context.

Code § 731(c)

In 1994, Congress recognized that marketable securities are the virtual equivalent of cash and enacted Code § 731 to treat distributions to a partner of more than his or her fair share of marketable securities as cash. Thus, for distributions after December 8, 1994, all or some part of marketable securities may be treated the same as a money distribution. This can hap-

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pen in only two circumstances: (1) when determining whether money distributed exceeds basis under Code § 731(a) and (2) when the distribution of marketable securities also results in the application of Code § 737, which is discussed below. As Code § 731(c) applies before Code § 737, any portion of marketable securities that is treated as money under Code § 731(c) is ignored in applying Code § 737. See Treas. Reg. § 1.731–2(g). This may actually have a positive effect. First, it reduces the property portion under Code § 737 and thus the Code § 737 gain potential, and, second, the amount of deemed cash received because of Code § 731(c) may not be enough to exceed the receiving partner's basis in his or her partnership interest resulting in no gain recognition.

There are three exceptions to the rule that marketable securities are treated as money. First, marketable securities are not considered "money" if the partner who contributed the securities gets them back in a distribution. But unlike Code § 704(c), transferees of partnership interests are not treated as the partner who contributed the securities. In other words, there is no "step into the shoes" rule. Second, marketable securities are not treated like money if the property was not a marketable security when acquired by the partnership and the entity to which the security relates had no marketable securities on that date, the security was held by the partnership for at least six months before it became marketable, and the security was distributed within five years of the date on which it became marketable. See Treas. Reg. § 1.731–2(d). And, third, marketable securities are not treated like money when distributed by an "investment partnership" to an "eligible partner." Simply put, this final exception refers to partners who never contributed anything other than cash or investment assets to partnerships that have never engaged in a trade or business and have always held only investment assets. See Treas. Reg. § 1.731–2(e).

Under Code § 731(c), a partner may exclude marketable securities from the "money" he or she receives to the extent the securities represent his or her share of the unrealized gain or loss in the partnership's marketable securities. To calculate the exclusion, first determine the partner's share of the partnership's unrealized gain in all of its marketable securities before any are distributed to the partners. Second, determine the partners' share of the unrealized gain in the partnership's remaining marketable securities after the distribution to such partners. Any distribution to other partners is ignored when performing this calculation. Finally, subtract the result of the second step from the result in step one. Partners may exclude this difference from the amount of "money" they are deemed to have received.

The regulations provide a clear example:

Example: Able and Baker form a partnership AB as equal partners. AB holds securities X, Y, and Z worth $100 each. The basis of these securities is $70, $80, and $110 respectively. In order to avoid recognizing a $30 gain on the sale of X, the partnership distributes it to Able. Able's share of the gain before the distribution is $20 and his share of the gain after the distribution is $5. Thus, Able may reduce the portion of Security X that is treated like cash by the $15 difference. So, only $85 of Security X is treated like cash. The balance is treated like property.

Security	Value	Basis	Gain/ (Loss)	Able's 50% Share
With X:				
X	100	70	30	
Y	100	80	20	
Z	100	110	(10)	
Subtotal	300	260	40	20
Without X:				
Y	100	80	20	
Z	100	110	(10)	
Subtotal	200	190	10	5
Difference				15

Treas. Reg. § 1.731–2(j), ex. (2).

Code § 737

Code § 737 was enacted in 1992 and may also trigger gain (but not loss) to a contributing partner if, within seven years of contribution, the contributing partner receives a distribution of property other than the property it contributed. The partner is required to recognize gain equal to the lesser of (1) the excess distribution (the excess of the distributed property's value over the partner's outside basis) or (2) the partner's net precontribution gain or precontribution gain not previously recognized. As with Code § 704(c), Code § 737 applies only to contributions made within the seven years preceding a distribution.

A transferee of a partnership interest will "step into the transferor's shoes" for purposes of Code § 737. See Treas. Reg. § 1.737–1(c)(2)(iii). Some commentators feel this "step into the shoes" rule applies only to the Code § 704(c) capital account and not for determining whether a transferee partner will be treated as the contributing partner for property distributions under Code § 737(d)(1). See Richard Robinson, *"Don't Nothing Last Forever"—Unwinding the FLP to the Haunting Melodies of Subchapter K*, ACTEC J., Spring 2003, at 302; Harrison & Blum, *Another View: A Response to Richard Robinson's "'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*," ACTEC J., Spring 2003, at 313; and Richard Robinson, *Comments on Blum and Harrison's "Another View*," ACTEC J., Spring 2003, at 318. As the regulations under Code § 704(c)(1)(B) and Code § 737 were written at the same time, by the same people, as part of the same regulation project, it is this author's opinion that they were designed to work in harmony with each other and coordinate the two statutes. Thus, it is logical to conclude that a transferee partner will be treated as the contributing partner when analyzing the tax consequences under both Code §§ 704(c)(1)(B) and 737.

When the Rubber Hits the Road

One thing for sure, FLPs have a lot of moving parts. In many cases, distributions from FLPs will invoke a combination of all three aforementioned Code sections. When all three are involved, the Code sections must be applied in the following order: Code § 704(c)(1)(B), Code § 731, and finally Code § 737. See Treas. Reg. § 1.731–2(g)(1). In considering each section, any basis adjustment to a partner's partnership interest resulting from the application of a previous Code section should be made before application of the next Code section. The interaction of all three Code sections in the same transaction can be very complicated and is best illustrated in an example. Additional Code sections could apply, but a complete analysis of such Code sections extends beyond the scope of this article.

Facts

A. Rich Barrister and his wife, I. Sue Barrister, live in a luxury condo high above the city in the heart of downtown Chicago. Years of success from the practice of copyright and trademark law have made Rich and Sue two of Chicago's wealthiest citizens. Wanting to protect their accumulated wealth, they always kept an eye out for smart estate planning ideas. After reading an article in *Probate & Property* magazine, Rich and Sue decide to form the Barrister Family Limited Partnership (BFLP). Each contributes three assets: (1) 50 shares of Big Bucks Industries, Inc. stock; (2) 50 shares of White Wig Products, Inc. stock; and (3) a parcel of undeveloped real property called Bench Cove, which they own as tenants in common. The contributions are tax free for Rich and Sue. The investment partnership rules do not apply because Rich and Sue contribute equally diversified portfolios of marketable securities and, in any case, the stock represents less than 80% of the value of the BFLP's total assets.

On the contribution date, the assets' bases, fair market value, and built-in-gain are:

Partner	Property	Basis	Value	Built-in Gain
Rich	Big Bucks	100	400	300
	White Wig	50	100	50
	Bench Cove	150	200	50
	Subtotal	300	700	400
Sue	Big Bucks	100	400	300
	White Wig	50	100	50
	Bench Cove	150	200	50
	Subtotal	300	700	400
Total		600	1,400	800

Shortly afterwards, Rich and Sue each makes a gift to their daughter, Barbara, of a 25% partnership interest in the BFLP. (They used to call her Barbie but had to stop after learning that the name might be trademark protected.) After the gifts, the family holds the following interests in the BFLP's assets:

Partner	Property	Basis	Value	Built-in Gain
Rich	Big Bucks	50	200	150
	White Wig	25	50	25
	Bench Cove	75	100	25
	Subtotal	150	350	200
Sue	Big Bucks	50	200	150
	White Wig	25	50	25
	Bench Cove	75	100	25
	Subtotal	150	350	200
Barbara	Big Bucks	100	400	300
	White Wig Products	50	100	50
	Bench Cove	150	200	50
	Subtotal	300	700	400
Total		600	1,400	800

Barbara, being a wild child of sorts, doesn't want a partnership interest. She wants her share of the money out of the partnership and into her pocket. But Rich and Sue refuse. Unhappy, Barbara heads to New York City with her boyfriend Bruiser to seek fame and fortune. Rich and Sue are not happy about this and begin to neglect their law practice as they nudge Barbara to return home. In addition, Congress makes changes to the copyright and trademark laws resulting in a decline in trademark and copyright violations. This threatens Rich and Sue's law practice and extravagant lifestyle. Much to their angst, they are forced to liquidate the partnership to continue to fund their lavish indulgences. For Barbara, it's a dream come true. She owns 50% of the BFLP and will now get her share.

When Rich, Sue, and Barbara examine the BFLP's books, they discover that the value of the assets have appreciated by $600, as did their partnership interests. The new breakdown of assets among the partners is:

Partner	Property	Basis	Value	Unrealized Gain
Rich	Big Bucks	50	250	200
	White Wig	25	150	125
	Bench Cove	75	100	25
	Subtotal	150	500	350
Sue	Big Bucks	50	250	200
	White Wig	25	150	125
	Bench Cove	75	100	25
	Subtotal	150	500	350
Barbara	Big Bucks	100	500	400
	White Wig	50	300	250
	Bench Cove	150	200	50
	Subtotal	300	1,000	700
Total		600	2,000	1,400

Each partner would prefer to receive one of the partnership's assets. Specifically, Barbara wants all of the Big Bucks Industries stock in exchange for her partnership interest. Rich and Sue would each receive a 50% interest in the White Wig Products stock and Bench Cove. The partners consider selling all the BFLP's assets and distributing the proceeds in liquidation of their partnership interests. But that would create $1,400 of taxable gain. Thinking that what went in tax free must come out tax free, the Barristers determine that their best course of action is to liquidate the BFLP and distribute the assets outright. Much to their surprise, they must now face the taxman.

Step 1: Code § 704(c)(1)(B)

First, Code § 704(c)(1)(B) applies to the distributions. To the extent that any portion of the partnership properties contributed by one partner is distributed to another, the contribut-

ing partner recognizes Code § 704(c)(1)(B) gain.

All three Barristers recognize Code § 704(c)(1)(B) gain because property that each contributed or is deemed to have contributed is distributed to another partner. To avoid Code § 704(c)(1)(B) gain, each partner must receive a portion of each property at least equal to his or her percentage ownership of that particular property while it was in the partnership. Based on the Code § 704(c)(1)(B) gain calculated in the third table, Rich and Sue each recognizes $150:

Big Bucks Industries, Inc.

Partner	Interest in Property Before	Value Transferred	Interest in Property After	704(c) Gain Recognized
Rich	200	(200)	—	150
Sue	200	(200)	—	150
Barbara	400	400	800	—
Total	800	—	800	300

Barbara also will recognize Code § 704(c)(1)(B) gain because Rich and Sue receive all of the White Wig Products stock and Bench Cove. As Rich and Sue's transferee, Barbara is deemed to have contributed 50% of those properties to the BFLP. Half of the $200 total built-in gain belongs to her. As shown below, the White Wig Products stock had a built-in gain of $100, as did Bench Cove. The distribution of these properties to Rich and Sue causes Barbara to recognize that built-in gain of $100. Again, the family uses the third table to determine Barbara's built-in gain:

Partner	Interest in Property Before	Value Transferred	Interest in Property After	704(c) Gain Recognized
White Wig Products, Inc.				
Rich	50	50	100	—
Sue	50	50	100	—
Barbara	100	(100)	—	50
Total	200	—	200	50
Bench Cove				
Rich	100	100	200	—
Sue	100	100	200	—
Barbara	200	(200)	—	50
Total	400	—	400	50

The amount of Code § 704(c)(1)(B) gain recognized by each partner is added to the basis in his or her partnership interest before proceeding to Code § 731(c). Both Rich and Sue have a basis increase of $150, giving them a total basis of $300 each, and Barbara receives a basis increase of $100, giving her a basis in her BFLP interest of $400.

Step 2: Code § 731(c)

Rich and Sue originally contributed all of the property to BFLP. Thus, when Rich and Sue each receives White Wig Products stock worth $300, they are simply getting their stock back and meet one of the exceptions to gain recognition under Code § 731(c).

