ABA Section of Real Property | Trust & Estate Law

eReport

A Bi-Monthly Electronic Publication for Section Members October 2008

Section News

Group and Committee Conference Call Schedule Now Posted on the RPTE Home Page
Do you want to know when your group or committee is having its next conference call? The schedule is now posted on the RPTE Section home page. If you are a group or committee chair or vice-chair and would like to promote your conference calls to the Section, email Bunny Lee at leeb@staff.abanet.org.

Joint Fall CLE Meeting in San Francisco a Success
If you were not able to attend the Joint Fall CLE Meeting or would like a recap of the CLE materials from it, the materials are now available online. To view the materials, click here. To find out more about the Joint Fall CLE Meeting, click here.

RPTE Hosts Commercial Lending CLE Program
The CLE program "Can the Federal Bailout Catch a Falling Star?" was held in Atlanta on October 7, 2008. For a summary of the program, click here.

Equal Access to Justice for Person with Disabilities and the Elderly
Mark Your Calendars for the "Providing Persons with Disabilities and the Elderly with Equal Access to Justice" CLE program, December 5, 2008. Click here for more details.

Real Property News Trust and Estate News

Trust and Estate News

Advance Care Directives: Florida, Italy and the Holy Grail of Wishes
Donald Carroll and Christine Marciasini

Bianca Gross v. Commissioner

Technology and Law Practice Management

Social Networking Sites
David J. Bilinsky

Social networking sites are no longer just for teenagers. David Bilinsky reviews several social networking sites and offers tips on how lawyers may use them in their practices.

CLE Spotlight

TRUST AND ESTATE CLE
The Educated Use of 529 Accounts: Opportunities, Risks, and Complexities
(with Susan T. Bart and Christopher E. Houston)
Teleconference/Webcast
Date: Tuesday November 11, 2008
Time: 12:00 p.m. to 1:30 p.m. Central

REAL PROPERTY CLE
Danger, Will Robinson: Introduction to Securitized Lending
(with William G. Rothschild and Michelle A. Valteau)
Teleconference/Webcast
Date: Thursday, November 6, 2008
Time: 12:00 p.m. to 2:00 pm Central

Group & Committee News

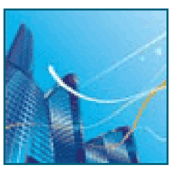
TRUST AND ESTATE
Elder Law, Disability Planning and Bioethics Group
The RPTE Section and the American Bar Association Commission on Law and Aging are pleased to announce the 2009 ABA Enterprise Fund Emeritus Attorney Pro Bono Indigent Guardianship Project. Click here for more information.

Steve Akers

[**Annual Exclusion for Gifts, and Internal Revenue Code §2032A and §2523 Adjustments Made**]
Jim Roberts

Certiorari in *Jelke* Denied: Simplicity in Valuation
Jim Roberts

The Uniform Principal and Income Act -- NCCUSL has amended Sections 409 and 505 of UPIA. The Section 409 amendment intends to satisfy the Rev. Rul 2006-26 marital deduction safe harbor for IRAs and defined contribution retirement plan accounts payable to marital deduction trusts. The Section 505 amendment clarifies the use of tax distributions from partnerships to mandatory income trusts to ensure that the trustee can pay the trust's income tax. The full text of the amendments is here and the full UPIA, as amended, is available here. See also, the Uniform Acts Committee website.



Real Property News

We're Not in Kansas Anymore: "Nomenclature Does Not Matter When the Mortgagee is a Mere "Nominee"
Kathleen Kraft
Kathleen Kraft reviews the district court decision in *Landmark National Bank v. Kesler*, where a second mortgagee and MERS sought to set aside a foreclosure by the first mortgagee on the grounds that the first mortgagee failed to name MERS as a party defendant.

Looking Down the Road: Estoppels, SDNAs, and other Lease Provisions That Can Make or Break a Sale
Scott W. Dibbs
This article, which is reprinted from *Probate & Property*, covers key issues in negotiating estoppel letters, SNDAs and other critical lease provisions. The article also includes form documents, redlined to reflect what might happen in a real negotiation, which did not appear in the original *Probate & Property* article.

Join a Committee Today!

RPTE members can join a group or committee (or several) online at www.abanet.org/rpte/join. For questions regarding membership, contact the Section at (312)988-5651 or email

REAL PROPERTY

Hospitality, Timesharing and Common Interest Development Group
On October 6, the Hospitality Group conducted its first Hot Topics conference call of the new bar year on the topic “Interstate Land Sales Train Wreck”. Group Vice-Chair Rob Freedman brought the participants up to date on some of the latest cases involving the Interstate Land Sales Act (ILSA) and its impact on common interest developments. Find out more here.

Partnerships and Limited Liability Companies Committee
The Delaware Court of Chancery recently issued its decision in *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, CA No. 3803-CC (Del. Ch. August 19, 2008), enforcing a waiver, contained in a limited liability company agreement, of a member’s right to petition for judicial dissolution and for appointment of a receiver. Learn more about the decision here.

Young Lawyers

Get Published in Your Field

A great benefit to being a member of the Young Lawyers Network is the chance to be published and gain visibility in your field. You could be chosen to write a column for the RPTE Section's flagship magazine, *Probate & Property* or the *eReport*. Click here for more information.

Law Students

Work-A-Day 2008

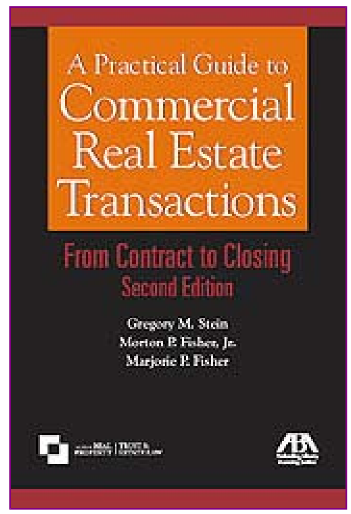
“Veterans' Advocacy: Serving Those Who Have Served Us”. This annual public service project brings together law students and law schools for a one-day public service project. For more details, click here.

Bunny Lee at leeb@staff.abanet.org.

Would you like to write an article for the eReport?

If you have something to say, and would like your article considered for the eReport, simply email Susan Talley, Editor, at stalley@stonepigman.com for further details.

New Book from RPTE



Practical Guide to Commercial Real Estate Transactions, Second Edition
Gregory M. Stein, Morton P. Fisher Jr. and Marjorie P. Fisher

For proven guidance and practical tips on handling a commercial real estate deal, turn to the newly revised and expanded edition of A Practical Guide to Commercial Real Estate Transactions. Logically organized to help you effectively negotiate and close the deal, this clearly written manual follows all of the steps of a transaction in the order in which they generally arise and offers the reader pertinent advice, practice comments, techniques, and sample forms. Several new form documents have been added to this edition and numerous text sections have been revised or added to address recent changes in law and practice. An accompanying CD-ROM contains forms and appendices.
Click here to learn more...

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- **PDF of Trust and Estate articles only**
- **PDF of Real Property articles only**

About RPTE eReport

The **RPTE eREPORT** is the bi-monthly electronic publication of the Real Property, Trust and Estate Law Section. It includes practical information for lawyers working in the real property and estate planning fields, together with news on Section activities and upcoming events. **RPTE eREPORT** also provides resources for young lawyers and law students to succeed in the practice of law. For further information on **RPTE eREPORT** or to submit an article for publication, please contact: Susan Talley (Editor) at stalley@stonepigman.com; Cheryl Kelly (Real Property Editor) at CKELLY@thompsoncoburn.com; Robert Steele (Trust and Estate Editor) at steele@whafh.com; or Michael Goler (Managing Editor Emeritus) at Goler@MillerGolerFaeges.com. We welcome your suggestions and submissions.

legal resource materials.

Section News Technology CLE Groups & Committees Young Lawyers Law Students

Advance Care Directives: Florida, Italy and the Holy Grail of Wishes

Donald Carroll and Christine Marciasini

Terri Schiavo and Eluana Englaro, two young women in persistent vegetative states, have riveted the respective attention of the U.S. and Italian public as their very personal and painful stories were broadcast to the world, while courts and legislatures in both countries have strained to define the conditions under which life sustaining medical measures may be terminated legally.

While the former case was U.S. based with Florida law applicable, the latter is taking place on Italian soil and adjudicated applying Italian law. The Schiavo case took eight years of litigation, while Englaro has racked up nine years of litigation and her case may just now be reaching resolution[1]. Different cultures and different legal systems – but these cases come together over the right of an individual to have a choice over his or her care – and to die with dignity.

One of the most interesting aspects of these cases is the way in which the courts have struggled to ascertain what health care Terri Schiavo or Eluana Englaro would have wanted, *implicitly* letting the public know through in their opinions how valuable it would have been to have had the patients' wishes on health care in writing.

Terri Schiavo

In 1990 Terri Schiavo, at the age of 27, collapsed in her home experiencing cardiac and respiratory arrest and was subsequently diagnosed to be in a persistent vegetative state with no expectation of recovery by her physicians. At the time Florida law provided - and continues to provide - for the use of an *Advance Care Directive* ("Directive")[2].

The absence of a Directive from Mrs. Schiavo was noted in the first petition filed on her behalf by her husband, Michael Schiavo in 1998. In that petition, Mr. Schiavo asked the Florida State District Court for authorization to discontinue artificial life support.

A bench trial was subsequently held by the Court in 2000 to consider Mr. Schiavo's petition which, given the lack of a "written instrument" from Mrs. Schiavo, sought to establish her wishes with respect to life prolonging measures, using other evidence.[3] The Florida court proceeded to wrestle with numerous testimonies in its efforts to determine whether, prior to Mrs. Schiavo's collapse 10 years earlier, there was "clear and convincing evidence" that she had made reliable oral declarations to the effect that if she had found herself in such a situation that she would have wanted her feeding tubes removed.

The court, relying on hearsay statements alleged to have been made by Mrs. Schiavo at varying times: after seeing her grandmother on life support, after watching a TV program concerning people on life support and after a movie on TV about a man in a coma, held that these statements rose to the level of clear and convincing evidence and granted the petition for authorization to discontinue life support. It took another 5 years of appeals and petitions before the court's decision for discontinuance was eventually carried out.

Eluana Englaro

Like Mrs. Schiavo, Eluana Englaro – who is known in Italy as the "Italian Terri Schiavo" - was determined at the age of 20 to be in a persistent vegetative state following an auto accident in 1992 which caused her to enter into an irreversible coma. Prior to the Italian Court of Cassation's[4] agreement to hear the case, her family had argued unsuccessfully seven times before various lower courts to have doctors remove her feeding tubes on the grounds that artificial feeding was futile medical therapy and that Ms. Englaro had manifested her will against such therapy.[5]

Importantly in the United States artificial feeding is generally viewed as a *medical treatment*. In Italy, on the other hand, there is still debate as to whether it is a *medical treatment* or *basic sustenance,* which is ethically due a patient[6]. The effects as to which side of the debate a court finds itself can be seen in the opinions of the Court of Appeals and the Court of Cassation in the Englaro case.

In 2006 the Milan Court of Appeals heard the sixth appeal on this matter. As the Court did not view artificial feeding and hydration as *medical treatment* but as *basic sustenance*, it dismissed the argument that artificial feeding was a form of futile medical care.

The Court did recognize that competent individuals have the right to refuse even indispensible health care[7]. It then distinguished this from the situation of an incapacitated individual whose wishes were unclear and who was only receiving *nutrition*, without which the patient would die. It noted that the irrevocable consequences of the suspension of artificial feeding must be taken into account as suspension would lead to death in a short period of time and would be tantamount to euthanasia[8] by "indirect omission"[9]. It reasoned that because of these consequences a balance had to be struck among the Constitutional rights to self-determination and personal dignity and the right to life[10].

The Court of Appeals in order to try to ascertain her wishes, then examined oral statements made by Ms. Englaro to the effect that she thought that a friend who had entered a coma after a car accident would have been better off if he had not survived, and testimony showing that she had manifested her conviction against life prolonging measures in a school discussion on the topic. Unsurprisingly, the Court of Appeals ultimately found that these statements were too general and could not be used to establish her wishes as they did not amount to a conscious decision arrived at on an informed basis. It noted that the comments were made in reference to the condition of another person, that they were made when she was very young and healthy and not living with an illness, that she was lacking in maturity with respect to the themes of life and death and that she could not have even imagined her present condition.

The total effect of the Milan Court of Appeals' words leads the reader to wonder whether perhaps Ms. Englaro would have needed to have expressed her wishes from the vantage point of actually being in a persistent vegetative state, which of course is an impossibility – a perfect *Catch-22*.

In the Court's view there was insufficient evidence as to her wishes and it held that Ms. Englaro had to be considered an incapacitated individual who had been silent as to her preference for medical care. Therefore, it could only achieve a balance among her constitutional rights by deciding "in favor of protecting her life", i.e., continuing artificial nutrition and hydration[11].

Ms. Englaro's family appealed the decision of the Milan Court of Appeals to the Court of Cassation, which accepted the appeal despite the opinion filed by the Court of Cassation's own solicitor general to reject the appeal on the basis that artificial feeding was not a *medical treatment*, but a form of *basic sustenance*. In its opinion the Court of Cassation makes clear its position by simply stating that artificial feeding is "without doubt[12]" a *medical treatment*.

As opposed to Florida, which has laws in place authorizing the use of advance care directives, Italy does not have any similar laws[13][14]. In view of the lack of legislation, the Court of Cassation reasoned that it still had a duty to protect the patient's rights within the parameters set by the constitution and thus in its holding of October 2007, it laid down a test for the type of proof necessary to allow for the discontinuance of *medical treatment*.

According to that decision, feeding may cease if:

1. The vegetative state is persistent and, according to internationally recognized scientific standards there is no medical basis to expect recovery of consciousness; and

2. It is clearly, unequivocally and convincingly shown that the patient, before losing consciousness, would have been against continuing treatment.[15]

The burden of proof set by this test is extremely high and requires court approval for the discontinuance of feeding- a process that leaves the door open to further litigation. Moreover, without legislation on point and the open debate as to whether artificial feeding is a *medical treatment* or *basic sustenance* the risk that court battles in situations similar to the Englaro case could still occur in Italy for the foreseeable future is high. It is questionable whether even the testimony in the Schiavo case would have met this burden of proof had that case been adjudicated in Italy.

Judicial "End Run"

In a case decided in May 2008, which seems to have been inspired by the Court of Cassation's holding in Englaro, a "guardianship judge"[16] in Modena, Italy used relatively new legislation[17] to devise a way around the legislative void on health care directives. This new legislation created a qualified guardian figure ("*amministratore di sostegno*") who, upon judicial appointment, may take decisions on behalf of an individual without the necessity for a court to declare an individual incompetent.

The case involved Vincenza Santoro Galano, a 70-year old woman hospitalized with end-stage Lou Gehrig's Disease. Upon admission to the hospital she indicated unequivocally that she did not want to undergo a tracheotomy to enable mechanical breathing when respiratory failure occurred. The issue before the guardianship judge however revolved around the fact that at the moment in which she would enter into respiratory arrest she would also be in a state that would render her incapacitated and unable to refuse life saving *medical treatment*. In all probability the medical staff would perform a tracheotomy to place her on mechanical ventilation to save her life. She therefore decided to petition the guardianship judge, with the backing of her family, asking the judge to provide "support […] so that once she became incapacitated someone could act on her behalf, in the denial of consent to that specific [tracheotomy] medical intervention".[18]

In rendering his decree, the judge focused on the woman's unequivocally expressed wish to not undergo the life prolonging medical therapy and devised a solution for carrying out that wish when she became incapacitated. By appointing her husband as her qualified guardian with the specific duty of denying consent to a tracheotomy the judge worked around the legislative void on Directives. The judge even went so far as to brazenly remark that the law which created the guardianship provides that the qualified guardian can be designated by the individual himself in a public deed or private writing in the expectation of a probable future incapacity". Out of the blue he then goes on to express his view that legislation on advance care directives was therefore "absolutely superfluous"[19]. This, of course, overlooked the fact that the guardian must ultimately be appointed by the guardianship judge[20] and that a tracheotomy is a *medical treatment*.

Directives

However, the Modena Court decree illustrates the important persuasive effect of the Court of Cassation's holding. By providing guidance to lower courts in Italy in the absence of legislation on Directives it stimulated a willing member of the judiciary to use the qualified guardianship legislation to fill this void when the wishes of the patient were unequivocally expressed. These cases all illustrate the courts' search for clear guidance from the patient as to their wishes.

This, however, still begs the question as to what a person can do to leave such proof in a country like Italy which does not have specific legislation providing guidance as to how an individual can legally express his or her wishes unequivocally on end-of-life medical care.

The use of Directives in the United States developed for just these reasons. If Terri Schiavo had executed a Directive her case may not have even been brought to court as there would have been no need to determine her wishes from statements made to family members. Her physicians and her family would have had written evidence that she had thought about her medical care and had made a decision as to its course[21]. Had Ms. Englaro executed a Directive it would have undone to some extent the Milan Court of Appeals' reasoning that she had not imagined her current state and that she lacked the maturity to face such themes as life and death. Further because of the constitutionally sanctioned rights to refuse medical care and to informed consent, the courts would naturally have looked to the Directive for guidance despite the on-going debate over medical treatment v. artificial feeding. It is very likely that Ms. Englaro and her family would have had resolution without having to appeal to the Court of Cassation.

Although there is no legislation on Directives in Italy, the courts' holdings show that knowing a patient's wishes is the holy grail in these matters. The Schiavo and Englaro cases have shown that courts need and look for direction from patients in adjudicating these matters. The Galano case illustrates that when faced with unequivocal direction from a patient the Courts will do the utmost to find a way to honor that request.

Executing a U.S. style Directive in Italy will allow an individual to express his or her health care wishes clearly. To the extent that these wishes can be honored by physicians and courts they will be. While a Directive may not resolve a situation in which the care received is considered *basic sustenance*, such as in Eluana Englaro's situation, in all those cases in which it is clear that what is being refused is a *medical treatment* the Directive will be welcome and highly valued evidence of what medical treatments the individual would have wanted or desired to be withheld, thus sparing the individual's family, physician and the justice system from protracted court battles.

* * *

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[1] On June 25, 2008 the first Section of the Milan Court of Appeals on remand from the Court of Cassation handed down a decision in favor of disconnecting Ms. Englaro's feeding tubes. The State's Attorney has up to one year to appeal the holding.

[2] An Advance Care Directive allows you to specify your wishes and appoint someone to express them at a future time when you may be incapacitated. Directives are typically divided into two sections: a "living will" portion, setting forth your wishes as to the course medical treatment should take in specific situations; and a "health care proxy", in which one or more individuals are appointed to act in a fiduciary capacity to make health care decisions based on your Directives.

[3] In re: Guardianship of Theresa Marie Schiavo Incapacitated," File No. 90-2908GD-003, Fla. 6th Judicial Circuit, February 11, 2000

[4] Final appellate review in Italy is divided between the Constitutional Court (*Corte Costituzionale*), and the Court of Cassation (*Corte di Cassazione*). The latter is Italy's highest ordinary court. It has no original jurisdiction and reviews only questions of law appealed from a decision of a court of appeal. It is divided into five member sections. A case may be reviewed *en banc (sezioni unite)* by a panel of nine judges selected from all sections of the Court. The Court also may sit *en banc* where a question of law has already been decided in a conflicting manner by different sections and, in any event, in cases involving questions of great importance. Until an issue has been decided *en banc,* there is the possibility of conflicting Court of Cassation precedents. *See* Title VI Article 134, Constitution of the Republic of Italy; Royal Decree N. 12 of January 30, 1941.

Since Italy is a civil law system decisions even of the highest courts are not binding as precedent but serve a persuasive function. The Englaro case was not heard *en banc,* but by the First Civil Section of the Court of Cassation -- giving less weight to its holding. Its persuasive function will be compelling to lower courts, but will not be as strong as if the Court had heard the appeal *en banc*. This also means that another section of the Court could hold differently on an appeal arising from a similar factual situation.

[5] In Italy under the principle of informed consent no one can be forced to undergo medical treatment, except in instances specifically provided by law (such as mandatory vaccination for school aged children) without consenting to it, even in those cases where lack of treatment would damage the patient's health or result in death. The concept of informed consent in Italy is expressly grounded in the Italian Constitution which provides a basic right to "self-determination". Arts. 13, 30 Constitution of the Italian Republic.

Italy is also a party to the Convention of the European Council on Human Rights and Biomedicine (signed in Oviedo, Spain on April 4, 1997; ratified by Italy on March 28, 2001 by Law No. 145). This convention states that if at the time of medical intervention the patient is unable to express an opinion on treatment, the patient's "*previously expressed wishes*" (emphasis added) must be taken into consideration (Art. 9)

The Italian Code of Medical Ethics (*Codice Deontologico Medico)* also recognizes the importance of informed consent and of a patient's previously expressed wishes. Article 30 creates an ethical duty on the part of physicians to inform patients as to the type of care, alternatives to such care, its purpose, success rate, risks and side effects. Article 32 specifically provides that physicians are to discontinue diagnostic testing and/or medical care if presented with a patient's documented refusal of such testing or care. Article 14 provides that a physician is to desist from futile treatment that cannot improve the patient's health or quality of life, although tempered by a reference to the physician's responsibility to act within the scope of the independence that characterizes the medical profession.

Thus, if the artificial feeding and hydration are considered futile therapy a physician would be ethically bound to discontinue such therapy. Moreover if Ms. Englaro had previously manifested her wishes against the therapy then again physicians would have an ethical duty to discontinue the treatment, or at least document refusal to follow the patient's wishes.

[6] The Italian National Committee on Bioethics ("Committee"), an important government advisory body created in 1990 by a decree of the President of the Republic of Italy composed of medical professionals, university professors and researchers, religious leaders and legal professionals, provides advice to the government on issues dealing with bioethics. In 2005, it addressed the issue of artificial feeding and hydration taking the stance that artificial feeding is *basic sustenance* and not a *medical treatment*. The opinion was not unanimously taken, but on a majority vote and was published with two dissenting notes.

In its opinion on artificial feeding the Committee referred to one of its earlier opinions on advance care directives in which it had recommended that legislation be passed authorizing the use of Directives. In the advance care directive opinion it had noted that providing for suspension of artificial feeding and hydration in an advance care directive was "very controversial", but had limited itself to setting out the two points of view held in the Committee without providing guidance on the issue. See *Dichiarazioni Anticipate di Trattamento*, 28 December 2003. After reviewing the positions expressed in that opinion the Committee concluded that artificial hydration and nutrition of patients' in PVS may only be ethically and legally suspended based on objective parameters, such as when the patient no longer assimilates the nutrition provided or has an intolerance to it, and it becomes futile therapy. In all other instances the Committee advised that a request in a Directive of suspension of artificial feeding would be a request for euthanasia. See *L'Alimentazione e l'Idratazione di Pazienti in Stato Vegetativo Persistente*" Opinion of the National Committee on Bioethics ("*Comitato Nazionale per la Bioetica" or "Committee")* approved in plenary session on September 30, 2005, page 2.

[7] Article 32, Constitution of the Italian Republic.

[8] Euthanasia is illegal in Italy.

[9] Cassazione Civile Sezione Prima, 14 October 2007 n. 21748 at page 10, quoting the Milan Court of Appeal judgment

[10] See Article 2, Constitution of the Italian Republic; Title I; Article 13 Constitution of the Italian Republic; Title III, Article 32, Constitution of the Italian Republic; See also Constitutional Court case number 471, October 9, 1990 (personal freedom includes the right to give directions concerning one's body).

[11] *Id*. at page 11, quoting the Milan Court of Appeal judgment

[12] Cassazione Civile Sezione Prima, 14 October 2007 n. 21748 at p. 53

[13] There are several bills pending before both houses of Parliament on advance care directives. Among these bills is *Proposta di Legge* n. 779 before the Chamber of Deputies which specifically prohibits a patient or a physician from allowing, encouraging or consenting to the suspension of "life sustaining intervention which is not of an extraordinary character *such as artificial feeding or hydration*" (emphasis added).

[14] There are no EU directives regarding advance health care directives. Their regulation is left up to national legislation. However, the European Union nations have enacted The Oviedo Convention for the protection of Human Rights and dignity of the human being with regard to the application of biology and medicine, to which Italy is a party. Italy has also ratified the Convention, but it has not yet entered into force in Italy. The Convention provides in article 9 that "the previously expressed wishes relating to a medical intervention by a patient who is not, at the time of the intervention, in a state to express his or her wishes shall be taken into account."

[15] Cassazione Civile Sezione Prima, 14 October 2007 n. 21748 at p. 55

[16] A "guardianship judge" or "*giudice tutelare*" is a judgeship created to protect the rights of minors and legally incompetent adults.

[17] Law No. 6 of January 9, 2004

[18] Decree of Dr. Guido Stanziani, Guardianship Judge of the Tribunal of Modena, 13 May 2008.

[19] Decree of Dr. Guido Stanziani, Guardianship Judge of the Tribunal of Modena, 13 May 2008.

[20] Article 408 (2) of the Civil Code as amended by Law No. 6 of 9 January 2004. In fact Article 408 also provides that if there are "grave reasons" the guardianship judge can choose a different individual to act as the qualified guardian. The "grave reasons" are not defined by the legislation.

[21] Florida's law at the time of Terri Schiavo's collapse provided that a competent adult could provide a declaration instructing a physician to withhold or withdraw life-prolonging procedures, or designating another to make the decision. See §§ 765.01-765.17 Fla. Stat. (1991). In 1992 these sections were repealed and replaced with broader provisions allowing, in the absence of an advance care directive, a proxy to make decisions for the incapacitated patient.