In comparison, Barbara recognizes gain. She receives Big Bucks Industries stock worth $1,000, which carries an $800 unrealized gain immediately before the distribution. As a 50% partner, Barbara "owns" $400 of that unrealized gain. The calculation of money deemed distributed requires consideration of the marketable securities in the BFLP and a calculation of Barbara's share of gain in all of the securities before and after the distribution. That difference creates a subtraction from FMV for determining the money portion under Code § 731(c). The following table illustrates the consequences, if any, to Barbara:

Security	Value	Basis	Gain/ (Loss)	Barbara's 50% Share
With Big Bucks Industries:				
Big Bucks	1,000	200	800	
White Wig	600	100	500	
Subtotal	1,600	300	1,300	650
Without Big Bucks Industries:				
White Wig	600	100	500	
Subtotal	600	100	500	250
Difference				400

Thus, Barbara reduces the amount of the "money" she receives by $400. The remaining $600 exceeds her $400 basis in her partnership interest. Accordingly, she recognizes gain of $200 under Code § 731(a).

The money distribution causes Barbara's basis to decrease to $0 because the "money" received of $600 exceeds her $400 partnership interest basis. Her basis in Big Bucks Industries will be $600 ($400 basis in partnership interest plus $200 gain recognized). Because $600 of the distribution constitutes money, only the balance of $400 will be treated as property for purposes of the Code § 737 analysis below.

Step 3: Code § 737

This Code section requires the partners to recognize gain, if any, equal to the lesser of their "net pre-contribution gain" or the value of property distributed in excess of their partnership bases.

Rich and Sue do not have an excess distribution, but Barbara has one of $200:

	Rich	Sue	Barbara
Stock, but not "Money" under Sec. 731(c)	300	300	400
Bench Cove	200	200	—
Less: Amount They Each Contributed	(250)	(250)	(200)
Total Distribution	250	250	200
Less: Basis in Partnership	(300)	(300)	—
Excess Distribution	—	—	200

There is no need to determine Rich and Sue's net precontribution gain because their excess distributions are already zero. Because Barbara has a partnership basis of zero after application of Code § 704(c), she must determine if she has net precontribution gain:

	Barbara
Initial share of all built-in gain	400
Less: Portion of Asset's built-in gain contributed	(300)
Less: 704(c)(1)(B) gain recognized	(100)
Net precontribution gain	—

Barbara will not recognize any Code § 737 gain because her net precontribution gain is zero.

Note that the partners must reduce their initial share of the

BFLP's built-in gain by their share of the asset or assets they receive. For example, Barbara is deemed to have contributed 50% of the stock she receives because she steps into Rich and Sue's shoes under Code § 737 ($600 built-in gain x 50%). If the "step into the shoes" rule did not apply, Barbara would have recognized $300 of Code § 737 gain ($400 - $0 - $100).

Finally, we need to determine the basis of each asset in each partner's hands. Their partnership interest basis is first reduced for any cash received and then adjusted for any gain recognized attributable to property distributions. Rich and Sue started with basis of $150 each and received an upward adjustment of $150 each from recognition of their Code § 704(c) gain. They will allocate their basis among the two assets received based on their relative fair market values: $200 to Bench Cove and $100 to White Wig Products. Barbara started with a $300 basis, which was increased by $100 under Code § 704(c) to $400. This basis was used to measure her gain or loss under Code § 731, but it also remains her basis for receiving property from the partnership. As Barbara recognized $200 of gain under Code § 731(c), her basis in the Big Bucks Industries stock is adjusted upward by the same amount. Thus, Barbara takes a basis in the Big Bucks Industries stock of $600 ($400 partnership interest basis + gain recognized of $200). The tenth table below summarizes the results:

	Rich	Sue	Barbara	Total
Partnership interest basis after gifts	150	150	300	600
Sec. 704(c) Gain	150	150	100	400
Subtotal	300	300	400	1,000
Sec. 731(c) gain recognition	—	—	200	200
Total	300	300	600	1,200
Ending basis in assets received:				
Big Bucks	0	0	600	600
White Wig	100	100	0	200
Bench Cove	200	200	—	400

Conclusion

It is clear that this is not the result the Barristers desired. The mixing bowl rules reach further than the abuses they were designed to correct. Had the Barristers simply taken pro rata distributions and then made intra-family gifts, the above result could have been avoided.

Compare this result to the Code § 701 Treasury regulations. In essence, they state that a taxpayer cannot use a partnership to create a tax result that they would not be able to achieve without using a partnership. Common sense presumes that the reverse also should be true. But, here, the mixing bowl rules prevent taxpayers from doing just that.

In any case, the above discussion demonstrates that any attempt to liquidate an FLP should be executed with a high degree of planning. Consultation with a tax advisor is strongly advised. The applicable rules are complicated and should be analyzed in detail. Otherwise, unsuspecting families may face an unexpected and unwelcome tax liability. ■

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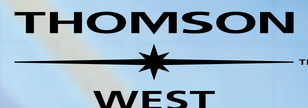

Retirement Benefits Planning Update

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Retirement Benefits Planning Update provides information on developments in the field of retirement benefits law. The editors of *Probate & Property* welcome information and suggestions from readers.

New Bankruptcy Rules for IRAs and Retirement Plans

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub. L. No. 109–8, 119 Stat. 23, referred to herein as BAPA) was signed by the President on April 20, 2005, and generally applies to bankruptcy petitions filed on or after October 17, 2005. BAPA expands, modernizes, and greatly clarifies the U.S. Bankruptcy Code protections that apply to a debtor's retirement arrangements by adopting a broad federal exemption for retirement funds. The new exemption applies to a variety of retirement arrangements, including IRAs and nontrustee plans such as Code § 403(b) tax-sheltered annuities, regardless of whether a debtor chooses to exempt other property from the bankruptcy estate under the state and local law exemptions or, if permitted, under the federal bankruptcy law exemptions. Although the new federal exemption may restrict even more favorable state exemptions (for example, by imposing a $1 million cap on the exemption for IRAs to the extent funded by annual account owner contributions), the new law resolves numerous interpretive quandaries and eliminates what most commentators would view as artificial distinctions between the forms of retirement plans that have evolved over the years.

Current Law Exclusion

As described in the January/February 2001 "Retirement Benefits Planning Update" column, all of a debtor's legal and equitable interests in property are included in the debtor's bankruptcy estate unless specifically excluded. Bankruptcy Code § 541(c)(2) provides for the exclusion of a debtor's interest in a trust if there is "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law." In *Patterson v. Shumate*, 504 U.S. 753 (1992), the Supreme Court held that ERISA is an "applicable nonbankruptcy law." Thus, pre-BAPA law excludes a debtor's interest in a trusteed pension, profit-sharing, and stock bonus plan that is subject to ERISA, although courts differ on whether the plan involved must be income tax qualified under the Internal Revenue Code for the exclusion to apply.

Plans that are not subject to Title 1 of ERISA, including Code § 457 plans of tax-exempt employers or governmental units, some Code § 403(b) plans, IRAs (and SEPs and SIMPLEs), Keogh plans that do not benefit common law employees, and nonqualified deferred compensation plans, can be excluded from a debtor's bankruptcy estate only if (1) the debtor's interest can be said to be in a trust, (2) an applicable nonbankruptcy law other than ERISA (a state law) is determined to restrict the beneficial interest of the debtor, and (3) if applicable, the court is willing to disregard the debtor's immediate access to the benefits. The recognition of the exclusion for non-ERISA plans has been sporadic. Certain jurisdictions determined the exclusion to be available, based on specific state statutes and specific plan provisions, for IRAs (*In re Yuhas*, 104 F.3d 612 (3d Cir. 1997), cert. denied, 521 U.S. 1105 (1997), and *In re Robert P. Davis*, 108 Fed. Appx. 717 (3d Cir. 2004), setting forth five criteria for exclusion)), for Keogh plans (*In re Moses*, 167 F.3d 470 (9th Cir. 1999)), for Code § 403(b) annuities (*In re Barnes*, 264 B.R. 415 (Bankr. E.D. Mich. 2001)), and for Code § 457 plans (*In re Mueller*, 256 B.R. 445 (Bankr. D. Md. 2000)).

The Bankruptcy Code § 541(c)(2) exclusion is unaffected by BAPA and will remain available. For tax-exempt plans, however, the new federal exemption will also effectively remove retirement benefits from the debtor's estate and the exclusion will provide added protection, if at all, in only limited circumstances. For example, in those jurisdictions in which the income tax qualification of an ERISA plan is not required for the exclusion to apply (and the debtor is unable to

demonstrate that the plan is exempt from taxation under the new federal exemption's criteria described below), the exclusion may apply. In the unlikely case of an IRA that is large enough to exceed the federal exemption limit without having received significant rollovers from a tax-exempt plan, a debtor could avoid the limit if the elements for an exclusion could be established.

Current Federal and State Exemptions

The pre-BAPA federal exemption contained in Bankruptcy Code § 522(d)(10)(E) applies to a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor. The Supreme Court recently resolved a conflict among the circuits by holding that the phrase "similar plan or contract" includes a traditional IRA and that the Code § 72(t) 10% early withdrawal tax that applies to distributions until age 59½ is attained effectively limits the payment of IRA benefits to payments "on account of" age. *Rousey v. Jacoway,* 125 S. Ct. 1561 (2005). Although the federal exemption is relatively expansive in the kinds of benefits covered (including tax-sheltered annuities and certain non-qualified plans), the relief granted by the exemption is limited to payments that are reasonably necessary for the debtor's support as determined by the bankruptcy court. As a result, even if the current federal exemption is available (that is, the debtor's state of domicile is not one of the majority of states that have "opted out" of the federal exemption under Bankruptcy Code § 522(b)), debtors often elect to have the state and local law exemptions apply. The current federal exemption is not amended by BAPA but will be effectively superseded for tax-exempt retirement plans by the more expansive new federal exemption.

One of the immediately effective provisions of BAPA (section 307) changes the Bankruptcy Code § 522(b)(2)(A) rule for determining a debtor's domicile for purposes of determining the state and local law that applies to exemptions. The former minimum domiciliary period of 180 days before the petition being filed is now extended to 730 days. If a debtor has not been domiciled in a single state for that 730-day period, the applicable state law is the law of the debtor's domicile for the 180-day period preceding the 730-day period before filing (or the debtor's domicile for the greatest number of days within such 180-day period). As described in the May/June 2001 "Retirement Benefits Planning Update" column, state law exemptions frequently follow the pattern of the current federal exemption, exempting only payments from IRAs and non-ERISA plans that are necessary for support, may impose dollar or percentage limits on the portion of a plan interest exempted, or may require that a plan be in pay status for the exemption to apply. In the case of tax-exempt retirement benefits covered by the new federal exemption, the decision of whether to elect either the federal exemption or the state exemptions for nonretirement properties will no longer be affected by the state exemptions for retirement benefits except to the extent that nonqualified deferred compensation arrangements are involved.

New Federal Exemption

BAPA § 224 amends Bankruptcy Code § 522 to provide for the exemption of that portion of a bankruptcy estate that consists of retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under

Code § 401—qualified pension, profit sharing, stock bonus plans including ESOPs, 401(k) plans, and Keogh plans (even those with no common law employee);

Code § 403—qualified annuity plans and tax-sheltered annuities and custodial accounts;

Code § 408—traditional IRAs (accounts and annuities), simplified employee pensions (SEPs), and savings incentive match plans for employers (SIMPLEs);

Code § 408A—Roth IRAs;

Code § 414—multi-employer plans and church plans;

Code § 457—deferred compensation plans of state or local governments or tax-exempt organizations; or

Code § 501(a)—tax-exempt organizations (including certain retirement trusts).

The new federal retirement funds exemption is available regardless whether, under Bankruptcy Code § 522(b), the debtor (1) elects to have the federal exemptions of Bankruptcy Code § 522(d) apply to other bankruptcy estate properties or (2) chooses (or, in an "opt out" state, is required to choose) to have the state and local exemptions of amended Bankruptcy Code § 522(b)(3) apply to other properties. The new exemption language is included in both amended Bankruptcy Code §§ 522(b)(3)(C) (state and local) and 522(d)(12) (federal) exemption sections of the amended Bankruptcy Code.