Bianca Gross v. Commissioner

Tax Court Rejects Indirect Gift Attack for Gift of Partnership Interest At Least 11 Days After Contribution of Stock Portfolio to Partnership, *Bianca Gross v. Commissioner*, T.C. Memo 2008-221 (September 29, 2008)

October 2008
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Facts

1. The donor and her two daughters agreed to form a limited partnership on July 15, 1998, to hold the donor's stock portfolio. (The donor thought one of her daughters was extravagant and she believed having her stock portfolio in a family limited partnership would encourage her daughters to work together and would enable them to learn from her experience while preserving her control over the partnership's assets [by serving as the general partner]). The donor and her daughters agreed to the major terms of the partnership, including that the donor would contribute $100 and the two daughters would each contribute $10, and the donor would also contribute securities.
2. On July 15, 1998, a certificate of limited partnership was filed with the New York Department of State (even though no partnership agreement had been signed). Notice of the formation of the limited partnership was filed in newspapers and an affidavit of publication was filed with the New York Department of State.
3. Funding of partnership: The daughters contributed $10 each on July 31, 1998, and the donor contributed $100 on November 16, 1998. Also, the donor transferred various shares of stock of "well-known, publicly traded companies" having a value of $2,158,646 into the name of the partnership from the beginning of October 1998 through December 4, 1998.
4. On December 15, 1998, the donor and the daughters signed a "Limited Partnership Agreement" containing the terms agreed to on July 15, and the donor signed a document styled "Deed of Gift" for each of her daughters transferring a 22.25% interest as a limited partner to each of them.
5. A gift tax return was filed reporting the gift, valuing the limited partnership interests with a 35% discount. Attached to the Form 709 was a schedule showing the capital accounts. Each partner's capital account was credited with the $100, $10 and $10 cash contributions, and the donor's capital account was credited with the $2,158,466 of securities. The donor's capital account was then debited with $960,598 to reflect the gifts, and each of the daughter's capital accounts was credited with $480,299 because of the gifts. (The gifts were reported on the return as $312,500 to each daughter, reflecting the 35% discount.)
6. The IRS audited the return and took the position that the gift was an indirect gift of the securities valued at $480,299 for each daughter.

Holdings

1. The partnership was formed (either as a limited partnership or as a general partnership) by the time the certificate was filed on July 15, when the parties had agreed to the essential terms of the partnership. The securities were legally contributed into the partnership on their funding dates, completed by December 4, 1998. The donor did not make indirect gifts of the securities when the gifts of partnership interests were made eleven days later on December 15, 1998.
2. The gifts were valued as reported on the gift tax return.

Court's Analysis

1. <u>Formation of Partnership</u>. The IRS contended that the partnership was not formed until the partnership agreement was signed on December 15 and that the gifts were made contemporaneously. The New York Revised Limited Partnership Act is not totally clear as to whether signing a partnership agreement is a prerequisite to forming a valid limited partnership. Paragraph (a) of N.Y. Partnership Law section 121-210 provides that to form a limited

partnership the general partners shall execute a partnership agreement, and a certificate of limited partnership shall be executed and filed with the department of state. That suggests that having a signed partnership agreement is a prerequisite to having a valid limited partnership. However, Paragraph (b) of section 121-201 says that a limited partnership is formed at the time of the filing of the certificate of limited partnership, and the filing of the certificate "shall, in the absence of actual fraud, be conclusive evidence of the formation of the limited partnership as of the time of filing or effective date if later…" That paragraph suggests that the time of creation of the partnership relates back to the date of filing the certificate, and the taxpayer argued that the Act contemplates "that a limited partnership may be formed before all statutory formalities are completed."

The court observed that neither party made a compelling argument for its interpretation, so the court addressed whether a general partnership was formed on July 15, even if a limited partnership were not formed on that date. The court noted that under New York law, an agreement to all essential terms of a partnership, even if just orally or impliedly, creates a partnership. The court concluded that the parties had agreed to all of the essential terms and conditions of the partnership on July 15 just before filing the certificate. Therefore, if the parties failed to satisfy the requirements to form a limited partnership on July 15, the court deemed that they formed a general partnership on that date.

2. Funding of Partnership. The IRS argued that if the partnership was not formed until December 15, the donor "could not have contributed the securities to an entity that did not yet exist," and that the funding occurred on December 15 (the same day as the purported gifts). The IRS pointed to a schedule attached to the gift tax return titled "Securities Contributed to the Partnership on 12/15/98." However, the court agreed with the taxpayer that the schedule was intended to reflect securities owned by the partnership on that date, not to reflect that the securities were contributed on that date. The court concluded that the securities were contributed during the October-December 4 time frame, and that the funding was completed by December 4.

3. Indirect Gifts in Fact. The IRS argued that the donor made indirect gifts because she contributed the securities to the partnership for inadequate consideration, arguing that only 55.5% of the value of the securities was allocated to her capital account. The court observed that the IRS must be arguing that the gifts of limited partnership interests preceded her contributions (or would be deemed to have preceded the contribution under the step transaction doctrine, discussed below).

A gift tax regulation provides that a contribution to a corporation owned partially by other shareholders is treated as an indirect gift of a proportionate part of the contribution, rather than as a gift equal to the increase in value of the interests of the other shareholders. Treas. Reg. §25.2511-1(h)(1).

The court looked to the Estate of Jones and Shepherd cases as precedent. In Estate of Jones, 116 T.C. 121, 123-127, the father contributed assets to a partnership, the contributions were credited to his capital account, and on the same day he gave his children substantially all of his interests in the partnership. The court refused to rule that he had made indirect gifts of the assets contributed to the partnership (rather than the partnership interests) because the contributions "were properly reflected in the capital accounts of the decedent, and the value of the other partners' interests was not enhanced by the decedent's contributions."

In contrast to Estate of Jones (where contributions were first credited to the contributor's capital account) is Shepherd v. Commissioner, 115 T.C. 376, 389 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002). In Shepherd, the taxpayer created a partnership in which he was a 50% owner and his two sons were each 25% owners. The taxpayer transferred real property to the partnership, and (pursuant to the partnership agreement) the contributions were allocated pro rata to the capital accounts of each partner. The court in Shepherd concluded that the transfers were indirect gifts to the sons "[b]ecause the contributions were reflected partially in the capital accounts of the noncontributing partners [and] the value of the noncontributing partners' interests was enhanced by the contributions by the taxpayer."

In this case, the Gross court made clear how to avoid the "indirect gift in fact" argument:

> "Petitioner made a series of contributions of securities to [the partnership] and received increasing partnership interests in return. All of the contributions were reflected in her capital account, and the value of her daughters' capital accounts was not enhanced because of her contributions. After she contributed the … securities to the partnership, she made gifts of interests in the partnership to her daughters." [The opinion also noted that after the gifts, the donor's capital account was decreased and the capital accounts of the daughters were increased.]

4. Indirect Gifts Under Step Transaction Doctrine. The IRS argued that the step transaction doctrine should be applied to treat the gift as a gift of a proportionate part of the underlying securities contributed to the partnership rather than as a gift of partnership interests. Judge Halpern generally reiterated his analysis from the Holman case about four months earlier (although the Gross analysis was a much shortened version of his analysis in Holman). Holman v. Commissioner, 130 T.C. No. 12 (May 27, 2008).

The step transaction doctrine "treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result." (In Holman, Judge Halpern explained in further detail that the interdependence test requires that the legal relations created by one transaction would have been fruitless without a completion of the series. In other words, even if the donor intended later to make gifts of partnership interests sometime after contributing assets to the partnership, the issue is whether the "legal relations created by the partnership agreement would have been fruitless had petitioners not also made the … gift.")

Interestingly, the court only gave passing notice in a footnote to Senda v. Commissioner, 433 F.3d 1044 (8th Cir. 2006). In that case, as in Estate of Jones, the contributions and gifts of partnership interests occurred on the same day. The Tax Court and the Eighth Circuit agreed with the IRS that the contributions and gifts of partnership interests "were integrated and simultaneous." In light of the factual uncertainty of what occurred first, the contribution or the gifts, the taxpayers had argued that whether the gifts of partnership interests were in fact made before the contribution should not matter because the partnership agreements credited contributions to the parents' capital accounts before being credited to the children's capital accounts. The Eighth Circuit rejected that argument, stating: "In some situations, formally distinct steps are considered as an integrated whole, rather than in isolation, so federal tax liability is based on a realistic view of the entire transaction." (Judge Halpern analyzed Senda in more detail and distinguished it in his Holman opinion.)

The court focused its analysis on the Holman case, in which Judge Halpern concluded that a gift of a partnership interest made six days after a contribution of Dell stock to a new FLP would not be treated as an indirect gift of a proportionate part of the contributed stock. In Holman, the court listed two reasons for distinguishing the Senda opinion and rejecting the step transaction doctrine argument. First was that the contribution and gifts were not made on the same day. Judge Halpern did not repeat that reason in Gross. Instead, the opinion focused on the second reason that he gave in Holman, i.e., that the taxpayers bore a "real economic risk of a change in value" between the time of the contribution and the time of the gifts. In Gross, the gifts of partnership interests were made at least 11 days after the contributions and the contributions "were mostly, if not all, common shares of well-known companies." (Similar to footnote 7 in Holman, footnote 5 in the Gross opinion observes that the real risk of a change in value arises from the nature of the contributed securities as "heavily traded, relatively volatile common stocks" and that 11 days may not have been a sufficient period to have a real economic risk of a change in value for another type of investment, such as a preferred stock or a long-term government bond.)

5. Valuation. The IRS stipulated that if the donor was found to have made gifts of limited partnership interests to her daughters on December 15, 2008, the values reported on the gifts tax returns (with a 35% discount) were correct. The court said that it only determined that gifts of partnership interests were made on December 15, not whether those gifts were of interests in a limited as opposed to a general partnership. However, the uncontradicted testimony of the taxpayer's expert was that the values would not have been different even if the gifts were of interests in a general partnership, based on the terms of this partnership. The court accepted the values as reported on the gift tax return.

Observations

1. Continued Rejection of IRS's Integrated Transaction Approach. This case does not plow new ground with respect to the IRS's "integrated transaction" argument. It is very similar to the Holman case in finding that a gift of a partnership interest made several days after contributions to the partnership (in this case, at least 11 days after contributing a portfolio of common stocks) would not be treated as an indirect gift of a proportionate part of the contributed shares, without a discount.

   Unlike Holman, there was no direct statement in the opinion that the donor intended eventually to make gifts of partnership interests when the contributions were made. However, it is clear from the facts that the purpose of the partnership was oriented to educating and encouraging the donor's daughters; implicit in the facts is that eventually there would transfers of interests in the partnership to the donor's daughters.

2. How Long of a Delay is Needed? The court reiterated that a short time delay (11 days in this case) is sufficient to reflect a "real economic risk of a change in value" where the contributions consisted of "heavily traded, relatively volatile common stocks." Under this analysis (now repeated in two different cases, albeit by the same judge), waiting just one day after a contribution may not be sufficient. Planners must look to the nature of the contributed assets to determine how long of a delay is needed to have a "real economic risk of a change in value." Some types of assets (such as some preferred stocks, long term government bonds [as referenced in footnote 5], or real estate) may need a longer time delay to satisfy this test. (Even as to real estate, the IRS does not always make the indirect gift argument. In Astleford v. Commissioner, T.C. Memo 2008-128, the contributions of real estate to a partnership and gifts of partnership interests occurred on the same day. The IRS apparently did not make the indirect gift argument in that case. The Astleford court merely observed that the parent's percentage interest in the partnership was initially increased as a result of the contributions, before being reduced as a result of the "simultaneous" gifts of additional partnership interests to the children.)

3. Best Practices For Documenting Contributions Prior to Gifts of Partnership Interests. The court's reasoning highlights how planners should document transactions to put their clients in the best position to rebut an "integrated transaction" argument by the IRS.

- Unlike the facts of this case, the partnership agreement should be signed initially and all formalities should be completed to create the limited partnership (such as filing a certificate of limited partnership with the appropriate state authorities).
- Initial contributions as referenced in the partnership agreement should be completed, and those contributions should be reflected in the initial capital accounts of the initial partners.
- As additional contributions are made, the contributions should increase the percentage interests owned by the contributing partner, and the value of the additional contributions should be credited to that partner's capital account. (Various private rulings reasoned that merely booking additional contributions to the transferor's capital account is not sufficient. TAM 200432015 & 200212006. However, the Estate of Jones and Gross cases both place considerable reliance on the fact that additional contributions were first allocated to the contributing partner's capital account.)
- Wait more than just one day after forming and funding the partnership to make transfers of limited partnership interests. Waiting one day avoids the problem in the Estate of Jones and Senda cases of knowing whether the funding or the gifts of interests occurred first, where they both happened on the same day. However, that would not necessarily be enough to pass muster under the analysis of the Holman and Gross cases, where the delay must be long enough to have a real economic risk of a change in values (although recent one-day gyrations in the stock market may suggest that even a one day delay bears a real economic risk of changed values if the funding consists of publicly traded common stocks or even a diversified stock portfolio.)
- Verify that legal titles to contributed assets have been transferred to the partnership before making transfers of limited partnership interests.
- Some planners recommend discussing with the client the possibility of making transfers of limited partnership interests in the planning discussions to decide whether a client will form a limited partnership, but do not discuss how much the client wants to transfer after the partnership is created. Leave that as an open question so no one can argue that there was a step transaction or prearranged transaction. (However, this conservative approach would not be essential if courts continue to analyze this issue as in the Holman and Gross cases, where all that is needed is to wait enough time for there to be a real economic risk of changed values, even if the client does have a clear intent to make transfers of partnership interests after the partnership is formed and funded.)
- Gifts of limited partnership interests should be clearly documented (in Gross, the donor and the daughters signed "Deed of Gift" instruments documenting the gifts).
- Capital accounts should be adjusted after the gifts to reflect the transfer of capital account values from the donor to the donees. (The court observed that the adjustment should have reflected the portion of the increased value in the assets that is attributable to small interests, if any, held by donees at the time of the contributions. In Gross, the agreement reflected that the daughters each initially contributed $10, and the very small portion of the increase in value of the contributed assets between the time of contribution and the time of the gifts of limited partnership interests attributable to their small initial interest in the partnership — in this case less than 0.1% — should have been included in the transfer of value to the donees' capital accounts.)

4. Formation Factual Complexity. This case has the added messy factual complexity of having the certificate of limited partnership filing and contributions to the partnership before the parties got around to signing a partnership agreement (with a gift of limited partnership interests to the daughters on that same day). The taxpayers were fortunate that the court bailed them out of this less than squeaky clean fact situation to find that the partnership was indeed created and funded before the partnership agreement was signed and before the gifts of the limited partnership interests were made. The facts of the case are certainly not a blueprint of how best to plan FLP funding and gift transactions. (The case is somewhat reminiscent of the early Church case in which the court held that transfers would be recognized as transfers of restricted interests, even though the transfers were made before the certificate of limited partnership had been filed, but after the partnership agreement had been signed. Church v. United States, 268 F.3d 1063 (5th Cir. 2001), *aff'g*, 85 A.F.T.R.2d 2000-804 (W.D. Tex. 2000).)

ANNUAL EXCLUSION FOR GIFTS, 2032A AND 2523 ADJUSTMENTS MADE

By

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On Wednesday, October 16, 2008, the Internal Revenue Service issued Rev.Proc. 2008-66, 2008-45 IRB 1, in which the Service published inflation adjusted tax items for 2009. This type of revenue procedure is published annually, and covers the new tax tables and rates for the coming year, adjustments to credits, and a number of other items that are changeable because of inflation.

Of importance to estate planners are three things: (a) the change in the annual gift tax exclusion; (b) the maximum reduction amount under Internal Revenue Code Section[1] 2032A; and (c) the non-citizen spouse gift limit.

Annual Gift Tax Exclusion Under Section 2503: For calendar year 2009, the first $13,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Section 2503 made during that year. The last change to the annual gift tax exclusion amount was made in 2005 for 2006 (changing the amount to $12,000),[2] and the one prior to that was in 2001 effective in 2002 (changing the amount to $11,000).[3] Before that, the annual gift exclusion was statutorily set at $10,000, and indexed to inflation.[4] The relative rarity of adjustments to the annual gift tax exclusion amount occurs because changes are allowed only in $1,000 increments, and the statute specifically requires inflation adjusted computations to be rounded downward to the next lowest $1,000 multiple. Given the small size of the exclusion to start with, as can be seen, often several years pass between revisions.

Annual Gift Tax Exclusion for Gifts to Non-Citizen Spouses: This is a figure, unlike the annual gift tax exclusion, that adjusts every year. Generally speaking, there is no marital deduction for gifts to non-citizen spouses. Instead, the annual gift tax exclusion in Section 2503 is modified via Section 2523(i)(2) to allow a special, increased annual gift tax exclusion for gifts to non-citizen spouses, and the number therein (originally $100,000) is indexed to inflation. For calendar year 2009, the first $133,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Sections 2503 and 2523(i)(2) made during that year. For 2008, the limit was $128,000[5] and for 2007 the limit was $125,000.[6]

Valuation of Qualified Real Property in Decedent's Gross Estate: Like the Section 2523 amount, this number changes annually. For an estate of a decedent dying in calendar year 2009, if the executor elects to use the special use valuation method under Section 2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use Section 2032A for purposes of the estate tax cannot exceed $1,000,000. In 2007, the dollar limit was changed for 2008 to $960,000.[7] In 2006, the dollar limit was changed for 2007 to $940,000.[8]

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[1] For convenience, any reference to "Section" means a Section in the Internal Revenue Code
[2] Rev. Proc. 2005-70; 2005-47 IRB 1
[3] Rev. Proc. 2001-59; 2001-52 IRB 1
[4] Code Section 2503(b)(2), an amendment added by Section 501(c)(3) of the Taxpayer Relief Act of 1997
[5] Rev. Proc. 2007-66; 2007-45 IRB 1
[6] Rev. Proc. 2006-53; 2006-48 IRB 1
[7] Rev. Proc. 2007-66; 2007-45 IRB 1
[8] Rev. Proc. 2006-53; 2006-48 IRB 1

CERTIORARI IN JELKE DENIED: SIMPLICITY IN VALUATION

By

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In the February 2008 edition of eReport, we reported on the Eleventh Circuit's decision in *Jelke*[1] which purports to lay down a simple rule for valuations experts, and others, to deal with the potential tax liability for built in gains in C corporations. Basically, the Eleventh Circuit said that investment companies, operated as C corporations, will be evaluated as though they were liquidated on the date of death, triggering the recognition of tax liability for the gains built into the assets of the corporation. And as a result, the value of the corporation will be reduced dollar for dollar by that tax liability.

The government disagreed with that decision and applied for writ of certiorari to the United State Supreme Court. On October 6, 2008, the Supreme Court denied the government's application for writ, letting the Eleventh Circuit's decision stand.

At issue in the case was the extent to which built-in capital gain tax liability should be taken into account in determining the date of death value of a C corporation with assets which, if liquidated, would produce a gain, and, as a result, tax on that gain. As noted in the February article on the case, the Court provided an easy to read, short history of valuation of investment companies. Ultimately, the Court concluded that valuation of such corporation should assume that such corporations will always be liquidated on the date of death, and the tax liability paid, thus requiring a reduction of value by 100% of the tax attributable to the built-in capital gain. The net result is an easy to understand method of valuation, similar to that mandated by the Fifth Circuit in *Dunn*[2].

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[1] *Estate of Frazier Jelke, III, Deceased v. Commissioner*, 507 F.3d 1317, U.S. App. LEXIS 26477, 2007-2 U.S. Tax Cas. (CCH) P60,552; 100 A.F.T.R.2d (RIA) 6694; 21 Fla. L. Weekly Fed. C 188 (11th Cir. 2007)
[2] *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002)

AMENDMENTS TO THE
UNIFORM PRINCIPAL AND INCOME ACT

drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

at its

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MEETING IN ITS ONE-HUNDRED-AND-SEVENTEENTH YEAR
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AMENDMENTS TO UNIFORM PRINCIPAL AND INCOME ACT

AMENDMENT 1

Section 409 is amended to read:

SECTION 409. DEFERRED COMPENSATION, ANNUITIES, AND SIMILAR PAYMENTS.

(a) In this section~~, "payment"~~:

(1) "Payment" means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer~~, including:~~. For purposes of subsections (d), (e), (f), and (g), the term also includes any payment from any separate fund, regardless of the reason for the payment.

(2) "Separate fund" includes a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(b) To the extent that a payment is characterized as interest, ~~or~~ a dividend, or a payment made in lieu of interest or a dividend, a trustee shall allocate ~~it~~ the payment to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not “required to be made” to the extent that it is made because the trustee exercises a right of withdrawal.

(d) ~~If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.~~ Except as otherwise provided in subsection (e), subsections (f) and (g) apply, and subsections (b) and (c) do not apply, in determining the allocation of a payment made from a separate fund to:

(1) a trust to which an election to qualify for a marital deduction under Section 2056(b)(7) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(7)] [, as amended], has been made; or

(2) a trust that qualifies for the marital deduction under Section 2056(b)(5) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(5)] [, as amended].

(e) Subsections (d), (f), and (g) do not apply if and to the extent that the series of payments would, without the application of subsection (d), qualify for the marital deduction under Section 2056(b)(7)(C) of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 2056(b)(7)(C)] [, as amended].

(f) A trustee shall determine the internal income of each separate fund for the accounting period as if the separate fund were a trust subject to this [act]. Upon request of the surviving spouse, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee shall allocate principal to income to the extent the internal income of the separate fund exceeds payments made from the separate fund to the trust during the accounting period.

(g) If a trustee cannot determine the internal income of a separate fund but can determine the value of the separate fund, the internal income of the separate fund is deemed to equal [insert number at least three percent and not more than five percent] of the fund's value, according to the most recent statement of value preceding the beginning of the accounting period. If the trustee can determine neither the internal income of the separate fund nor the fund's value, the internal income of the fund is deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under Section 7520 of the Internal Revenue Code of 1986 [, as amended] [, 26 U.S.C. Section 7520] [, as amended], for the month preceding the accounting period for which the computation is made.

~~(e)~~(h) This section does not apply to ~~payments~~ a payment to which Section 410 applies.

Comment

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~~**Marital deduction requirements.** When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) should not be necessary.~~

Marital deduction requirements. When an IRA or other retirement arrangement (a "plan") is payable to a marital deduction trust, the IRS treats the plan as a separate property interest that itself must qualify for the marital deduction. IRS Revenue Ruling 2006-26 said that, as written, Section 409 does not cause a trust to qualify for the IRS' safe harbors. Revenue Ruling 2006-26 was limited in scope to certain situations involving IRAs and defined contribution retirement plans. Without necessarily agreeing with the IRS' position in that ruling, the revision to this section is designed to satisfy the IRS' safe harbor and to address concerns that might be raised for similar assets. No IRS pronouncements have addressed the scope of Code § 2056(b)(7)(C).

Subsection (e) requires the trustee to demand certain distributions if the surviving spouse so requests. The safe harbor of Revenue Ruling 2006-26 requires that the surviving spouse be separately entitled to demand the fund's income (without regard to the income from the trust's other assets) and the income from the other assets (without regard to the fund's income). In any event, the surviving spouse is not required to demand that the trustee distribute all of the fund's income from the fund or from other trust assets. Treas. Reg. § 20.2056(b)-5(f)(8).

Subsection (e) also recognizes that the trustee might not control the payments that the trustee receives and provides a remedy to the surviving spouse if the distributions under subsection (d)(1) are insufficient.

Subsection (f) addresses situations where, due to lack of information provided by the fund's administrator, the trustee is unable to determine the fund's actual income. The bracketed language is the range approved for unitrust payments by Treas. Reg. § 1.643(b)-1. In determining the value for purposes of applying the unitrust percentage, the trustee would seek to obtain the value of the assets as of the most recent statement of value immediately preceding the beginning of the year. For example, suppose a trust's accounting period is January 1 through December 31. If a retirement plan administrator furnishes information annually each September 30 and declines to provide information as of December 31, then the trustee may rely on the September 30 value to determine the distribution for the following year. For funds whose values are not readily available, subsection (f) relies on Code section 7520 valuation methods because many funds described in Section 409 are annuities, and one consistent set of valuation principles should apply whether or not the fund is, in fact, an annuity.

*** * ***

AMENDMENT 2

Section 505 is amended to read:

SECTION 505. INCOME TAXES.

(a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid ~~proportionately~~:

(1) from income to the extent that receipts from the entity are allocated only to income; ~~and~~

(2) from principal to the extent that~~:~~

~~(A)~~ receipts from the entity are allocated only to principal; ~~and~~

~~(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).~~

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and

(4) from principal to the extent that the tax exceeds the total receipts from the entity.

(d) ~~For purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.~~ After applying subsections (a) through (c), the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.

Comment

~~**Electing Small Business Trusts.** An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the~~

~~trust even if some or all of that income is distributed to the beneficiaries.~~

~~A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.~~

Taxes on Undistributed Entity Taxable Income. When a trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.
Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket.
Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T

uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

D = (C-R*K)/(1-R)

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

Applying the formula to Example (2) above, Trust T must pay $230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1		1,000,000
Payment to beneficiary		230,769[1]
Trust Taxable Income		$ 769,231
35 percent tax	269,231	

Partnership Distribution	$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income, including the $500,000 that the entity retained that presumably increased the value of the trust's investment entity.

If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in UPIA section 506 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under UPIA section 104 to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

[1] D = (C-R*K)/(1-R) = (500,000 – 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

AMENDMENT 3

Section 606 is added to read:

ALTERNATIVE A

SECTION 606. TRANSITIONAL MATTERS. Section 409, as amended by this [act], applies to a trust described in Section 409(d) on and after the following dates:

(1) If the trust is not funded as of [the effective date of this [act]], the date of the decedent's death.

(2) If the trust is initially funded in the calendar year beginning January 1, ______ [insert year in which this [act] takes effect], the date of the decedent's death.

(3) If the trust is not described in paragraph (1) or (2), January 1, ______ [insert year in which this [act] takes effect].

ALTERNATIVE B

SECTION 606. TRANSITIONAL MATTERS. Section 409 applies to a trust described in Section 409(d) on and after the following dates:

(1) If the trust is not funded as of [the effective date of this [act]], the date of the decedent's death.

(2) If the trust is initially funded in the calendar year beginning January 1, ______ [insert year in which this [act] takes effect], the date of the decedent's death.

(3) If the trust is not described in paragraph (1) or (2), January 1, ______ [insert year in which this [act] takes effect].