For purposes of determining whether the fund or account is exempt from taxation, it will be presumed that funds in a retirement plan that has a favorable determination letter under Code § 7805 that is in effect at the time the petition is filed is exempt from taxation. If a fund has no favorable determination letter, the funds will be exempt from the debtor's bankruptcy estate if the debtor demonstrates that

- no prior determination to the contrary has been made by a court or the IRS and
- the retirement fund is in substantial compliance with Internal Revenue Code requirements (or, if not in substantial compliance, the debtor is not materially responsible for that failure). Amended Bankruptcy Code § 522(b)(4)(A) and (B).

Neither a direct trustee-to-trustee transfer nor a rollover of retirement funds from one of the enumerated funds or accounts to another enumerated fund or account will cause the funds to cease to qualify for the federal exemption. Amended Bankruptcy Code § 522(b)(4)(C) and (D).

IRA Exemption Cap and Rollovers

New Bankruptcy Code § 522(n) limits the exemption for the aggregate value of a debtor's traditional IRAs and Roth IRAs (excluding SEPs or SIMPLEs) to $1 million, as adjusted for inflation, except that such exemption amount may be increased if the interests of justice so require. The exemption limit is computed without regard to IRA amounts attributable to rollover contributions, either via an eligible rollover distribution under Code § 402(c) deposited in a tax-exempt fund or account within 60 days or by a trustee-to-trustee transfer under Code § 401(a)(31), from any of the non-IRA tax-exempt plans or accounts described in the Internal Revenue Code sections listed in the federal exemption.

As a result of the protection of the full amount of rolled over retirement benefits by the federal exemption, the current reluctance to roll over qualified plan benefits to an IRA (for example, so as to obtain investment and dispositive flexibility) because the exclusion from the bankruptcy estate would be lost should no longer prevent rollovers. Note, however, that the federal exemption from a debtor's bankruptcy estate does not provide creditor protection in a pre-bankruptcy setting, and, if potential creditor problems exist, state laws regarding creditors' rights should be consulted before a rollover that will eliminate the spendthrift protections of an ERISA plan.

Additional BAPA Provisions

BAPA § 323 also amends Bankruptcy Code § 541(b) to add new subparagraph (7) that excludes from a debtor's bankruptcy estate amounts withheld by an employer from wages of employees for payment to a plan subject to Title 1 of ERISA, a governmental plan under Code § 414(d), a Code § 457 plan, or a Code § 403(b) plan, as well as amounts received by an employer from an employee for payment as contributions to such a plan.

BAPA § 224 amends Bankruptcy Code § 523(a) by adding new subparagraph (18) that provides that no loan owed by a debtor participant to a plan established under Code §§ 401, 403, 408, 408A, 414, 457, or 501(c) shall be discharged in bankruptcy, thus preserving the retirement fund's ability to collect any plan loan made to the debtor.

BAPA § 225 amends Bankruptcy Code § 541(b) to add new subparagraphs (5) and (6) that provide for the exclusion from a debtor's bankruptcy estate of funds contained in a Coverdell education savings account under Code § 530 and funds used to purchase a tuition credit or certificate (or contained in an account) under a qualified state tuition program under Code § 529(b)(1)(A). The exemption applies to funds that were placed in the account (or program) at least one year before the filing of the petition (with the exemption for funds placed in the account for any one beneficiary not earlier than 720 days before filing but not later than 365 before filing being limited to $5,000). The individual benefited by the account or program must have been a child, stepchild, grandchild, or stepgrandchild of the debtor at the time funds were placed in the account or program. The exemption excludes amounts that exceed the maximum permissible contributions to the account or program, and, in the case of Coverdell accounts, such funds may not be pledged or promised to any entity in connection with any extension of credit. ■

High Rise Multi-use Development

THE RISE OF VERTICAL MULTI-USE CONDOMINIUMS

By Edward A. Peterson

During the second half of the 20th century, large cities in the United States began to experience what became known as urban sprawl. Most cities grew horizontally rather than vertically with some notable exceptions such as Chicago, New York, and Miami. The proliferation of the automobile brought increased mobility to society, and the close proximity to living space of goods and services was not perceived to be necessary. But as urban sprawl reached out 40 and 50 miles and traffic congestion became the rule rather than the exception, people began to put a premium on living and working in closer proximity. This seemingly natural progression has resulted in what is now known as the "New Urbanism," which can loosely be described as multi-use real estate developments including "new towns," "vertical multi-use condominiums," "cluster homes," and other ownership structures, all of which are often included in "smart growth initiatives" of progressive cities and towns.

This article will focus on the structuring fundamentals and critical considerations involved with vertical developments that include not only residential uses and amenities, but also retail, office, entertainment, and hotel uses in the same real estate project. The structures available under the law of most, but not all, states will be explored, and the challenges in the overall development process will be examined. There is no cookie-cutter approach to planning a multi-use common ownership project; however,

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Max Licht

there are guidelines to help the developer's counsel in guiding the legal process. Condominium legislation is the statutory basis for all vertical subdivision of property at this time.

Structuring Fundamentals

Ownership

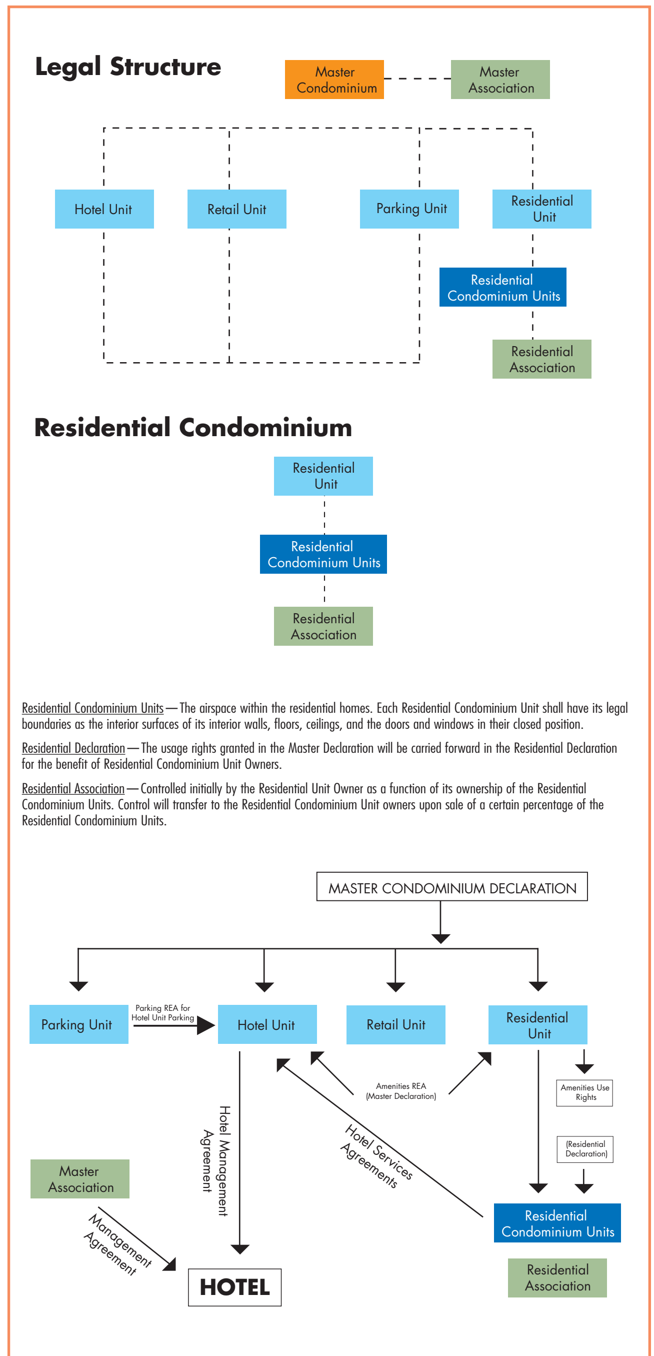
The owner of a property can use it for more than one purpose if the applicable zoning and land use regulations permit multiple uses. A planned unit development (PUD) is an example of a land use regulation permitting and often encouraging multiple uses of a tract of land. There is very little reason to have a common form of ownership in relation to a horizontal development if it is planned correctly. Separate ownership can be arranged for various platted parcels and the property can be separately owned and financed with a common management or easement structure for some portions of the development that are jointly used. In a vertical structure, however, common ownership is generally necessary, although not required, and the issues become evident. If the development is multi-storied and separate uses are planned, then specialized talents may be needed to lease or operate the planned components of the building. In such instances, the common ownership structure must be given consideration.

Zoning and Land Use Considerations

Full use of a building is imperative in urban settings. Often to make the site a profitable development, the project must have multiple stories and various uses. If the separate uses will be operated and owned by different owners, then the project is a candidate for condominiumization because replatting is generally not required, floor area ratios can be increased, and more flexible development plans can be accomplished.

Facilitate Financing

Lenders are more interested in financing a property that is used for a separate purpose because the stream of income and value is easier to underwrite. If the developer wants to develop a project that contains a hotel, residential space, and retail rental space, for example, it will not be easy to find permanent lenders to finance the entire project, but lenders in the marketplace will finance each of the above uses. Financing of commercial condominium units is still an infant industry; however, the author has found that a clear, precise presentation of the structure and a graphic display of the project with a short, simple explanation of the legal basis for the structure are extremely effective in gaining an expeditious understanding of the legal and business concepts.



Maximization of Value—Flexible Exit Strategy

Often the parts are worth more than the whole, and developers can achieve a higher sales price for individual uses. If the developer owns an office building in a soft office market, the division of the building into multiple uses that may or may not include office space can substantially increase the value of the property. The condominium structure can be used, if there is a residential component, to provide another way to sell the rental property by condominiumizing the apartment units and selling them to individuals in the future when the market is favorable. Buildings are currently being structured that contain retail space on the ground floor with several levels of rental units above the retail. Most of these rental units have a reserved right to create a sub-condominium unit if the owner desires to market the residential units as residential condominiums in the future.

Conversion of Uses

Many owners of property in areas where the original use has run its course can use the multi-use concept to make a property useful and therefore more profitable. Examples are warehouses that can be converted to retail and lofts, apartments that are

converted to retail and residential condominiums, hotels that are converted to retail and residential condominiums, and hotels that are converted to retail and office space.

Critical Considerations

The balance of this article will consider the critical issues that face a real estate lawyer who is structuring a multi-use condominium containing five separate units including a hotel unit, a retail unit, a residential unit, a parking unit, and a future development area unit. The basic structure is set forth in the box on the previous page.

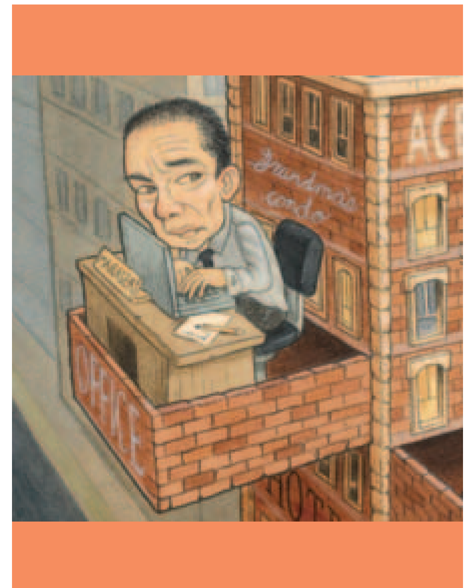
Understanding the Project

The developer's attorney must carefully establish unit boundaries and fully comprehend and explain to the developer how the multiple unit boundaries will affect the responsibility for maintenance, repair, or replacement of the property, whether the property is a unit or a part of the common elements. This process will help the attorney to understand the project and to advise the developer of the many use rights necessary to address the needs of each unit owner. Within the condominium structure, separate categories of common elements, such as general common elements, residential limited common elements, hotel limited common elements, retail limited common elements, and special limited common elements should be created. These separate categories will help avoid the typical disputes between co-owners over financial responsibility for maintenance, repairs, and replacements of portions of the property, particularly disputes that arise when sharing responsibility for common elements. It is possible to structure a multi-use condominium with most of the common elements placed in a separate unit of which the associated costs are shared on a predetermined basis.

Structuring the Project—Who Is in Control?