END OF ALTERNATIVES

Legislative Note: *Use Alternative A if your state has already enacted the Uniform Principal and Income Act. Use Alternative B if your state has not enacted the Uniform Principal and Income Act.*

If your state has not adopted the Uniform Principal and Income Act, use the text of Sections 409 and 505, as amended by these amendments, instead of the text of the previous version of those Sections.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

e Report

A Bi-monthly Electronic Publication for Section Members October 2008

Group and Committee News

2009 ABA Enterprise Fund
Emeritus Attorney Pro Bono Indigent Guardianship Project

Grant Announcement and Request for Proposals

Emeritus Attorney Pro Bono Indigent Guardianship Project

We are pleased to announce the 2009 ABA Enterprise Fund Emeritus Attorney Pro Bono Indigent Guardianship Project. The project is awarding up to 10 mini-grants of $2500 each to states with emeritus attorney pro bono practice rules to develop model approaches to specifically recruit emeritus pro bono attorneys to handle indigent adult guardianship cases.

Project Overview and Objectives

Doctors, hospitals, nursing homes, and long term care facilities face a serious and persistent problem of deciding what to do on behalf of patients who are incapacitated and have no available surrogate decision-maker. While no hard data exists, many individuals who are incapacitated have a compelling need to have a surrogate appointed to make health care and other decisions for them. For a small group of these individuals, a family member or friend may be willing and available to serve as guardian, but neither the individual who is incapacitated nor the family member or friend has the financial resources to hire a lawyer to establish the guardianship.

The Emeritus Attorney Pro Bono Indigent Guardianship Project is designed to address the special legal needs of this underserved population by assisting states that have emeritus attorney pro bono rules develop a specialized program to recruit emeritus pro bono attorneys who have experience handling guardianship cases to handle these cases and help meet the special legal needs of this underserved population.

The project is awarding up to 10 mini-grants of $2500 each to states with emeritus attorney pro bono practice rules to develop model approaches to specifically recruit emeritus pro bono attorneys to handle indigent guardianship cases. Grants will provide seed money to assist state emeritus attorney pro bono programs, bar sections or committees that focuses on elder law or probate and estate law, and bar-sponsored or non-profit programs through which the attorney would handle or be assigned the case in developing specialized recruitment campaigns to engage emeritus pro bono attorneys in providing legal services to low-income clients seeking to establish a guardianship of an incapacitated person with a compelling need for a guardian.

Applicant Eligibility

Any state or local bar association, bar section or committee, or bar-sponsored or non-profit program that is committed to developing a model approach for conducting specialized recruitment campaigns to engage emeritus pro bono attorneys in providing legal services to low-income clients seeking to establish a guardianship of an incapacitated individual with a compelling need for a guardian and enhancing awareness of the emeritus attorney pro bono rule or program in the state's legal and pro bono communities is eligible to apply.

Application Due Date

The deadline for submitting applications, by email or by fax, is Monday, November 10, 2008 at 5:00 pm EST.

Proposal Review and Section Process

Proposals will be reviewed by the ABA Commission on Law and Aging and the ABA Section on Real Property, Trust and Estate Law. Awards will be announced in early December.

Grant Period

The grant period runs from December 15, 2008 to July 15, 2009.

Reporting Requirements

Grantees are required to participate in one teleconference mid-way through the grant period and submit a final narrative and budget report by July 31, 2009 including items such as project outcomes, challenged faced and how they were addressed, how funds were used, and how the project will be sustained beyond the grant period.

Proposals should be no longer than 5 pages, line spacing of at least 1.5, typed in Times New Roman 12-point font (or equivalent), with 1-inch margins, consisting of:

- Up to 3 pages of narrative, answering the questions on Page 3 of this RFP in the format presented. Please include the questions as part of the narrative.
- One page listing the organizations that will participate in the project and the collaborative activities that each will conduct.
- One page presenting a proposed budget reflecting how the $2500 mini-grant will be spent.

Method of Submission

- If submitted by email, please send to EFGuardianship@staff.abanet.org
- If submitted by fax, please send to 202-662-8690.

Questions

If you have questions about this project or about the application process, please email them to EFGuardianship@staff.abanet.org.

2009 ABA Enterprise Fund
Emeritus Attorney Pro Bono Indigent Guardianship Project
Proposal Narrative

Applicant Organization:
Contact Name:
Address:
Phone:
Fax:
Email Address:

1. Describe the proposed project, highlighting the approaches you propose to use to specifically recruit emeritus pro bono attorneys to handle adult guardianship cases.

2. Describe how the participating organizations will screen and refer cases to emeritus pro bono attorneys.

3. Describe how the participating organizations will ensure that all alternatives to guardianship have been considered before initiating the case and that obtaining counsel for the respondent in the guardianship case has been considered.

4. Describe the specific, quantifiable outcomes that will result from your project and how you will measure them.

5. Describe how you will sustain the recruitment effort beyond the grant period.

WE'RE NOT IN KANSAS ANYMORE: NOMENCLATURE DOES NOT MATTER WHEN THE MORTGAGEE IS A MERE "NOMINEE"

By Kathleen E. Kraft[1]
Thompson Coburn LLP
www.thompsoncoburn.com

In a recent decision, the Kansas Court of Appeals held that a senior mortgagee's failure to name and serve Mortgage Electronic Registration Systems, Inc. ("MERS") as a defendant in a foreclosure action in which the lender of record had been served was not a fatal defect necessitating that the foreclosure judgment be set aside. *Landmark National Bank v. Kesler*, -- P.3d --, 2008 WL 4180346 (Kan. App. Sept. 12, 2008).

Landmark National Bank ("Landmark"), the holder of the senior mortgage on real estate owned by Boyd Kesler ("Kesler"), brought suit to foreclose its mortgage. Landmark named Millennia Mortgage Corporation ("Millennia") as a defendant. Millennia's second mortgage on the property had been filed of record based on a loan between Millennia and Kesler. (Apparently, Millennia had sold its mortgage to another party.) Landmark obtained a default judgment of foreclosure when neither Kesler or Millennia responded to the suit.

Subsequent to the entry of the default judgment, Sovereign Bank ("Sovereign), the owner of the Millennia loan, moved to set aside the judgment. MERS also filed a motion to set aside the judgment on the basis that MERS held legal title to the mortgage, originally on behalf of Millennia and then on behalf of Sovereign. Both claimed that MERS was a necessary party to the foreclosure suit and that the failure to include MERS as a defendant justified setting aside the judgment. The court disagreed.

The court found that MERS, as mortgagee "in name only," was not a necessary party to the foreclosure suit. Relying heavily on pertinent definitions from Black's Law Dictionary, the court focused on the usual connection between "lender" and "mortgagee." The court pointed out that a mortgagee is "the lender who gives the loan secured by the mortgage" and a foreclosure is a "legal proceeding to terminate a mortgagor's interest in property, instituted by the lender (the mortgagee) either to gain title or to force a sale in order to satisfy the unpaid debt secured by the party." 2008 WL 4180346, at *2, citing BLACK'S LAW DICTIONARY 674, 1034 (8th ed. 2004). The court concluded that a mortgagee is one who has an interest in the debt; in the usual case, this person or entity is the lender. *See id*. In its analysis of MERS' position as "nominee" for the true lender, the court noted that MERS had no right to the underlying debt, MERS did not receive payments and remit them to the lender, MERS was not listed as the party to contact upon default or foreclosure, and the mortgage strictly limited MERS' right to enforce

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the mortgage. In the court's view, MERS lacked any greater rights than normally given to a nominee or agent. Therefore, MERS was not a necessary party because MERS acted as an agent for a disclosed principal, the lender, and had no beneficial interest in the foreclosure suit.

The court also rejected MERS' and Sovereign's argument that the failure to include MERS as a defendant violated due process, finding that MERS has no direct property interests at stake in the lawsuit.

The author will be following this case in the event the decision is appealed and will provide updates as appropriate.

LOOKING DOWN THE ROAD

Estoppels, SNDAs, and Other Lease Provisions That Can Make or Break a Sale

By Scott W. Dibbs

All commercial rental properties, whether retail shopping centers, industrial parks, or multi-tenant office buildings, will eventually be sold. To maximize sales prices, owners seek to keep their projects filled with credit tenants paying the highest possible rentals; yet many owners fail to recognize how important a properly drafted lease can be when the time comes to sell a project.

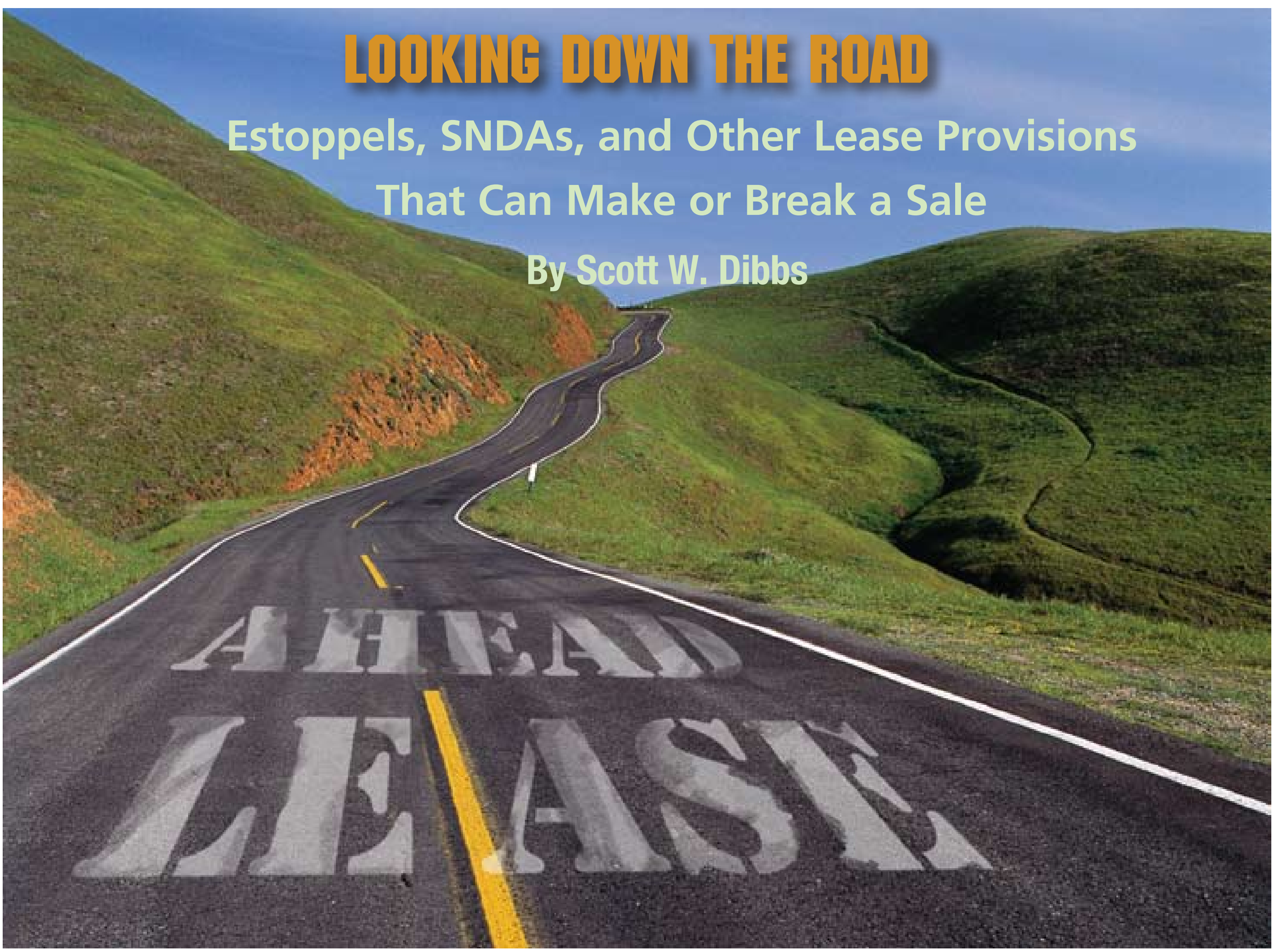
These days, a buyer of commercial property will require that a seller satisfy a number of technical requirements and demands as conditions to a sale, such as obtaining estoppel certificates and subordination, nondisturbance, and attornment agreements (SNDAs) from project tenants. How the lease addresses estoppels and SNDAs, as well as other lease provisions, can have a big effect, positive or negative, on a sale. In fact, many of these lease provisions can serve not only to facilitate a smooth sale process but also to increase (or at least preserve) the property's value and, therefore, the sales price. This article discusses the issues relating to these lease provisions from the respective viewpoints of the interested parties—seller, buyer, tenant, and lender—and attempts to provide practical solutions to some of these issues.

Scott W. Dibbs is a shareholder in the Tampa, Florida, firm of Hill Ward Henderson and vice-chair of the Office Leasing Committee.

Buyer's and Lender's Concerns

To understand how to draft leases to maximize the potential for a successful sale, it is important to understand a buyer's two primary concerns in evaluating the leases in a sale transaction: lease economics and potential liabilities. As you might expect, these buyer concerns are also the primary concerns of the lenders that finance property acquisitions.