If there is a residential component to a multi-use project, and depending on the relative size of the commercial and residential components, a critical issue will be to balance control carefully among the units' owners. Control involves several aspects, including negotiations relating to the condominium and other project documentation, the administration and financial management of the overall condominium project, maintenance and repair of the common areas, actual control of the governance of the master association, and structure of the dispute resolution provisions. For obvious reasons, the commercial owners will have a strong desire not to be involved with the multiple owners of the residential condominiums. The eventual owners of the individual residential condominiums will have little or no desire to be involved in any of the commercial aspects of the condominium. The owner of the hotel unit will be subject to a complex set of requirements imposed on the hotel under the hotel operating agreement.

If a developer decides to reserve the right to build a second residential condominium in the air space over the parking garage, the developer must have the proper rights and easements to allow future construction and to integrate the future residential tower into the project or perhaps keep the second condominium completely separate. Assuming that the developer has arranged ownership of the various units, there will be complex negotiations among the various parties before the commencement of construction. The lawyer must guide the parties so that the uses can co-exist in the same structure and have a minimum of overlap in administration and a workable process to deal with dispute resolution. Through the negotiations it will become apparent which unit will have the leverage necessary to control the administration of the property. A variety of control mechanisms can be used for actual control of the master association. Class voting may be allowed if the class has a legitimate interest to protect. See, e.g., Unif. Condo. Act § 2–107(c) (1980). For example, if the hotel unit has a legitimate interest in maintaining the quality of the overall project, giving the hotel unit control through a class of membership should be allowed under the Act. It is important to segregate the residential units from the commercial to the greatest extent possible. This segregation can be accomplished in numerous structures; however, the formation of a master condominium (the "Master Condominium"), as shown in the box on the previous page, is the most efficient. The Uniform Condominium Act permits the subdivision of units, and the declarant is allowed to reserve a development right to subdivide units. Unif. Condo. Act §§ 2–113, 1–103(11). The residential unit will be subdivided into multiple residential units, and these units will have a residential association (the "Residential Association") that will handle the administration of the individual residential units. The master condominium association will have a representative of the Residential Association on its board of directors, but the commercial unit owners will generally control the master association. Although not appropriate in the structure shown in the box on the previous page, there are projects in which the residential unit owners would control the master association or where one association would be appropriate.



Regulation of Uses

The uses for each unit within the condominium must be carefully analyzed so that each unit is properly defined, limited, and permitted. A natural ten-

sion exists between the residential and commercial uses in a building. The box on page 54 illustrates the tension between the hotel owner and operator and the residential condominium owners. Counsel must examine applicable zoning ordinances and covenants, conditions, and restrictions when preparing the condominium declaration so that there are no conflicts and so that the condominium declaration is properly integrated with the provisions in these land use regulations. All parties, particularly owners of units other than the residential units, and their mortgagees and tenants must determine that the condominium declaration permits uses that will be necessary to the conduct of their respective businesses. Commercial unit owners and their mortgagees must ensure that the condominium declaration cannot be amended without their respective consent. Owners of individual residential units will want to provide reasonable limitations on the commercial uses in the condominium so that there is no unreasonable interference with their lifestyles. Developers generally impose restrictions that are usual in the market and do not affect the marketability of the individual residential units.

Having a separate "shared facilities unit" provides the benefits of a mechanism for one or more of the constituencies in the Master Condominium to control the quality of the overall condominium project.

Easements and Licenses

There will be many easements in relation to a multi-use project as outlined in the box on page 54. Counsel must carefully analyze and determine the easements to be granted and retained in the condominium declaration. Under many states' laws, the easements must include a legal description of the area to the extent feasible. See, e.g., Tex. Prop. Code § 82.059(5). Some easements may be expressly provided by applicable state law, but it is good practice to carefully outline and set forth each necessary and required easement. A partial list of the possible easements that will be required includes access, support and encroachment, parking, loading, elevator, utilities, amenities, signage, stairs, garbage chutes, construction, easements relating to the future development area, roof, communications, and common element easements. A determination should be made about the permanence of each easement and whether it is assignable, exclusive, or non-exclusive. Each easement should specifically state who is responsible for maintenance of the easement. Some use rights might properly be licenses that can be easily terminated by the master association. If payments are associated with the use rights, consideration should be given to suspension of the rights if the payments are not made.

Allocation of Expenses

A predetermined expense allocation must be established between the owners or potential owners of the various units based on some formula or method. This allocation can be accomplished in numerous ways. The condominium declaration may authorize the allocation of common expenses and votes in a manner other than based on a unit owner's common interest. The Uniform Condominium Act states:

> The declaration shall allocate a fraction or percentage of undivided interests in the common elements and in the common expenses of the association, and a portion of the votes in the association, to each unit and state the formulas used to establish those allocations. These allocations may not discriminate in favor of units owned by the declarant.

Unif. Condo. Act § 2–107(a).

The method most often used is to require the developer (and the unit owners) to prepare a line item schedule specifically indicating how different expenses will be split on a percentage basis among the unit owners. Under a variety of alternatives, however, the declaration can

- allocate based purely on the percentage of common interest, if appropriate;
- provide that expenses relating to each particular portion of the property will be paid by those unit owners that use that portion of the property;
- assign the responsibility to the master association to allocate expenses reasonably and fairly;
- try to get utilities and other services sub-metered or assigned;
- require that the parties agree to split expenses based on third-party reports of actual usage after a reasonable period of usage;
- use the appraised value of each unit as the basis; and
- develop a formula that includes subsidization of one or more uses based on benefit received or penalty based on burden inflicted.

Common Elements; Shared Facilities

The designation of the common elements for a multi-use condominium is very important. All spaces that are used by one or more, but not all, unit owners are limited common elements. Unif. Condo. Act § 1–103(19). All common elements that are not limited common elements are general common elements. See, e.g., Tex. Prop. Code § 82.003(14). Parking can be designated as a limited common element, together with balconies and patios. Any space

that is used only by a unit or units in the Master Condominium, such as amenities used by the hotel unit and the residential unit, would generally be limited common elements. Parking and storage can be designated as separate units within the condominium and often are so designated. The designation of common elements will be different for each project and each developer.

In a project such as that diagrammed on in the box on page 54, the aspects of the project that must be examined to designate common elements include the swimming pool and the pool area, health and fitness club, spa, parks and other public spaces, private club, meeting or club rooms, lobbies, elevators, and staircases. Each of these spaces can be part of the common area or can be included within one of the units, depending on the negotiations between the unit owners and their operators. In addition, the project could be structured so that all of what normally would be common elements are placed in a separate unit, provided there are at least some common elements, such as the real property and the structure of the building. Having a separate "shared facilities unit" provides the benefits of a mechanism for one or more of the constituencies in the Master Condominium to control the quality of the overall condominium project. The common elements also can be divided among the units by designating limited common elements as "hotel limited common elements," "retail limited common elements," "residential limited common elements," and so on.

Parking

The parking plan for a multi-use condominium project inevitably becomes one of the most difficult decisions for the developer. The plan must, of course, meet code for the number of available spaces and must be practical and efficient in relation to the design of the building or buildings. Counsel should remember to advise the developer that the parking spaces can be individual units of the condominium that can be sold separately and that all the parking for the hotel unit and the residential unit could be placed in a separate unit that could in the future be sold separately. These decisions could benefit the profitability of the entire project. Parking for the residential component ideally should be separate from the parking for the other units. Parking for the retail unit should be located as close to the retail establishments as possible, and, for the hotel unit, parking must be reasonably convenient but can be offsite. Access to each of the parking areas must be carefully planned.

Amenities

Depending on how the amenities are structured, special easements or use rights may be needed so that the owners of the individual residential units will have the right to use each of the amenities intended for use by such unit owners. The right to use these facilities can be structured as revocable licenses that can more easily be terminated if the users fail to pay the required fees. The hotel owner will want to have the exclusive right to use some of the amenities for limited time periods, and these types of rights can be provided in the rules and regulations.

Future Development Rights

Often the developer has additional land adjacent to the primary development or conceives a way to add additional density to the site under development. In the structure contemplated by the condominium that is diagrammed in the box on page 54, the developer contemplates building an additional residential tower in the airspace above the parking deck attached to the main hotel/residential tower ("Future Development Area") and intends to build the parking structure so that the necessary structural components to support an additional 25 stories are in place. This future use can be accommodated if the declaration is properly structured. The developer of the condominium can reserve "development rights" as defined in the Act. The Act defines "development rights" as a "right or combination of rights reserved by a declarant in the declaration to (i) add real property to a condominium; (ii) create units, common elements, or limited common elements within a condominium; [or] (iii) subdivide units or convert units into common elements . . . ." Unif. Condo. Act § 1–103(11). Because the Future Development Area is real property, the developer can add it to the condominium as part of the residential unit or as an additional unit to the Master Condominium, which can be further subdivided. These rights must be specifically set forth and special declarant rights reserved to exercise the development rights in the condominium declaration filed in connection with the master declaration. Unif. Condo. Act § 1–103(23). Easements relating to the construction of improvements in the Future Development Area should be reserved in the master declaration, and the configuration of the added area should be analyzed to assess the need for access, parking, and use rights, if the Future Development Area is added.

Dispute Resolution

The more complex the structure of the condominium, the more problematic the dispute resolution process becomes. Having all disputes in a multi-use structure end up in the courthouse is not the most efficient way to deal with this issue. The alternatives are forced mediation, binding arbitration, or a combination of these processes. The author believes that a combination of forced mediation and mandatory "final offer" or "baseball" arbitration is a fundamentally sound approach to encourage the parties to compromise their disputes.

> Given the vastly disparate uses between the [residential and the commercial units in a multi-use condominium], a balance must be established on the question of the governance and affairs of distinctly separate owners and uses, maintaining, on the one hand, flexibility for one owner's use while, on the other hand, respecting the rights of and ramifications upon neighboring owners. Thus, drawing upon a dirt lawyer's knee-jerk drafting technique of conditioning defaults based on "materiality" or (as here),

> "adverse effect," a balance of the potentially competing interests is reached which should accommodate the day-to-day operations of each of [the competing interests] in . . . [a] multi-use building. Providing a dispute resolution mechanism—such as one which would be triggered by a reasonable notice by an objecting party challenging a [board determination]—affords all users in a multi-use property an equitable avenue to communicate concerns over a Board's action which may affect an owner's use and operation.
>
> Arbitration is sometimes suggested as a mechanism for the board to resolve its differences. However, deferring to issues of corporate law, some practitioners have questioned whether a board can be emasculated and delegate its right of decision to another body. If this is a concern under local law, creative lawyers might consider whether it would be possible to craft a system of guidance which would, in fact, rely upon what is essentially an arbitrarial device.

See Alan Goldberg & Matthew J. Leeds, *A Guide to Special Concerns in a Multi-Use Condominium: A Review by Annotated Example*, American College of Real Estate Lawyers, Spring Meeting, Mar. 2003, available at www.acrel.org/Documents/Seminars/Goldberg.rtf (last visited May 20, 2005).

Special Provisions for Casualty and Condemnation

The Act requires certain provisions on casualty and condemnation. Unif. Condo. Act § 3–113 (dealing with insurance and administration of proceeds of insurance) (the provisions cannot be varied if there is a residential component to the condominium), § 1–107 (dealing with condemnation) (these provisions may not be varied by agreement). Notwithstanding that the condominium is multi-use, these provisions cannot be varied if there is a residential unit, and counsel must be careful to assure that the condominium declaration reflects the provisions of the Act. Some practitioners have suggested that these provisions could be circumvented by having unit owners give powers of attorney to the association; however, this procedure is specifically prohibited by Unif. Condo. Act § 1–104. The Act allows the use of an insurance trustee if the condominium association deems such a procedure appropriate. Unif. Condo. Act § 3–113(e). It is suggested that in a multi-use context the declaration should provide that insurance proceeds above a fixed amount be administered by the master association as insurance trustee.