A buyer's first concern in understanding and evaluating the economic value and risks inherent in the leases on the property being acquired is whether any of the leases provide a tenant with a right of first refusal or option to purchase the leased property. The buyer will also want to determine whether any provisions in the leases endanger the rent payment stream for the full lease term. Consequently, most buyers will focus on the lease provisions relating to the lease term, the base rent and operating expenses, insurance requirements, maintenance and repair obligations, condemnation, casualty damage, and any rights of early termination or rent setoff. A prudent buyer will also conduct a thorough lease review to



Corbis

confirm that the provisions of each lease are consistent with those of the other leases and that all leases work together without potential ambiguities and problems. For example, the buyer should review all lease provisions that purport to limit the rights of other tenants and confirm that they are not being violated. Buyers are also concerned with understanding and minimizing their potential liabilities on acquisition of the property. For all of these reasons, in drafting its leases, a landlord should pay careful attention not only to the rights of other tenants and early termination rights but also to lease provisions relating to service interruptions, landlord defaults, tenant remedies, and casualty and condemnation provisions, all of which create potential liabilities for a purchaser on its assumption of the leases.

Lease reviews alone, however, will not provide most buyers with the comfort they seek, and most buyers will need assurances from the tenants themselves to evaluate properly the tenant leases being acquired.

Estoppel Certificates

Estoppel certificates are the most common method used by buyers to obtain the necessary assurances about the terms of the tenant leases. A buyer will typically insist on obtaining from each tenant (or, at least, each major tenant) an estoppel certificate stating not only the term of the lease, the base rent, the date through which the rent has been paid, and the security deposit, but also some or all of the following assurances:

- the lease is in effect, with no amendments other than those listed, and there are no oral or other side agreements;
- there are no defaults, events, or circumstances that, with notice or expiration of time to cure, would lead to a default on the part of either the landlord or the tenant;
- all of the landlord's and tenant's construction and other obligations have been fully performed, all construction has been accepted, and all tenant improvement allowance amounts have been paid;
- the number and length of extension terms, if any, are as stated in the estoppel certificate;
- the charges (other than the rent) payable by the tenant are in the amounts specifically set forth or described in the certificate;
- the tenant has paid no rent or other charges more than one month in advance;
- the tenant has no right to deduct or offset any amounts from the rent;
- whether a security deposit has been paid and, if so, the amount of the deposit;
- there are no outstanding concessions, rent abatements, or rent rebates due the tenant;
- the tenant has no defenses to the enforcement of the lease;
- the tenant is not subleasing any part of its space, and its rights have not been assigned (including assignment to a leasehold mortgagee);
- the tenant has received no notices of default from the landlord and has given the landlord no notices of default;
- the tenant has previously made no claims against the landlord;
- the tenant has no right of first refusal or option to purchase the premises or right of first refusal, right of first offer, or other expansion rights for any other premises; and
- the tenant's use of the premises has not involved the generation, storage, treatment, disposal, or release of hazardous substances, and the tenant is in compliance with all environmental and other laws.

Given the number of interested parties involved—seller, buyer, tenant, and lender—and their varying respective interests, negotiating tenant estoppel certificates can be difficult and can complicate and even delay the closing process. A better practice is to negotiate a lease provision listing the matters to which the tenant must certify on request or even attach a form estoppel certificate as an exhibit to the lease. Although a buyer and its lender may attempt to insist on using their own estoppel form, a set of certifications approved in advance by a tenant that takes buyer and lender concerns into account will often be acceptable to potential buyers and their lenders.

Delineating in advance the matters to which the tenant will certify is also important to tenants because buyer and lender estoppel forms often go well beyond the fundamental purposes of the estoppel and can lead to problems if not reviewed carefully. As a general matter, tenants can and should object to any statements in an estoppel that are readily ascertainable through a review of the lease, other than basic business terms such as the rent, the security deposit, and the term. From a tenant's standpoint, the estoppel certificate should not be a substitute for a buyer or lender doing its own due diligence and reviewing the lease. For example, buyers and lenders often include a certification as to whether the tenant has certain rights and options, such as renewal or expansion options, rights of first offer or refusal, or termination rights. The presence or absence of these options and rights can be easily determined by reviewing the lease, so tenants may try either to strike these types of certifications or to except from the certification any options or termination rights that are expressly provided for in the lease.

In addition, because of the potential for confusion and conflict between an estoppel certificate and the lease to which it relates, the tenant may want to include a statement that, in the event of a conflict between the estoppel certificate and the lease, the lease provision will control. A tenant with bargaining power may also try to include a statement protecting it against liability in the event of a good faith mistake or inaccuracy in the certificate, arguing that it should not assume liability in a transaction to which it is not a party and from which it receives no benefit. This type of language, however, may not be acceptable to a buyer or lender that is relying on the statements in the certificate to make its buying or lending decision. In fact, owners, buyers, and lenders may want language specifically putting tenants on the hook for liability for misstatements, although few sophisticated tenants will agree to incur an express indemnification obligation.

As a further limit to exposure relating to estoppels, a tenant should also qualify certain factual certifications (for the existence of defaults, rights of offset, and claims against the landlord, for example) as only to its actual, then-current knowledge, and without duty of investigation. Most buyers and lenders will agree to these types of knowledge qualifiers because they do not really expect the tenant to certify matters that have not yet been discovered. The buyer's legitimate concerns should be satisfied by an actual knowledge certification for these types of claims and defaults, coupled with absolute certifications—with no qualifiers—for the rent, the term, and the fact that the lease document attached to or otherwise identified in the certification is the entire agreement and has not been assigned by the tenant. A tenant (particularly a larger corporate or institutional tenant) also may seek to limit its certification to the knowledge of certain identified individuals such as the tenant's property manager or director of leasing. This type of additional limitation often is acceptable to a buyer or lender, as long as the tenant also certifies that the identified individuals are the persons within the tenant's organization who have direct knowledge of such issues.

The time required to obtain an estoppel certificate can be critical to a sale. The buyer typically wants the estoppel certificate to be dated very close to the sale date, and the purchase agreement may even obligate the seller to provide estoppel certificates dated no fewer than five or 10 days before the closing.

There is a downside to waiting too long to get the estoppels, however. The buyer will need an opportunity to review the estoppels and seek a remedy if any estoppel is not in accordance with its expectations. Sellers will rather give the buyer a specified period to conduct its due diligence than to allow the buyer to terminate as late as the scheduled closing date. Moreover, the seller will not want to be liable to a buyer if one of the estoppels deviates slightly from the rent roll. Consequently, the estoppels should be obtained early enough to permit the buyer to object to any matters contained in the estoppel and, if the buyer's objections are not satisfactorily addressed, renegotiate business terms or even refuse to go forward with the sale.

Recognizing these timing issues, a landlord should draft its leases to require the tenant to provide an estoppel in as short a time frame as the landlord can negotiate, but no more than 10 days after request. Some larger tenants will insist on longer periods, arguing that their internal procedures will not permit a faster response. Especially in the case in which a landlord permits a tenant to have 15, 20, or 30 days to deliver an estoppel certificate, the landlord will need to confirm that the estoppel delivery requirements in its purchase agreement are achievable in light of the estoppel requirements in its tenant leases.

But, even if the landlord has successfully negotiated for short turnaround times for tenant estoppels in its leases, the landlord could have problems if the tenant does not in fact comply with the lease provisions. These problems include potentially losing the sale or even incurring liability to the buyer. Therefore, a landlord/seller needs meaningful and immediate remedies to compel a tenant to deliver its estoppel certificate in a timely manner. Typically, the lease's basic default provisions will not provide an adequate solution for a couple of reasons. First, the landlord will probably not have time to give a default notice and wait for the nonmonetary default cure period to elapse before exercising its remedies. Second, putting the tenant in default for failure to deliver an estoppel when required is not a practical solution, because typically it is critical to the sale that all tenant leases are in good standing at closing.

Leases frequently will provide that, if the tenant does not timely complete and return an estoppel certificate, the landlord may execute the certificate as the tenant's attorney-in-fact. Some leases also provide that, if the estoppel certificate is not produced when required, the tenant will be deemed to have certified all of the matters set out in the requested certificate. Few buyers or lenders, however, will be satisfied with an estoppel certificate executed by the seller on behalf of its tenant (especially a significant tenant), and even fewer will be satisfied with an unsigned estoppel certificate that is deemed to be accurate. Although some buyers may agree in the purchase agreement to accept, in lieu of a tenant estoppel certificate, the seller's certificate on the status of the lease, many sellers will not want to have this continuing liability for a position that may be taken by a tenant after the sale contrary to the seller's certificate. If a buyer does accept the seller's certificate, the buyer may require a substantial holdback of purchase proceeds for a period of time until it is comfortable that seller's certifications are accurate.

One solution that often proves effective is a lease provision requiring the tenant to pay a significant per diem monetary penalty if the tenant does not return an estoppel certificate on time. Another option, which is much less likely to be acceptable to a tenant with bargaining power, is an acknowledgment in the lease that a failure to return the certificate on time will cause the landlord to incur significant damages and that the tenant will be liable for all losses and damages incurred by the landlord by reason of the tenant's failure, including loss of the sale. In either case, the risk of a monetary penalty or significant damages should motivate most tenants to be timely in reviewing and returning requested estoppel certificates—particularly if these risks are highlighted by the landlord when it sends the estoppel certificate to the tenant. A sophisticated tenant might argue for a second notice and cure period before any such penalties would apply and might opt for two shorter time periods (an initial five-day notice followed by a second five-day notice, for example), rather than one longer period, to avoid an administrative snafu that could lead to significant liability for the tenant.

Lender Concerns

As noted above, a buyer's lender has all the concerns of the buyer about the terms of the leases and the certainty of the rent payment streams. Consequently, an estoppel certificate from the tenant in favor of the lender may be necessary to confirm the lease terms and that the tenant has no immediate right to terminate the lease, to set off amounts from rent, or to seek damages against the landlord.

In addition to these concerns, because acquisition lenders typically require that their mortgages be first-priority encumbrances, all tenant leases will need to be subordinated to these mortgages. A subordination of a lease means that, if there is a default under a mortgage, the lender will have the right to foreclose on the property and sell it free of all junior encumbrances, including the lease. In today's economy, however, few lenders that extend loans on property occupied by credit tenants will actually want a foreclosure to wipe out the leases. Therefore, the lender will also want the option to keep all leases in effect despite the borrower's bankruptcy or default, to transfer the leases as part of the property assets to pay the debt, and to have the tenants pay rent and perform lease obligations in favor of any transferee.

Subordination, Nondisturbance, and Attornment Agreements (SNDAs)

An SNDA from a tenant in favor of a lender is the document that satisfies the lender's competing concerns of confirming that the lease is subordinate in priority to the mortgage and of making sure that the lease will not terminate on a foreclosure sale.

When a commercial rental property is sold and the sale is financed, the lender will require that the buyer provide it with an SNDA from each tenant (or, at least, each major tenant). The buyer frequently passes this obligation on to the seller, but, even if the seller is not the party that will solicit the SNDAs, the seller needs to be sure that the buyer can obtain the SNDAs from the tenants because the sale will not go forward unless the lender's requirements are satisfied. SNDAs are also frequently required during the term of a lease if the leased property is refinanced. To be sure that each tenant delivers SNDAs when needed, the landlord must include in its leases provisions that address the content of, and the tenant's obligation to deliver, these SNDAs.

As discussed above, from the lender's standpoint, the basic purpose of the SNDA is to have the tenant acknowledge that its lease is subordinate to the mortgage (the "subordination" portion of the SNDA) but also agree that, at the lender's option, the tenant will recognize and perform its obligations in favor of the lender if the lender forecloses and becomes the landlord under the lease (the "attornment" portion of the SNDA). The quid pro quo for tenants is an agreement from the lender that, so long as the tenant is not in default under the lease, the lender (or any successor owner in a foreclosure sale) will recognize the tenant's rights and will not terminate the tenant's lease on foreclosure (the "nondisturbance" portion of the SNDA). The practical effect of this nondisturbance agreement is that the acceptance of the lease by the transferee after a foreclosure sale (a sale that technically wipes out the subordinate encumbrances, including the lease) is mandatory rather than optional for the lender.

Most landlord lease forms contain a provision under which the tenant subordinates its rights to all current and future mortgages but also agrees that, at the lender's option, the tenant will recognize a foreclosure transferee as its landlord and perform its lease obligations in favor of the transferee for the rest of the term. Theoretically, a separate subordination and attornment agreement may not be needed when the lease includes this language. Lenders, however, generally require a separate subordination and attornment agreement that is expressly addressed to them, so most landlord lease forms require that the tenant also agree to provide a separate subordination and attornment agreement on request.

Strong (or represented) tenants will argue that their leases should not be subordinate to a mortgage unless the mortgagee simultaneously agrees in writing that no foreclosure or other exercise of remedies under the mortgage will disturb the tenant's possession of the leased property and that, if there is a sale or other transfer under the mortgage, the transferee will accept the lease and the tenant. A nondisturbance agreement is particularly important if the leased premises are essential for or unique to the tenant's business operations or if the tenant has spent significant amounts of money constructing improvements in the premises. Some landlords may resist this type of mandatory nondisturbance provision (especially for smaller leases in multi-tenant projects), arguing that it could limit the ability to procure financing. It has become increasingly more customary, however, for lenders to agree to give nondisturbances in commercial leases. It should also be noted that, in many states, recording a nondisturbance agreement will be necessary to assure the tenant that its subordinate lease will not be terminated in the event of a foreclosure sale.