Plats and Plans

The plats and plans that define the condominium are the portion of the condominium declaration that allows the creation of separate parcels that can be conveyed. It is therefore extremely important that great attention be paid to the specificity and detail of these documents. Tex. Prop. Code § 82.061 provides the detailed requirements of the plats and plans required to be filed. Structuring a multi-use condominium by using a Master Condominium with a sub-unit structure for the individual residential units magnifies the complexity of the plats and plans. An experienced condominium surveyor will be helpful, if not crucial. Each of the master units must be identified, all easements must be legally described, all property subject to development rights must be described, horizontal and vertical dimensions of the units must be set forth, and many other requirements under the Act must be followed.

Sub-unit Condominium

The residential component of a multi-use project is often structured as a subdivision of the residential unit of a Master Condominium. As previously stated, this is one of the most efficient ways to separate the residential owners and the administration of their community from the commercial units. This structure is authorized by provisions of the Act previously discussed. In practice, this subdivision is achieved by the filing of a residential sub-unit condominium declaration in the condominium records of the county where the property is located that subdivides the airspace of the residential unit of the Master Condominium and the appurtenant common elements into the required number of individual residential units in the sub-residential condominium. The sub-unit residential condominium will have its own residential condominium association that will administer the business affairs of the sub-unit individual residential units. The sub-unit condominium will have representation on the board of directors of the master association.

Conclusion

Multi-use condominiums are more than just residences. The multi-use project can include any combination of uses of real property. The project can include all the environments of urban existence (live, work, play, living essentials, and entertainment). These types of projects require the lawyer to be more than a scrivener. The lawyer must understand what the developer is creating and assist with a structure that will facilitate the workability of the live, work, and play environments.

If the use-model or governance-model structured by the developer and its lawyers fails, the "New Urbanism" project also may fail. Users must have the necessary legal structure to navigate the often choppy waters that make up a high-density, multi-use environment. The lawyer must have a thorough understanding of the Act, land use regulations, covenants, conditions, and restrictions covering the property, and of the site plan and preliminary plans relating to the project so that a proper structure can be developed.

The above discussion by necessity is a broad summary of the many considerations in the multi-use condominium structure process and does not purport to cover all that will be required to complete the final development plan and its documentation. This summary should give the practitioner a good starting point to working through the many complexities of the process. ■

Technology Property

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Technology—Property provides information on current technology and microcomputer software of interest in the real property area. The editors of *Probate & Property* welcome information and suggestions from readers.

Membership Survey Results on Document Drafting Technology

The magazine's technology editors created and completed an initial survey of the entire Real Property, Probate & Trust Law Section (RPPT) membership on members use of document drafting technology. This column will provide an overview of the survey results, which will be discussed in more detail in the magazine's next technology column. The editors intend to conduct and report on additional surveys in future magazine editions. The purpose of these surveys is to inform RPPT members of the technology other RPPT members use.

The 2.8% response rate to this initial survey broke the RPPT's response record by a wide margin. Although this rate is significantly lower than the 13.7% response rate of the 2004/2005 legal technology survey conducted by the American Bar Association's Legal Technology Resource Center (LTRC), it should be noted that LTRC surveys only a fraction of the ABA's membership. RPPT surveyed all of its members, and the 2.8% response compares favorably to the LTRC response as a percentage of the total ABA membership.

The survey contained 18 questions, and the first six elicited information about those taking the survey to aid in the analysis of the survey results. The first six questions asked for date of birth, date the practice of law commenced, gender, location of office by city, whether the individual is currently practicing law, and the size of the law firm or law department. These results show that 96% of the respondents are currently practicing law. Seventy-five percent of the respondents who answered the gender question were male. Forty-nine percent of the respondents were in law firms or law departments of 1 to 4 lawyers. Eighteen percent were from legal organizations of more than 50 lawyers and 6% were in organizations exceeding 300 lawyers.

The following chart shows the approximate percentage of the respondents who were born in each of the decades from the 1930s through the 1980s.

Decade of Birth	Percentage of Respondents
1930 to 1939	9.3%
1940 to 1949	25.2%
1950 to 1959	35.9%
1960 to 1969	18.3%
1970 to 1979	11.0%
1980 to 1989	0.3%
Total	100%

Question 7 called for the word processing software used for drafting documents. Fifty-seven percent said they used Microsoft Word exclusively, 19% said they used WordPerfect exclusively, and 24% said they used both Word and WordPerfect. It is important to note that this means Word is used by 81% of respondents. Seventeen individuals reported using other products. Six of these actually use Word or WordPerfect, but answered "other" to explain their particular use. One respondent indicated no software was used. Perhaps that person still uses only a typewriter or pen and paper. Not surprisingly, the greatest use of the less expensive WordPerfect program is at smaller firms. Solo practitioners had the greatest percentage for the exclusive use of WordPerfect at 31.3% (with another 26.4% using both Word and WordPerfect). At the other end of the spectrum, of the 98 individuals who responded to this question from legal organizations with more than 100 lawyers, only one individual reported using WordPerfect exclusively and seven said they used both Word and WordPerfect.

Question 8 asked the respondent to indicate who in the organization actually typed the documents being

drafted, with an instruction to select all that apply. The results are shown in the following table.

Documents Typed by	Number Responding
Lawyer	625
Secretary	484
Paralegal	278
Word processor	105
Other	36

It is interesting to note that 84% of lawyers are typing (or should we say word processing) their own documents to some degree. Since those taking the survey were asked to include all applicable categories, this might not be too surprising, because many lawyers may be doing limited editing and relying on others to do the heavy word processing work. It may come as a surprise to many that the largest legal organizations have the highest percentage of lawyers doing their own typing. All 20 of the lawyers responding from firms or law departments with more than 500 lawyers (including 11 with more than 1,000 lawyers) say that they type documents, and all but one of them also say that their secretaries type their documents as well. After this category, the group with the largest percentage of lawyer typists (at 91%) is solo practitioners. The percentage generally declines to 79% as the size of organizations get larger until the larger-than-500-lawyer category is reached. Half of those who responded "other" indicated they themselves or another lawyer did at least some of the typing. The high percentage of typing by solo practitioners was not surprising to this editor, who has spoken to quite a few over the past few years whose use of technology allows them to practice law without the expense of secretaries or assistants.

Question 10 addressed the drafting method used by those surveyed. Again the respondent was asked to select all that apply, because lawyers might use different approaches depending on the circumstances. The basic results are shown in the following table.

Drafting Approach	Number Using Approach	Percent Using Approach
Marking up a document previously drafted	707	95%
Marking up a model or standard form	688	92%
Starting from scratch	605	81%
Use of automated templates	374	50%
Dictation that is later transcribed	332	44%
Other	14	2%

Almost all lawyers mark up documents previously used. They get the benefit of the thinking that went into the drafting of the prior document, and they do not have to write an entire document from scratch. One concern, of course, is that the prior document may have included or excluded material based on negotiations or unique facts of a prior transaction. One must have an excellent knowledge of a standard or model form to ensure that inappropriate additions or omissions are not carried over to a new transaction. For example, one of the carve outs to the exculpatory provision in a mortgage note may have been deleted or significantly modified because of unique facts of a certain transaction or because of the negotiating position of a highly regarded borrower. If a later user marks up that mortgage note, he or she might inappropriately carry over the change to the normal carve outs unless he or she is familiar with normal carve-out language and has the time to carefully consider that provision as well as the other areas of the mortgage note that might vary from standard language because of negotiated or fact-based changes.

A close second in drafting method is marking up a standard form. Here

Survey Particulars

Rob King, assistant director of technology, marketing, and communications of RPPT, used the survey tool, Zoomerang, to permit Section members to complete the survey on-line. The software's skip feature avoided members' answering irrelevant questions based upon their prior responses. For example, different questions would be asked of those who did or did not indicate use of automated templates. Users were asked several questions about their use of automated templates, while non-users were asked why they did not use automated templates and what might motivate them to use automated templates.

Seven hundred forty-seven members completed the survey, compared to the previous record response of 157 members. There were 947 visits to the survey site. The survey response rate was approximately 747 out of approximately 28,000, which equals approximately 2.7% of those invited to take the survey.

LTRC surveyed only a fraction of total ABA membership. If one compares the approximate 2.7% response of all RPPT members to the RPPT survey to the ratio of (1) the approximately 1,500 responses to the LTRC survey to (2) the total ABA membership of approximately 400,000 (yielding a ratio of approximately 0.4%), the response to the RPPT survey appears quite good. The editors in no way intend to be critical of the LTRC survey. LTRC deals with a much larger membership to survey, more than 14 times the size of RPPT's membership, and LTRC uses a scientifically valid sample of the total membership. Commercial surveys are typically performed on only a scientifically valid sample, and the results of such sampling are generally recognized by experts in the survey industry as statistically valid.

Zoomerang provides a cross tabulation analysis tool, enabling a view of the substantive questions to see how different categories of lawyers responded to the survey.

the lawyers get the benefit of the thinking that went into preparing the standard form, and they also do not have to write an entire document from scratch. They do, however, miss the benefit of using a well-selected precedent document from a very similar transaction. For example, the firm may have a standard form for a commercial mortgage for a permanent loan. If the new transaction is a loan to be secured by a first mortgage on a full-service hotel in a downtown location, marking up the standard form will not have the benefit of the thinking that went into drafting a mortgage on a prior deal on a full-service hotel in a downtown location. Of course, the person drafting the mortgage will avoid the downside of missing negotiated or inappropriate fact-based changes in the prior document. Obviously there are positives and negatives to each approach. Standard forms are sometimes annotated to indicate the changes that should be made for different circumstances, but the quality control provided by extensive annotations can significantly slow down the document drafting. This issue may be the subject of a future survey and column.

Eighty-one percent use the "start-from-scratch" approach. One would expect this to be limited to the occasional document that is both too small and unique to justify the use of a standard form or precedent document. It seems unlikely lawyers are drafting lengthy documents from scratch other than in the rare circumstance when a document is so unique that neither a useful precedent document nor a standard form is available.

Fifty percent of all respondents use automated templates. That is probably a large increase from 10 years ago and even as recently as five years ago. It appears that more lawyers are recognizing the quality control and productivity gains that are available from automated templates. In fact, such templates can provide all the benefits of the highly annotated type of form mentioned above without the drawback of significantly increasing the drafting time, because a well-designed automated template will reduce to a fraction the drafting time required to mark up either a precedent document or an annotated standard form.

Less than half of the respondents dictate documents for transcription. Twenty years ago that percentage was probably much higher. The declining use of recorded dictation is not surprising to those lawyers who can keyboard and have experienced the efficiency of bypassing the delays and inaccuracies of the transcription process. The ever-increasing expectations of clients for fast turnaround of legal work may mean that keyboarding ability is becoming an increasingly important competitive edge. Does this trend mean that lawyer keyboarding eventually will become the standard operating procedure?

Fourteen respondents answered "other" for the drafting method. All of these respondents use variations on the other categories. One worth noting from a technology standpoint is the use of voice recognition software to dictate and have the computer automatically convert the dictation to a typed document. Three respondents use such software, indicating the failure of voice recognition software to gain wide acceptance.

It is interesting to view the differences in drafting approach used by the size category of the legal organization. In every size category, at least 90% of the lawyers mark up previously drafted documents. One hundred percent of respondents from organizations with more than 100 lawyers use this method, and nearly 100% of such respondents mark up standard forms. Also, in a couple of categories (9 to 14 and 51 to 100 lawyers) the percentage marking up standard forms falls slightly below 90%. The category with the largest use of the "start-from-scratch" method is 5 to 8 lawyers at 92%, and the category with the smallest percentage is organizations with more than 1,000 lawyers at 73%. By a large margin, the smallest use of dictation is by solo practitioners at 22% and the largest use, again by a wide margin, is organizations with 500 to 1,000 lawyers at 89%. Interestingly, if there are more than 1,000 lawyers, the percentage drops to 55%.

The organizations using automated templates the most are those having 150 to 300 lawyers at 58%, followed by solo practitioners at 55%. The lowest use of automated templates is by the category with 500 to 1,000 lawyers at 22% (although the organizations of more than 1,000 lawyers are at 46%).

The balance of the survey questions and additional cross tabulations will be discussed in the November/December "Technology—Probate" column. ■

Andrew O. Alcala

An attorney drafting an irrevocable life insurance trust (ILIT) is like an artist crafting a landscape painting. There are two primary aspects to each activity: the design and the execution. In the design phase, the attorney or artist plans the work, deciding what elements to use and where to place them. In the execution phase, the attorney or artist must draw on skills that have been honed through use of specialized knowledge and experience to place the raw elements to achieve the right result. Drafting a flexible ILIT is both an art and a craft. This article looks at trust design features that recognize the changing needs of the trust grantor or beneficiary and provides some sample language to assist the attorney with the drafting.

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Elements of a Typical Irrevocable Life Insurance Trust

In designing an ILIT, an attorney makes use of an array of elements, including the following:

- the identity of the settlor (grantor) and the trustee;
- a statement of the trust's irrevocability;
- administrative and dispositive provisions, including the identity of the beneficiaries during the lifetime of the grantor and after the grantor's death;
- beneficiary withdrawal powers to provide for present interest gifts and other powers of appointment;
- powers of the trustee;
- trustee's powers relating to life insurance;
- provisions for compensating the trustee and appointing a successor;
- directions for administering the trust and accounting for and safeguarding trust assets;
- miscellaneous provisions relat-

Drafting Flexibility into an Irrevocable Life Insurance Trust

By Richard C. Baier

ing to trust construction, applicable state law, binding agreement, or other important items; and
- proper execution of the trust document under applicable state law, including the dating of the trust and signatures of the parties and witnesses.

Advantages and Disadvantages of Irrevocability

An irrevocable trust cannot be terminated or amended in any way by the grantor who creates the trust. The grantor's inability to alter the trust to adapt to changing circumstances makes the disadvantages of such a trust obvious. Death or disability of a beneficiary, divorce, births of children or grandchildren, changing needs of family members, or changes in the law can create a need to change or terminate the trust. An attorney often can anticipate and specifically provide for some of these circumstances in the trust document. It would be impossible, however, to anticipate every event or circumstance that could occur. For that reason, the trust provisions often give someone other than the grantor the power to change the terms or beneficiaries of the trust.

A person often creates an irrevocable trust to achieve transfer tax advantages. By giving up ownership and control of certain assets, the grantor's gross estate for estate or generation-skipping tax purposes will not include those assets. Transfer taxes include gift, estate, and generation-skipping taxes, which in combination could consume over half a person's gross estate.

Trust Design Tools

Design tools that can provide flexibility in an ILIT include (1) general and special powers of appointment, (2) distributions or withdrawals within the scope of a specified ascertainable standard, and (3) administrative powers in the trustee: for example, the powers to merge similar trusts, make transfers between trusts for the same beneficiaries, determine the definition of trust income, adjust the distribution of principal and income among beneficiaries, and appoint additional beneficiaries from a specified class. In addition, the trust document can grant the power to replace the trustee with a person who is not related or subordinate to the grantor. See Rev. Rul. 95–58. Finally, appointing a trust protector and making the trust a grantor trust for income tax purposes also increase trust flexibility.

Powers of Appointment

A power of appointment in an irrevocable trust enables the holder of the power to transfer property from the trust to another person or, depending on the nature of the power, to himself or herself. Basically, there are two types of powers of appointment: general powers and special (or limited) powers.

General Power of Appointment

A general power of appointment allows the power holder to transfer property to certain people or trusts. The holder of a general power of appointment may appoint the trust property to another person, to the power holder himself or herself, to his or her estate, or to the creditors of either. Property subject to a general power of appointment is includable in the power holder's gross estate for federal estate tax purposes. For that reason, the grantor of an ILIT cannot retain a general power of appointment and remove the underlying insurance policy from the grantor's estate.

ILITs, however, commonly grant a general power of appointment to individuals other than the grantor. Most ILITs include *Crummey* withdrawal powers to ensure that gifts to the trust qualify for the gift tax annual exclusion. *Crummey* powers are simply general powers of appointment that partially or wholly lapse within a specified time period.

The lapse of a *Crummey* withdrawal power in excess of the greater of $5,000 or 5% of the trust assets can cause the power holder to be treated as having made a transfer to the trust for tax purposes. Code § 2514(e). To prevent a lapse of a general power in excess of the so-called five-and-five limits of Code § 2514(e), many planners use a "hanging" power. With a hanging power, the excess amount does not lapse; rather, the power holder maintains a continuing right to exercise the general power of appointment over the excess amount. If the life insurance policy in the ILIT reaches a point at which no more premiums are due and no further contributions are made to the trust, the "hanging" amount can begin to lapse at the greater of $5,000 or 5% of the trust assets subject to the power until no amount is left hanging.

Special Power of Appointment

A special (also called a limited) power of appointment allows the power holder to transfer certain property to another person, but not to himself or herself, his or her estate, or creditors of either. A non-grantor spouse can hold a limited power of appointment to alter the beneficial interests of the children.

Some planners use limited powers of appointment in lieu of a hanging

power to prevent the lapse of a *Crummey* withdrawal power in excess of the greater of $5,000 or 5%. Because the amount in excess of the greater of $5,000 or 5% does not lapse but is subject to a limited power of appointment, there is no deemed transfer to the other beneficiaries.

Spousal Access Limited to Ascertainable Standard

Sometimes a grantor would like to have indirect access to trust assets during his or her lifetime. A planner can accomplish this by giving the trustee the discretionary power to make distributions to the grantor's spouse for the spouse's health, education, maintenance, and support. Because the distributions are

limited to an ascertainable standard, the power should not cause inclusion in the grantor's or the grantor's spouse's estate. To make sure that transfers to the trust are excluded from the grantor's estate, the trust document should not relieve the grantor of any support obligations imposed by law. Following is sample language that can be used for this purpose.

> Until the death of the Grantor's Spouse, in addition to any power of withdrawal or appointment that may be exercised by the Grantor's Spouse herein, the Trustee shall pay to or use for the benefit of the Spouse any Trust income or principal as is appropriate to provide for the Spouse's health, education, maintenance, and support in the Spouse's accustomed manner of living. In making payments of income or principal, the Trustee shall take into account other income and assets readily available to the Spouse. Without limiting the Trustee's discretion, it is the Grantor's primary intent in providing for the support and reasonable comfort of Grantor's Spouse for life. In exercising this power to use Trust principal to provide for the Grantor's Spouse under the ascertainable standard of health, education, maintenance, and support, the Trustee in no event shall relieve the Grantor from any support obligation imposed upon the Grantor by law.

Extract from Documents on Disk, InsMark, Inc.

Loans from the Trustee to the Grantor or Grantor's Spouse

Another way for the grantor to gain access to trust assets is through secured loans from the trustee. The grantor executes a note secured by property pledged by the grantor. The note accrues interest at a fair market rate at least equal to the appropriate applicable federal rate for the type of note and the term of the loan. The grantor's power to borrow using secured notes at fair market interest rates is similar to the right to substitute property of equal value. See *Estate of Jordahl v. Commissioner,* 65 T.C. 92 (1975), acq. 1977–2 C.B. 1. Following is language that can be used in the trust document to provide for such a secured loan feature.

> Upon the pledging of property of equal value for security, the Grantor or the Grantor's spouse may, at the Trustee's discretion, obtain loans from the Trustee. Such loans shall be paid back to the Trustee upon the Trustee's demand. These loans shall charge interest annually equal to the applicable federal short-term blended interest rate in effect on the date the demand note is executed and revised annually on the anniversary date of the note. The Trustee is not required to make a loan requested by the Grantor or the Grantor's spouse if, in the Trustee's sole discretion, the making of such loan would jeopardize the ability of any insurance policy owned by the Trust to remain in force until the policy's maturity date. The demand note may provide that interest be paid annually or added to the principal of the loan to be paid by the Grantor's estate at the death of the Grantor.

Extract from Documents on Disk, InsMark, Inc.

When the grantor dies, the cumulative loan and accrued interest are paid back to the trust from the grantor's estate. The loan and accrued interest payment should be deductible from the insured's gross estate as a bona fide debt. The effect of this deductible loan and accrued interest payment is to transfer a substantial portion of the decedent's estate to the trust free from transfer tax.

Trust Protector

To add even further flexibility, a trust instrument can name an independent party to act as the "trust protector." A trust protector holds wide-ranging powers to alter the terms of the trust agreement, sometimes including the power to add, remove, or change beneficiaries or change the distributive provisions of the trust. This person can, for example, hold a limited power of appointment to move assets from one trust to another. Following is sample language that when applicable to an independent, nonsubordinate person can allow the moving of assets from one trust to another, regardless of who the new beneficiary is.

> During the lifetime of the Grantor(s) of this Trust, [NAME OF LIMITED POWER HOLDER] shall have a limited power to appoint Trust assets as follows: the limited power holder (hereinafter, "LP") shall have the right at any time to transfer all or a portion of Trust assets, including any policy or policies of insurance, to a successor trust. LP is specifically precluded from naming

any of the following as beneficiaries of said successor trust: LP, creditors of LP, heirs of LP, creditors of heirs of LP, the estate of LP, or creditors of the estate of LP.

Extract from Documents on Disk, InsMark, Inc.

Although naming a trust protector can give a planner significant flexibility, it also has its drawbacks. The grantor must trust completely the judgment of the individual appointed as the trust protector. Otherwise, the trust protector potentially may exercise his or her powers to frustrate the grantor's intent as expressed in the trust agreement.

Increased Flexibility with a Grantor Trust

Most ILITs qualify as "intentionally defective grantor trusts." An intentionally defective grantor trust is a grantor trust for income tax purposes, but a transfer to such a trust is a completed transfer for estate and gift tax purposes. Planners can use this dual status to increase flexibility and effectiveness.

Essentially, the IRS ignores a grantor trust for income tax purposes. The grantor reports the income from a grantor trust on his or her personal return, instead of on the return of the trust or its beneficiary. If an ILIT holds income-producing property, trust income can be used to pay premiums on the insurance policy. Even though the trust uses the income to pay premiums, the trust income is taxed to the grantor. This has the effect of transferring an amount equal to the income tax from the grantor to the beneficiaries of the trust without having to treat transfers as a gift for gift tax purposes.

Because the grantor and his or her grantor trust are treated as the same person for income tax purposes, sales of appreciated property by the grantor to the trust do not create an income-taxable event. The sale of a life insurance policy to the trust for full and adequate consideration generally avoids the transfer for value rule and may be successful in avoiding application of the three-year rule for estate tax purposes. Code § 101(a)(2)(B). In PLR 200228019, the IRS ruled that no transfer for value occurred when one grantor trust sold a life insurance policy to another grantor trust for full and adequate consideration. See also Code § 2035(d). Thus, if the beneficiary's circumstances change, a trustee could sell a policy from an obsolete ILIT to a new ILIT with updated terms. A grantor trust may also allow the grantor not to recognize loan interest payments between the trust and grantor for income tax purposes.

An irrevocable life insurance trust agreement can be a grantor trust for income tax purposes but not give the grantor powers that will cause assets in the trust to be included in the grantor's estate for federal estate tax purposes.

Most grantor trust powers, if retained by the grantor personally, would cause the trust assets to be included in the grantor's estate for estate tax purposes. Certain powers, however, that create a grantor trust for income tax purposes do not simultaneously cause inclusion of trust assets in the grantor's estate. These powers are most frequently used in life insurance trust planning.

Most ILITs qualify as grantor trusts, at least in part, because the trustee has the power, without the permission of an adverse party, to use trust income to pay premiums on an insurance policy on the life of the grantor or the grantor's spouse. Code § 677(a)(3). Another power that is often used to create an intentionally defective grantor trust is the power in a nonadverse party to add trust beneficiaries. Code § 674. As with naming a trust protector, giving another person the power to expand the trust beneficiary class can defeat the purposes for which the trust was created. To create an intentionally defective grantor trust, some planners give the grantor the power to remove assets from the trust and replace those assets with other assets of equivalent value. Code § 675(4)(C). The power to substitute assets of equal value, however, could be considered an incident of ownership in a policy on the grantor's life when the policy is the only asset in the trust. If such a power were construed to be an incident of ownership in the policy, then the power would cause the policy's proceeds to be included in the grantor's gross estate. Code § 2042.