Although the three basic purposes of the SNDA (subordination, nondisturbance, and attornment) may seem simple, the document effectuating these purposes is often the source of a great deal of negotiation and can often complicate and prolong the sales process. The seller and buyer, after all, have less control than they would like to have over an agreement between two third parties—the tenant and the lender. Also, national and conduit lenders today are not satisfied with a simple subordination and attornment document. In their form SNDAs, these lenders also expect tenants to certify all of the facts generally included in an estoppel certificate and to agree to provisions that protect the lender or the person that purchases the property in the foreclosure sale from the consequences of the original landlord's defaults as borrower. These lender-protective provisions frequently include the following:

- Before a transfer to a lender or purchaser at foreclosure,
  —the tenant will not modify or cancel the lease, or surrender the premises to the original landlord, without the lender's consent;
  —the tenant will not make any rent or other payments more than one month in advance;
  —the tenant will give the lender notice of all landlord defaults and will not terminate the lease or exercise abatement or rent setoff rights until it has first given the lender time to cure the default, and if the default cannot be cured unless the lender takes possession of the leased space, the tenant will not terminate the lease while the lender is trying to obtain possession through foreclosure proceedings; and
  —the tenant will pay its rent directly to the lender if the lender demands this payment.
- After the leased premises are transferred to a lender or a purchaser in a foreclosure,
  —if the original landlord has breached the lease or owes the tenant any money, the tenant will not require the lender or other foreclosure successor to cure this breach or pay this money;
  —if the tenant has the right to offset or deduct amounts from its rent by reason of events that occurred before the transfer to the lender or other successor landlord, it will not assert this offset or deduction after the transfer;
  —the lender or other successor landlord will not be obligated to return the tenant's security deposit unless the original landlord has turned the deposit over to the lender; and
  —the lender or other successor landlord will not be required to repair casualty or condemnation damage unless it has received sufficient funds from the insurer or condemning authority, and even if it receives these funds, it will not be required to apply these funds to the restoration if its mortgage permits application of these proceeds to the outstanding loan amount.

Tenants may face serious concerns and issues when lenders attempt to go beyond the basic lender purposes of the SNDA (the basic subordination and attornment agreements) and use the document as an opportunity to obtain assurances, protections, and tenant concessions in favor of the lenders and successor owners that were not otherwise contemplated in the original lease. As a notable example, most modern lender SNDA forms include an agreement by the tenant not to proceed against the person that acquires the property in a mortgage foreclosure for any default by the prior landlord. This type of provision typically prohibits the tenant from seeking redress from the new owner or from deducting cure amounts from the rent and could leave the tenant with an action only against its original landlord, which is probably insolvent. Although a tenant is likely to be forced to give up the right to proceed against a lender or successor owner for money owed by the original landlord, a sophisticated tenant will require each new owner to assume the landlord's obligations under its lease that are to be performed after the date on which the new owner acquires ownership. If the tenant's bargaining power is strong, it will also require the new owner/landlord to cure any property conditions that are not in compliance with the lease.

Some SNDAs include an express waiver by the tenant of any obligation on the part of the successor landlord to perform construction or pay tenant allowances. Even in the absence of this express waiver, tenants should be wary of this issue because the general disclaimer of the successor owner's responsibility for defaults of the prior owner may include this waiver by implication. A lack of recourse against a successor owner can present some very immediate problems for a tenant whose improvements have not been completed by the original landlord or who has spent its own money on construction in reliance on the prior owner's agreement to reimburse the tenant through payment of an improvement allowance. The tenant could effectively be left without a remedy because the landlord is now out of the picture, and the lender is not obligated to complete the work or pay the tenant allowance. If the landlord was to have constructed the improvements, a solution for the tenant is to provide for a well-defined right of "self-help" in the lease to finish the improvements in the event the landlord fails to do so, coupled with a right to deduct the amounts spent by tenant from the rents due under the lease. If a construction allowance is not paid, the tenant may insist on the right to deduct this unpaid allowance amount from the rent, with interest.

Of course, any right on the part of a tenant to stop paying all or a portion of the rent by reason of a prior owner's default may be problematic for a lender because any such right diminishes the value of the lender's collateral and is the practical equivalent of a lender obligation to pay the amounts. If a lender agrees to setoff rights, it should require that these rights be limited to specific landlord obligations (for example, a specifically negotiated buildout or allowance obligation) and should require the tenant to give generous notice and cure rights before the tenant is entitled to exercise its self-help rights. Often these setoff rights are also capped at some percentage of the rent payable by the tenant to preserve at least a portion of the normal rent stream under the lease.

Many lenders simply refuse to allow setoff rights for tenants because of the concerns noted above. In this case, the tenant may be satisfied with a right to terminate the lease if the landlord's improvements are not completed within specified time periods. More problematic is the case in which the tenant is making the improvements and is to receive payment of a large tenant allowance from the landlord. In this case, the tenant is effectively lending money to the landlord by fronting the construction costs, and the lender will not want the payment of this debt to be superior in priority to the payment of the debt to the lender. Resolving this issue in a manner acceptable to the tenant and lender will generally require a more creative solution, such as a guaranty of completion by the principal of the landlord, a letter of credit, or some other security for the performance of this payment obligation, all of which could also be coupled with frequent disbursements of the tenant improvement allowance to minimize the tenant's exposure.

Other typical form SNDA provisions also have the effect of amending material lease provisions. One such provision is the grant to the lender of notice and cure rights that extend beyond those given to the landlord in the lease. To avoid having to give too many duplicate notices, a tenant may want to limit the default notices it must give to the lender to notices of those landlord defaults that could give rise to tenant termination, self-help, setoff, or abatement rights. In addition, a tenant may try to avoid giving a lender an open-ended cure period for landlord defaults that the lender claims it can cure only if it obtains possession of the leased space. The landlord's loan documents generally give the lender the right to cure landlord lease defaults, and if the lease already requires a tenant to accept cure or performance by the landlord's lender, a tenant can reasonably ask why the lender should have to obtain possession of the premises to cure the landlord default.

Most SNDAs also provide that no amendment or modification of the lease will be binding on the lender or a successor owner unless approved in advance by the lender. Although the tenant may object to this provision on the ground that it should be able to enter into an agreement with its landlord without third-party approval, the tenant is not likely to win this argument. At the very least, however, tenant should exclude from this approval requirement any amendment that arises out of the exercise of any tenant rights under the lease (for example, an amendment memorializing tenant's expansion into new space under a right or option in the lease) and, if possible, any amendment that does not materially and adversely affect the amount of the rent or the landlord's rights or tenant's obligations under the lease.

Many of the potential problems discussed in this section can be avoided by negotiating an acceptable SNDA form as part of the original lease negotiations. This will, in most cases, not entail additional expense or effort on the part of a landlord because a mortgage is often in place when the lease is executed, and a sophisticated tenant will require that an existing lender provide an SNDA anyway. This negotiated SNDA form can then be attached to the lease, the tenant will be obligated to sign a similar form whenever the property is sold or otherwise refinanced, and the landlord will have a negotiated form to give to future lenders. Of course, the landlord should be sure that the form is, in fact, commercially reasonable and satisfies normal lender requirements. The benefit to the tenant of an agreed-on SNDA form is that it will have leverage in the future to refuse to sign any SNDA form that does not adequately satisfy its concerns and protect its interests. If a prior lender signed or signed off on the SNDA form at the time of lease execution, the tenant has a much better argument to make to the landlord and future lenders that the agreed-on form is commercially reasonable and should be acceptable to the lenders.

As with estoppel certificates, the timing for obtaining SNDAs can be critical to the seller and the buyer in a sale transaction. The discussion above relating to estoppel timing issues, as well as the potential solutions to address these issues, applies equally to these SNDA timing issues.

Other Lease Provisions

Beyond the estoppel and SNDA requirements, a number of other lease provisions could have a significant effect on a sale transaction, both in terms of process and sales price.

Termination Rights

For obvious reasons, landlords, buyers, and their lenders do not like tenant termination rights. The value of a commercial rental property is derived in large part by the rent payment stream from the leases, and each lease's rental adds to the value of the property. Therefore, any lease provisions that may end the lease or disrupt its rental stream diminishes the property's value. As a consequence, landlords who give away too many termination rights in their leases could literally pay the price down the road.

Not all termination rights are created equal, however. Some termination rights are customary and will not diminish the property's value. For example, in leases other than long-term, single-tenant net leases, the tenant will generally have the right to terminate the lease following certain fire and casualty events (typically those occurring during the last years of the lease or if the landlord cannot or does not restore within a certain amount of time) and in the event of condemnation. In these cases, the loss of the tenant (and its rent payments) can be cushioned by the landlord's rent loss insurance proceeds or the condemnation award. In addition, some tenants may be able to bargain for an early termination right after a specified number of years with sufficient notice and payment of a termination fee that minimizes the economic effect of the termination. A credit tenant of an in-line retail lease may also be able to negotiate a right to terminate the lease if its gross sales do not reach a certain level at a specified point in time (generally about halfway through the term).

Most prudent landlords, however, will avoid termination rights in other circumstances, such as service interruptions and alleged maintenance or repair issues. Only in limited circumstances involving large tenants with significant bargaining power should landlords consider termination rights in the event of landlord default (failure to maintain or repair, for example, or interruption in services). Even then, termination should not be permitted unless the default makes the premises unusable for the tenant's business, was caused by a circumstance within the landlord's reasonable control, and continues for a certain number of days after notice from tenant to landlord specifying the default (generally no shorter than the period given to the tenant to cure nonmonetary defaults).

Limitations on Landlord's Liability

When a commercial rental property is sold, a seller will not want to continue to be liable to its tenants for lease defaults by the new owner. For this reason, the lease should provide that the seller is automatically released from all liability under the lease arising after the sale, and the tenant must automatically pay its rent to and perform its lease obligations in favor of the new owner. A sophisticated tenant will provide that this release is effective only on an express assumption by the new owner of the landlord's obligations under the lease. Such a tenant will also require that after the sale, the tenant retains its right to make claims against the seller and the proceeds of the sale for defaults that occurred before the sale—particularly because most transferees will assume the landlord's obligations only from and after the date of the transfer. If the estoppel certificates are sufficiently detailed and are obtained from all tenants, the seller should know of all claimed defaults and be able to make arrangements for its post-sale liabilities.

The common lease provision stating that the landlord's liability is limited to its equity interest in the property is also helpful to a seller when the property is sold. When the property is sold, the landlord/seller no longer has an equity interest in the property and can assert that it has no further liability under the lease or, at least, no liability beyond the proceeds that it received from the sale. Tenants may want to expand the concept of "equity interest" in these provisions to add a right to proceed against any rentals or other proceeds (insurance or condemnation proceeds, for example) derived from the property. A landlord that is a special purpose entity with limited assets (in many cases, just the leased property) may not be as concerned about this issue, but one that has other assets or that is a limited or general partnership may resist such a lease provision. Also, a prospective lender may look for this clause when evaluating the lease as collateral.

Financial Information

Another lease clause that may help a landlord when it is time to sell or finance a property is a requirement that the tenant provide financial information (and, in retail leases, sales information) on the landlord's request. Buyers and their lenders need to confirm the creditworthiness of the tenants to ascertain the certainty of the rental streams that create the value of the property. For a retail property, the buyer or lender may also want to know that the sales derived from the property are good to confirm both the tenant's satisfaction with the property and the likelihood of finding a new tenant that will pay the same or more rent if the tenant defaults or becomes insolvent. The retail landlord's lease form should, therefore, require sales figures annually, even from tenants that are not paying percentage rent (although many tenants not paying percentage rents will object to these reporting requirements as overly intrusive and burdensome). As with estoppels and SNDAs, timing is important, and landlords should add lease provisions that require the tenant to provide current information quickly on request.

Tenants may reasonably request that the landlord treat any nonpublic information confidentially, although the landlord should be sure that potential buyers, lenders, and their financial and legal consultants are permitted to view the financial information. A public company tenant may also wish to include a statement that it will not be required to produce financial information if such information is available to the public at no or nominal charge.

Short Form or Memorandum of Lease

Short form leases or memoranda of lease are sometimes used to provide public record notice of a lease and certain tenant rights. Although not as common for small tenants or in multitenant projects, and not common in some states because of cost, these instruments are customary in ground lease situations (especially when a leasehold mortgage is involved) or in other situations in which the tenant has valuable rights that it wants to protect (an option or right of first refusal to purchase the premises, for example).

As one might expect, however, persons buying or lending on property do not want the property's title to be littered with recorded lease notices that encumber title. These recorded lease notices are particularly troublesome when they remain in the public records after a tenant's lease has expired or been terminated. If a landlord agrees to allow a lease notice to be recorded, the landlord would be well advised to provide in the lease that the tenant must cause all recorded lease notices to be removed of record when the lease expires or otherwise terminates. The lease may also require the tenant to be liable for any legal fees or even lost sales or financings that the landlord incurs by reason of the tenant's failure to acknowledge of record lease expiration or termination. The landlord may even want to obtain, at the time of lease execution, a signed termination of the recorded instrument to be held in escrow until expiration or termination of the lease. In this case, the lease should expressly authorize the landlord to record the termination on expiration or termination of the lease, with or without tenant's further consent (although sophisticated tenants may not agree to this). In addition, landlords should ensure that any recorded short form or memorandum of lease includes language automatically subordinating such instrument to an existing or future mortgage. Although these are not necessarily fail-safe solutions, the incorporation of one or more of them in the lease may help avoid delays and other problems in connection with a sale or financing.