A grantor trust is often used in conjunction with certain "split dollar" agreements. Generally, a split dollar is an arrangement in which the owner of a life insurance policy (here, the ILIT) and a third party agree to split the responsibility for premium payments and the right to receive proceeds from the policy. If the grantor is party to a split-dollar arrangement that is characterized as a loan transaction, grantor trust status can alleviate some adverse income tax issues. Loan interest payments made by the trust to the grantor/insured are not income to the grantor. The grantor generally would have to either make a gift equal to the loan interest to the trust or make a deemed gift of the loan interest amount to the trust. Loans to a grantor trust can enable the ILIT to purchase comparatively large amounts of insurance on the grantor's life with the grantor having to recognize gift transfers of only the loan interest and not the entire premium.

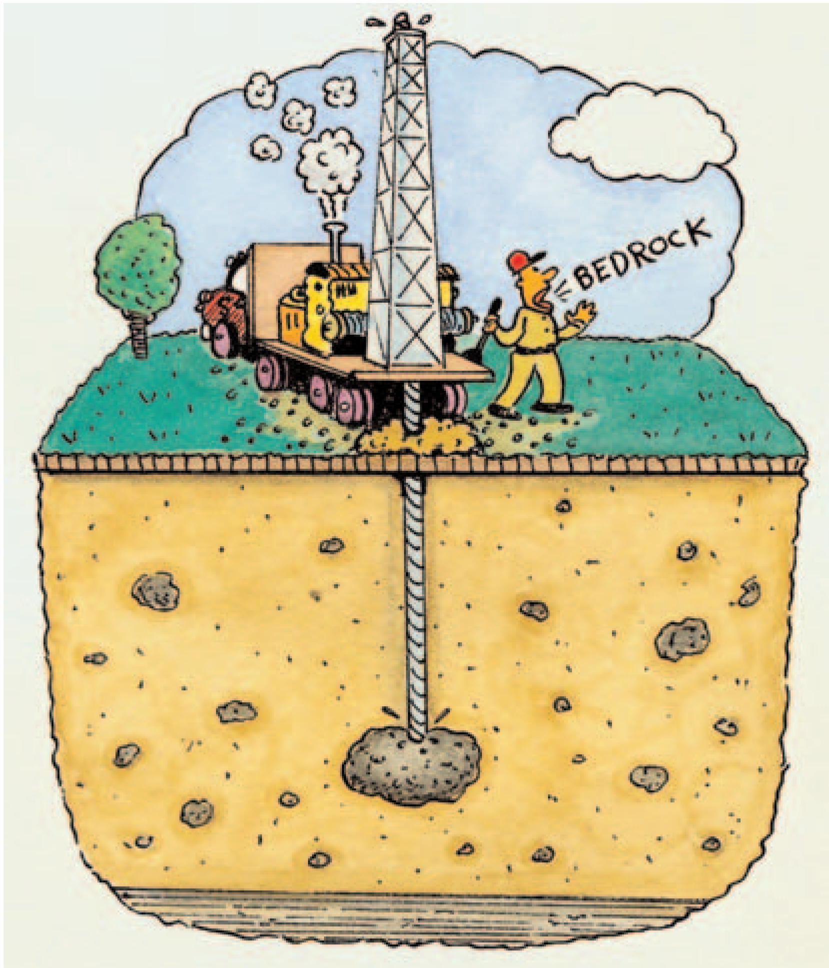
Summary

The constantly changing tax environment in which legal advisors live compels them to craft estate planning documents that can adapt to that volatile environment as well as the ever-changing circumstances and needs of clients. An ILIT permits individuals to leverage their transfer tax exclusions, exemptions, and credits. If constructed properly, an ILIT will shield the life insurance proceeds from estate, gift, and generation-skipping transfer taxes and provide liquidity to the grantor/insured's estate. By making use of available planning tools and a measure of creativity, the legal draftsman can be both an inspired artist and able craftsman through designing and drafting a flexible, legal document that meets the needs of his or her client. ■

THIRD-PARTY TESTING AND INSPECTION

Understanding Its Place in Construction and Maximizing Its Use

By Susan Linden McGreevy and J. Colby Cox



Slug Signorino

On just about all commercial, industrial, or public construction projects, the design professionals include many backup and fail-safe mechanisms to protect their clients from anticipated problems: they overdesign the structure; they have designs peer-reviewed; they insist on reviewing shop drawings, submittals, and samples of items to be incorporated into the work; and they test, inspect, and observe the work and material as it is going in.

Nevertheless, despite all these (and probably more) precautions—all of which the owner pays for—there are still enough lawsuits and arbitrations over construction defects to justify the continued existence of a flourishing construction litigation bar. Drafters of construction contracts are generally very good at clearly assigning responsibility for problems, but shouldn't the focus be on finding more ways to avoid creating problems in the first place?

One area where more thought, consideration, and attention might pay off is in drafting contract provisions on construction testing and inspection. Too often, an owner pays for testing or observation of work during construction, yet deficient work or defective material gets incorporated into the project anyway. In nearly every case, the problem could have been *significantly* reduced had it been addressed and dealt with at the time it was observed. Some real-life examples:

- A corporation building a new office complex hires a testing firm to observe pier drilling to assure that the penetration depth of the bedrock called for in the design documents is reached. An inexperienced technician mistakes large underground boulders for bedrock. (Although the same firm was responsible for observing excavation and backfill, different technicians did the work.) The late-discovered problem causes the owner to refuse to occupy any buildings for more than a year and to spend $1 million on consultants and repairs. The owner sues everyone and wins a judgment against the testing firm, which promptly files for bankruptcy. Legal fees for all parties involved exceed $1.5 million.
- A municipality builds a pool complex with a concrete wading area. The first and third of 10 loads of concrete are tested, but the results, which show

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inadequate air entrainment, are not reported to the construction manager until five loads are already placed. The concrete plant agrees to add more air to the remaining batches. The parties proceed, with no further testing of any concrete. One month later, just before the scheduled grand opening, the structural engineer issues a report to the owner advising that he just learned of the problem and recommends that the entire pool and all embedded piping be ripped out. The report is given to the press by an up-and-coming city council member.

- A school district builds a new school. The contract required a flooring subcontractor to hire a firm to test the concrete to ensure it has cured sufficiently to allow flooring to be installed. Later, the flooring delaminates because of excess moisture underneath. The flooring subcontractor is out of business. Because no records were required, nor received, for the test results, the general contractor must now defend the fitness of the flooring subcontractor's work without the evidence to prove it.
- A highway department builds an expressway through the inner city, taking homes by eminent domain as deemed necessary to accommodate construction. The contractor cuts and banks steep shoulders and blasts to remove rock. Eight years later (by which time the surety bond has expired), several hundred inner-city property owners sue the highway department for blasting and soil subsidence damage to their properties. The highway department joins the contractor in the lawsuit as a third party. Records of the vibration effects of blasting were kept for only five years and are now gone, and the embankment work was "observed" but not tested.

THE CONTRACT BETWEEN THE PARTIES WILL BE THE STARTING POINT FOR DETERMINING THE INSPECTOR'S DUTIES AND OBLIGATIONS.

Liability of Various Parties When Tested/Inspected Work Later Fails

In each of the above situations, the owner paid for the "fail-safe" mechanism of a testing/inspection firm, yet suffered the damage anyway. Who is responsible when this happens? Without question, each of the parties points the finger at someone else and denies liability. How does a third-party testing/inspection firm fit into this? What responsibility does a third-party testing/inspection firm have in situations in which defective work or material was not discovered until after everything is built? Is the testing/inspection firm liable only to the party that hired it or can someone else look to the testing/inspection firm to recover damages resulting from the testing/inspection firm's failure to identify the deficient work or defective material in a timely manner?

Very few cases specifically address the liability of third-party testing/inspection firms. Most decisions lump them in, and discuss their liability, with that of the project design professionals who are also required to "observe," "inspect," or "approve" the work. As with the design professionals, the testing/inspection firm's liability may be found in tort or contract. The first place to look, however, is the contract.

Testing and inspection may be required on a construction project by several mechanisms. The first, and most obvious, are the construction documents, which include the agreement, general conditions, supplemental conditions, specifications, plans, or other documents. Construction documents typically require the owner, the owner's representative, the architect, or the engineer to "approve," become "generally" familiar with, "guard against defects," and determine that the work is being completed in accordance with the contract documents. These obligations may be included in the contract between the owner and the design professional of record or a third-party inspection firm and also may be included in the contract with

the general contractor. Building codes, regulations, and other standards may require testing and inspection and may impose the responsibility for performing detailed full-time inspections for work critical to structural integrity.

Third-Party Testing/Inspection Firm's Liability to the Entity That Hired It

The contract between the parties will be the starting point for determining the inspector's duties and obligations. It is important to know and understand the testing/inspection firm's obligations under its contract, to include the appropriate level of involvement in writing, and to ensure that the firm complies with those requirements. For example, if the qualifications of the inspector to be hired are specified, the owner is entitled to get at least those qualifications.

- An engineering firm was determined to have breached its contract because the "resident engineer" had an educational background that included high school, two years of veterinary medicine, and some correspondence courses, but was not a licensed engineer and had been employed for only six months as a resident engineer and worked on only one other job. The testing laboratory also was found to have breached its contract with the owner in failing to provide adequate and experienced personnel and failing to make sufficient tests of construction materials. The inexperience of the resident engineer and the incomplete reports from the testing laboratory were found to have contributed substantially to the poor workmanship and construction that occurred on the project. *Town of Winnsboro v. Barnard & Burk, Inc.*, 294 So. 2d 867 (La. Ct. App. 1974).

Testing/inspection firms, like design professionals, are under a duty, implied in the contract as a matter of law, to exercise reasonable care in providing their services. Failing to use reasonable care can result in liability, even if the firm has technically complied with its contract.

TESTING/INSPECTION FIRMS ARE UNDER A DUTY, IMPLIED IN THE CONTRACT AS A MATTER OF LAW, TO EXERCISE REASONABLE CARE IN PROVIDING THEIR SERVICES.

- An inspection firm, hired by a subcontractor to provide rebar inspection and cylinder testing, failed to ensure that the rebar was in conformity with the plans. That failure resulted in cracks in the walls and the subcontractor's consequent liability to the building owner. The inspector's failure to determine that the rebar did not meet specifications was not a breach of a specific term of the contract, which only required the inspector to "observe" the work to be certain it conformed to the design drawings and specifications. But it was a breach of the duty to use reasonable care in the performance of the contract when the inspector did not take exact measurements of the rebar placement, which is typically done in this situation. *G.W. Constr. Corp. v. Prof'l Serv. Indust., Inc.*, 853 P.2d 484, 487–88 (Wash. Ct. App. 1993).

Liability of Third-Party Testing/Inspection Firm to Entities with Whom It Did Not Contract

Even if no contractual relationship exists between the testing/inspection firm and the claimant seeking recovery—typically the contractor who has to tear out a lot of work and pay damages to the owner—a question of duty that can lead to tort liability nevertheless arises. A duty to third parties can be established in three ways:

- third-party beneficiary to the contract between the inspector and the owner,
- common-law duty owed by inspector, and
- statutory duty owed by the inspector (for example, Uniform Building Code, among others).

In reality, these theories are rarely pursued. If the subcontractor responsible for performing the defective work is still in business and financially substantial (or, better yet, had a performance bond), its proximate causation of the damage makes it the easiest target. It is difficult to dispute the inspection firm's argument that the *true* cause of the damage associated with the defective work was the subcontractor's deficient work or supplier's defective material.

- A concrete supplier was terminated after a testing agency determined that concrete supplied for a school project failed to meet specifications. Subsequent testing revealed that the initial tests were wrong and the concrete did, in fact, meet the specifications. The court threw out the supplier's case against the testing firm, finding that the testing firm's statements were not the proximate cause of the damage associated with the termination. The

testing company did not recommend that the contractor quit using the supplier but instead recommended that the concrete pouring continue under careful scrutiny. *Century Ready-Mix Co. v. Campbell County Sch. Dist.*, 816 P.2d 795, 802 (Wyo. 1991).

A third-party claimant may be barred contractually, however, under the economic loss rule.

- A subcontractor claimed that an inspector negligently inspected painting and negligently misrepresented to the subcontractor how and where to apply the paint, which resulted in additional expense and delays when the subcontractor was later required to redo its work. The economic loss rule was said to bar the subcontractor's negligence claims against the inspection firm even though the subcontractor did not directly contract with the firm. The court held that the contract documents clearly limited the responsibility of the inspector and that those documents had been incorporated into the subcontract. The subcontractor was aware of them and had the opportunity to allocate the risks that might arise from such contracts. *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66, 73–75 (Colo. 2004).

Owner's Liability to Contractor

The owner's observation of the work by its third-party inspector may place an obligation on the owner to notify the contractor on a timely basis of any work deemed nonconforming as part of the owner's duty to mitigate its damage. Most contracts temper this obligation by including provisions that observations by the owner or its representatives are for the owner's benefit only and do not relieve the contractor of its responsibilities to furnish conforming work. But an owner's unprotesting observation or inspection of nonconforming work may, over time, constitute a practical interpretation of the contract by "course of dealing," or a waiver of the contract specifications. For example, a federal claims court has held:

> A contractor also can use the government's unprotesting observation or acceptance of a noncontractual performance to demonstrate that the government has waived a contract requirement. Professor John Cibinic has named this argument the "constructive waiver of specifications." . . . A constructive waiver of specifications occurs . . . where the government "has administered an initially unambiguous contract in such a way as to give a reasonably intelligent and alert opposite party the impression that a contract requirement has been suspended or waived."

Hannon Elec. Co. v. United States, 31 Fed. Cl. 135, 147 (1994) (citations omitted).

Extensive involvement and control over determining conformance and quality of materials used in construction by the owner or its inspection representative may shift the liability for nonconformance or inadequate construction on to the owner. *C. J. Langenfelder & Son, Inc. v. Commonwealth, Dep't of Transp.*, 404 A.2d 745, 751 (Pa. Commw. Ct. 1979) (holding that when the owner exercised detailed inspection and control rights in approving the contractor's concrete mix design, inspecting the batch plant, inspecting the ingredients before mixing, and testing the concrete before placement, the owner was responsible when the concrete was found to be defective).

Contractor Still Under Obligation to Inspect Work

Generally, the contract gives the owner the right, but not the obligation, to inspect the contractor's work, unless required by contract, statute, or building code. Even under these obligations, failure by the owner to inspect is seldom sufficient to relieve the contractor of its responsibilities to perform the work under the construction documents. *Town of Winnsboro,* 294 So. 2d at 875 (holding that "[t]he fact that an owner has an engineer and testing laboratory on

the job does not relieve a contractor of the contractor's duty to perform the work in a workmanlike manner in accordance with the plans and specifications"; the failure during the progress of work to discover or reject defective work is not to be considered an acceptance of the work or a waiver of defects).

How to Avoid These Legal Issues Through Drafting and Negotiating Contracts

In each of the examples discussed above, the owner might have avoided loss, inconvenience, and attorney's fees had it considered in advance its needs and risk exposure and incorporated into the contract documents the rules it wanted followed. Before that drafting can effectively protect the owner, however, a lot of questions need to be asked and discussions need to take place.

What Testing/Inspection Is Appropriate for the Project?

Frequently, this decision is left up to the designers, who have their own ideas, assumptions, motives, and "canned" specifications they routinely use. These may or may not be appropriate for the specific project. Not every project justifies the same level of scrutiny. Questions that need to be raised may include:

- What is the intended use of the project?
- Who are the expected tenants/users?
- What is the expected useful life?
- Are there aspects of the design that are unique or challenging?
- What testing and/or inspection is generally required for that particular locale?
- What requirements for testing and/or inspection are generally required by local or industry standards or codes?
- What are the lender's requirements for testing and/or inspection?
- How often has the design been used previously in similar climates, geologic conditions, or use applications?
- What specific aspect of the construction would expose all parties to the greatest liability?
- What input from the owner's lender, designer, contractor, insurer, surety, and other risk management consultants would help the owner come up with the appropriate level of testing and inspection for the project?

Who Should Hire the Testing/Inspection Firm(s)?

There is no clear consensus on who should, or in practice does, hire the testing or inspection firm, in part because of the variety of contract forms for the various delivery systems in use today. When a *construction manager* or a *design-builder* is involved, for example, it is often assumed that these firms should oversee this aspect of the project. When the owner is a *governmental entity,* it may be required to use its own engineering department for this purpose. When the owner is *a large development company,* it may prefer to use its in-house staff. Often, the contract requires the *contractor* to hire the "independent" testing firm. Whoever is required to hire the third-party inspection or testing firm, it is imperative to understand the significance of the legal relationship between the two.

- To whom is the testing firm ultimately responsible or liable?
- What are the firm's roles, responsibilities, and limitations on the project?
- Whom is the firm required to notify of defective work or material?
- Does the firm have the authority to reject the material or stop the work?
- Who is authorized to tell the firm that the inspector or technician is not qualified and needs to be replaced?
- Who can order more testing, on the spot?
- Will the firm share in the liability if defective work or material is not discovered until later?

All these questions and more should be explored in advance when there is time to think them through. Once discussed, the roles and responsibilities should be memorialized in the contract between the parties and referenced in the contracts with the other critical parties involved in the construction, so that everyone is clear about what is expected of each one.

To Whom Will the Testing/Inspection Firm Report, and in What Form?

Although the testing/inspection firm normally reports its results to the entity that hired it, it will generally agree to inform others if requested to do so. For obvious reasons, the initial reports are normally verbal (or perhaps now, electronic), with formal reports issued later. A formal written report often includes a lot more detailed information that might change the mind of a design professional when it is finally reviewed. Because in almost no other industry is the adage "time is money" more true than construction, it is important that the testing/inspection firm understand what *depth of information* is required, *when it is required,* and *to whom it should be sent.* Getting the information to all relevant parties in time for them to give input or take action with the least effect on the progress of the project and the work of others is the goal here. If the design professional or owner's representative who specified the requirements feels that he needs more information than the testing/inspection firm "typically" gives, it may be possible to negotiate for more detail.

Who Determines the Specific Testing/Inspection Protocol?

The more the attorney gets into this subject, the more he or she will see how many decisions have to be made about what is to be done. Left unaddressed, these decisions end up

getting made by default. Because the client's money is at stake, the attorney will want to force the parties to talk about these decisions and make the best ones for the project:

- Is every pier drill to be observed, and, if so, does the pier drilling subcontractor know this when planning his crews?
- Will multiple observers be necessary to keep up with the schedule?
- How many loads of concrete will be tested, and must the contractor wait until the test results are reported back as "okay" to unload the truck?
- To whom does the testing/inspection personnel report their findings, and is that person on-site or in some other way available? It does little good for the results to be relayed after the work in question is buried or—literally—set in concrete.
- If one random test/inspection shows a deficiency, does the intensity of inspection increase thereafter?
- Who pays for the extra inspections and the effects of delay, if any, on other work?

Does It Matter If "Observation," "Inspection," or Some Other Term Is Used in the Documents?

Although these terms sound very similar to the average person, attorneys know that they all can have significant legal differences. How many times has a contractor been heard to say about its defectively installed work that "the [owner/CM/architect/engineer/testing firm] was there watching and never said a thing"? Given the frenetic pace at which most construction moves, it is, obviously, in everyone's best interests for this "visitor" to speak up immediately if there is any question about the correctness of the work, rather than just take notes and go back to his or her office and prepare a report. What is the point of paying someone to be on-site if that person will not be responsible for even living up to a negligence standard for catching errors?

Although the owner's counsel should fight tooth and nail to get accountability, many consulting firms will refuse to commit to anything more than "observation" and "best efforts." They will say that their professional liability insurance will not allow them to do so. If this is the case, and another acceptable firm cannot be found to take on meaningful responsibility, then the owner needs to be aware of this fact and determine whether this is enough protection. It may want to add another step or two to the process to make up for this gap.

FAILURE BY THE OWNER TO INSPECT IS SELDOM SUFFICIENT TO RELIEVE THE CONTRACTOR OF ITS RESPONSIBILITIES TO PERFORM THE WORK UNDER THE CONSTRUCTION DOCUMENTS.

What Are the Qualifications of the People Doing the Testing/Inspection?

Every owner or developer is cost-conscious, and it makes no sense to pay a professional engineer to perform slump tests when a technician can do it at a fraction of the cost. Yet some parts of the work may be so structurally crucial that it is worth the time and cost to insist that the people who designed it must, themselves, be present for testing/inspection. Even when the presence of the designer of record is not justified, should a professional engineer from the testing/inspection firm be required for some specific items? Not all technicians have the same level of experience and expertise. Would a technician from a temp firm with only three days with the testing firm be appropriate for the job (as was the case in the corporate office complex mentioned above)? Should the minimum qualifications of the on-site people be specified in the contract with the testing/inspection firm? (And there *is* a written contract with the firm, isn't there?)

Who Is Authorized, and Who Is Required, to Stop Work?

It is sometimes amusing (although not when it is your problem) to observe how otherwise assertive people shrink from the prospect of being responsible for making a decision that has risk and money associated with it. It also appears to be one of those natural laws that the more people involved in supervising a project, the less any of them is responsible for its supervision. Among the owner's on-site representative, the construction manager, the structural engineer, and the general contractor, who decides whether to stop the work? It is crucial that the issue be raised and clarified (in writing) in advance. An owner—who is, after all, paying for the pres-

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ence and expertise of all these folks—is not well served by an "it's not my job" discussion on a jobsite. The hour or day consumed with making the right decision easily offsets the damage done by allowing improper construction to proceed.

What Is the Involvement of the Designer of Record, and When?

Architects and engineers of record typically are not on-site all the time, or even a significant part of the time. As noted above, in specific situations it may be prudent to require that person, or firm, to observe or even participate in the testing/inspection. More often, when this is not justified, the designer still will be advised of the test results—but when? There has to be an agreement that any negative or questionable results be reported to the appropriate persons *in time to do something about it* with the least effect on progress. If this means arranging to have the engineer available in his office or by cell phone from his daughter's soccer game, it can probably be accomplished *if* it is set up in advance.

Is There Professional Liability Insurance or a Surety Bond to Back Up the Responsible Party?

All the parties discussed in this article have the ability to adversely affect the entire job. Drafting documents that establish their liability for damages is not difficult. Judgments and awards against defunct firms are, literally, a dime a dozen, however, so it is important to explore the limits and coverage of professional liability insurance on the part of the designers and other professionals involved. Similarly, a properly drafted performance bond covering the work itself will provide another layer of assurance that there is recourse in the event of a failure to perform on the part of the contractor.

How Should Results Be Memorialized, and How Long Should Records Be Kept?

In two of the examples listed above, records of tests were not available when a problem later arose over the work. Asking that a copy of all test/inspection results be sent to the critical parties involved (owner, construction manager, architect, engineer, general contractor, among others)—without regard for who hired the testing/inspection firm—will allow all parties involved to be in a position to protect themselves and to minimize mistakes. A record retention policy should be established for the client, and record retention should be required in the contracts with others.

How Much Money Should Be Included in the Construction Budget for Testing and Inspection?

A construction budget is an endless series of trade-offs. If money and time were no object, professional engineers would be supervising compaction of every lift of soil and the torquing of every bolt. In the real world, that kind of supervision is almost never cost-effective or even necessary. But inspection funding should be more than an afterthought, not added at a time when nearly all of, and sometimes in excess of, the construction funds have already been committed. If the subject is raised early in the development process, then adequate funds have a better chance of being allocated for the testing/inspection of the project. Again, remember that the intent here is to spend pennies now for testing and inspection to save dollars later that would be involved in ripping out and repairing defective work (and to avoid the effect on the business in the process).

Conclusion

None of this is rocket science or brain surgery. It is common sense. Although it will take some forethought and conversation, and may ask more of the parties than they are typically used to, the customer who is hiring all these parties should be permitted to bring them all around or replace them on the team up front. ■

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