Future Lender Requirements

Most lenders have other requirements beyond estoppel and SNDA requirements. To address unanticipated lender requirements in ever-changing markets, a landlord should include in its leases a broad tenant obligation to make any future lease modifications reasonably requested by a lender. This type of provision presents obvious risks for tenants, so a wary tenant should insist on language providing that it will be obligated to agree only to modifications requested by institutional lenders that do not impose additional obligations or liabilities on the tenant or diminish the tenant's rights.

Ground Lease Issues

The concerns outlined above are even more important if the seller holds its interest in the rental property as a tenant under a ground lease. Not only will the seller/tenant need to obtain estoppel certificates and SNDAs from its subtenants, but it will also need to obtain estoppel certificates and consents and agreements from its ground lease landlord before its buyer and the buyer's lender will be willing to go forward with the transaction. The buyer is paying for a secure property interest, and the lender is lending based on a transferable property interest. Therefore, the ground lease landlord must give the buyer and its lender assurance that the leasehold interest held by the ground tenant is in effect and free from defaults, that the ground lease landlord will accept the buyer as its tenant, and that the buyer's lender will have the right and ability to keep the ground lease in effect notwithstanding the default or bankruptcy of the ground tenant.

Similar to the lender SNDA requirements discussed above, the buyer's lender will insist that the ground lease landlord agree that, if the lender must foreclose to cure the tenant's defaults, the ground lease landlord will not terminate the ground lease as long as these proceedings are moving forward. The lender also will insist on written assurances that, if the ground lease is terminated by reason of the tenant's defaults or is rejected in a bankruptcy, the ground lease landlord will enter into a new ground lease with the lender or its designee on the same terms as the original ground lease, and the improvements on the property will not become the ground lease landlord's property but rather will be the property of the tenant under the new lease. A savvy ground lease landlord may require that the rent be paid by the lender in a timely fashion while the lender is curing the tenant's defaults, obtaining possession of the tenant's interest by foreclosure, or having a new lease executed. The lender will not like this provision because it requires the lender to advance additional money while the loan is in default, but many lenders will agree to this provision so long as the ground lease landlord's only remedy for the lender's failure to make a rent payment after notice is the termination of the ground lease and not a suit against the lender for the unpaid or remaining rent. Some ground lease landlords may be willing to agree to forego rent for a few months during a cure or a bankruptcy to satisfy the lender's requirement, but this type of concession by a ground lease landlord is likely only when the lease is initially executed to induce the tenant (and its lender) to develop the property.

In a ground lease transaction, it is crucial to the marketability of the ground lease interest that the ground lease landlord agree in the lease that the lease is freely transferable and that it will enter into the estoppels, consents, and other agreements that will be required by buyers and their lenders in a timely manner. Of course, these agreements should be made terms of the ground lease itself, but each buyer and lender will want to have an agreement in its name directly with the ground lease landlord, so the ground lease landlord should also be required to put these provisions in a separate agreement. Again, attaching forms that will be executed by the ground lease landlord in the future (particularly the form negotiated between the landlord and the initial tenant's lender, which will be executed when the tenant still has the leverage of agreeing to invest money in the ground lease landlord's property in the future) will avoid future disputes with and delays caused by the ground lease landlord.

Conclusion

Through careful planning and thoughtful lease drafting, owners of commercial rental properties can facilitate smooth sale transactions, while still addressing and accommodating the often contradictory interests of tenants, buyers, and lenders. ■

APPENDIX A

FORM OF TENANT ESTOPPEL CERTIFICATE
(WITH LINED TENANT COMMENTS)

The undersigned ("***Tenant***") hereby certifies to ____________________ ("***Seller***") and to ____________________ (together with its successors and assigns, "***Buyer***") and ________________________ (together with its successors and assigns, "***Lender***") in connection with Buyer's proposed purchase of that certain building located at [Street Address], [City], [State] (the "***Building***") that, as of the date of this certificate:

1. Tenant is the lessee of certain space (the "***Premises***") in the Building, containing approximately ______ square feet and known as Suite No. _______, under a lease dated __________, ______ (collectively, the "***Lease***") entered into between Tenant and Seller, as landlord ("***Landlord***").

2. The Lease is currently in full force and effect and Tenant is not in default thereunder. Tenant has not given Landlord any notice of termination under the Lease and has no currently existing right to terminate the Lease.

3. The Lease, an accurate and complete copy of which is attached hereto as **Exhibit A**, constitutes the entire agreement between Landlord and Tenant with respect to the leasing and occupancy of the Premises; there are no other promises, agreements, understandings or commitments of any kind between Landlord and Tenant with respect thereto; and there are no amendments, supplements or modifications of any kind, whether written or oral, to the Lease except as referenced in Paragraph 1 above and included in **Exhibit A**. Tenant neither expects nor has been promised any inducement, concession or consideration for entering into the Lease, except as stated in the Lease, and there are no side agreements or understandings between Landlord and Tenant.

4. Tenant has accepted the Premises, subject to the terms and conditions of the Lease ***[Note: Insert any applicable construction requirements or warranties]***, and is paying rent under the Lease.

5. The term of the Lease commenced on _______________, ____, and will end on ____________, with ________________ options to extend the term for extension periods of _______ years each. ~~Except as otherwise set forth in the Lease, Tenant has no right to vacate the Premises or cease to operate its business therefrom~~.

6. The rent currently paid by Tenant under the Lease is $____________ per month, consisting of the following:

Base rent of $____________ per month; and

Pro rata share of estimated expenses of $____________ per month.

Such rent has been paid through the month of _______________, 200__.

7. Tenant is required to pay its pro rata share of operating expenses of the Building and Tenant's pro rata share of the Building's real property taxes and insurance costs, subject to the terms and conditions set forth in the Lease. Tenant's pro rata share is _________%. If Tenant's pro rata share of actual operating expenses, real property taxes and insurance costs is more than the estimated payments made by Tenant, Tenant is responsible for the payment of the deficiency in accordance with the Lease on the terms and conditions set forth in the Lease.

8. Tenant is current with respect to, and is paying the full rent and other charges stipulated in the Lease (including, without limitation, its pro rata share of operating expenses, real property taxes and insurance costs) with no offsets, deductions, defenses or claims.

9. ~~As of the date hereof~~, To Tenant's actual knowledge, Tenant is not entitled to any credits, reductions, offsets, defenses, free rent, rent concessions or abatements of rent under the Lease or otherwise against the payment of rent or other charges under the Lease.

10. ~~As of the date of this certificate,~~ To Tenant's actual knowledge, no uncured default, event of default or breach by Landlord exists under the Lease, no facts or circumstances exist that, with the passage of time or giving of notice, will or could constitute a default, event of default, or breach by Landlord under the Lease, and Landlord has performed all obligations of Landlord under the Lease. Tenant has made no claim against Landlord alleging Landlord's default under the Lease. ~~No~~To Tenant's actual knowledge, no circumstances have occurred or currently exist that, by themselves or with the passage of time and/or giving of notice, give rise to a right of Tenant to (a) abate, reduce or offset sums against rent or additional rent or (b) terminate or cancel the Lease.

11. The amount of the security deposit and prepaid rent, if any, paid under the terms of the Lease is $_____________. No advance rentals have been paid, and no other sums have been deposited with Landlord. To Tenant's actual knowledge, Tenant has no unsatisfied claims against Landlord.

12. The undersigned has not entered into any sublease, assignment or any other agreement of any kind (whether oral or written) transferring any of its interest in the Lease or the Premises except as follows: [Enter "None" or details of agreement].

13. Tenant is in full and complete possession of the Premises and has accepted the Premises, including any work of Landlord performed thereon pursuant to the terms and provisions of the Lease, subject to any express warranties provided by Landlord in the Lease and Landlord's performance of any and all construction obligations under the Lease.

14. To ~~the best of~~ Tenant's actual knowledge~~ and belief~~, there are no rental, lease, or similar commissions payable with respect to the Lease, except as may be expressly set forth therein.

15. After receipt of written notice of the conveyance of the Building to Buyer, Tenant will deliver to Lender a copy of all notices Tenant serves on or receives from Landlord to [Lender's notice address]; provided, Tenant's failure to provide any notice to Lender shall not affect the sufficiency or effectiveness of such notice unless such notice relates to a Landlord default that could give rise to a termination, abatement, self-help, or rent offset right of Tenant.

16. ~~All~~To Tenant's actual knowledge, all of the obligations of Landlord under the Lease have been duly performed and completed including, without limitation, any obligations of Landlord to make or to pay Tenant for any improvements, alterations or work done on the Premises, and the improvements described in the Lease have been constructed in accordance with the plans and specifications therefor and have been accepted by Tenant, subject to any express warranties provided by Landlord in the Lease and Landlord's performance of any and all construction obligations under the Lease.

17. Tenant has no option or right to purchase the property of which the Premises are a part, or any part thereof, except as expressly provided in the Lease.

18. Tenant has not at any time and does not currently use the Premises for the generation, manufacture, refining, transportation, treatment, storage or disposal of any unlawful levels of hazardous substance or waste or for any purpose which poses a substantial risk of imminent damage to public health or safety or to the environment, and to the extent hazardous substances customarily used in Tenant's business are used at the Premises, they ~~other than toner, cleaning fluids and other substances in types and quantities typically used in general office space, which~~ are stored, handled and used in compliance with all applicable laws.

19. The undersigned representative of Tenant is duly authorized and fully qualified to execute this instrument on behalf of Tenant thereby binding Tenant.

20. Neither Tenant nor any guarantor of the Lease is currently the subject of any proceeding pursuant to the United States Bankruptcy Code of 1978, as amended.

21. All Exhibits attached hereto are by this reference incorporated fully herein. Tenant makes the statements in this certificate for Buyer's, Lender's and Seller's benefit and protection with the understanding that Buyer intends to rely upon these statements in connection with Buyer's intended purchase of the Building from Seller and Lender's making a mortgage loan that will be evidenced by a note secured by a mortgage upon the Building; provided, however, in the event any statement or certification by Tenant in this Tenant Estoppel proves inaccurate, Tenant shall be estopped from taking a position contrary to the inaccurate statement or certification but shall not be subject to any damages or liability for such inaccuracy except in the event of fraud or intentional misrepresentation. The undersigned agrees that it will, upon receipt of written notice from Seller, commence to pay all rents to Buyer (or its assignee) or to any agent acting on behalf of Buyer or its assignee.

22. In the event of a conflict between any statement or certification in this Tenant Estoppel and any provision of the Lease, the Lease provision shall control.

23. As used in this Tenant Estoppel, the term "Tenant's actual knowledge" means the actual current knowledge, as of the date of this Tenant Estoppel and without investigation, of ***[Insert individual's name—e.g., property manager, director of leasing]***, whom Tenant represents to be the individual in Tenant's organization most likely to have direct knowledge of the issues set forth in this Tenant Estoppel.

Dated: _______________, 200__.

[TENANT], a ______________________

By:________________________________
Name:________________________
Title:_________________________

APPENDIX B

FORM OF SNDA
(WITH LINED TENANT COMMENTS)

SUBORDINATION NON-DISTURBANCE AND ATTORNMENT AGREEMENT

THIS SUBORDINATION, NON-DISTURBANCE AND ATTORNMENT AGREEMENT (the "***Agreement***") is dated as of the _____ day of ____________ 200__, between ____________________, a ____________ ("***Lender***"), and ____________________, a ____________ ("***Tenant***").

RECITALS

Tenant is the tenant under a certain office lease (the "***Lease***') dated ____________, 200__, with ____________________, a ____________ ("***Landlord***"), of premises described in the Lease (the "***Premises***") located in an office building located at ____________________, City of ____________, ____________ County, ____________ and more particularly described in **Exhibit A** attached hereto and made a part hereof (such office building, including the Premises, is hereinafter referred to as the "***Property***").

Lender is the owner and holder of a mortgage/deed of trust and security agreement (the "***Mortgage***") and an assignment of leases and rents on the Property (the "***Assignment of Leases and Rents***" together with the Mortgage, the "***Security Documents***") recorded in the Real Property Records of ____________ County, ____________, which documents secure a Promissory Note now payable to Lender and the lien of which encumbers all or part of the Premises.

C. The parties desire to enter into this Agreement to define their obligations to one another under the terms of the Lease and the Mortgage.

AGREEMENT

For mutual consideration, including the mutual covenants and agreements set forth below, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

1. Tenant agrees that, subject to the terms of this Agreement, the Lease is and shall be subject and subordinate to the lien of the Mortgage, which Mortgage includes ~~Security Documents and to all present or future advances under the obligations secured thereby and~~ all renewals, amendments, modifications, consolidations, replacements and extensions thereof. ~~of the secured obligations and the Security Documents, to the full extent of all amounts secured by the Security Documents from time to time.~~ The advancement of additional monies by Lender, the repayment of which is secured by the Mortgage, shall not affect the subordination provided for in this Agreement.

2. Lender agrees that, so long as Tenant is not in default of any term, covenant or condition of the Lease beyond all applicable notice and cure periods, if the Lender exercises any of its rights under the Security Documents, including an entry by Lender pursuant to the Mortgage or a foreclosure of the Mortgage, Tenant's rights and privileges under the Lease shall not be terminated, diminished or interfered with by Lender in the exercise of any of Lender's rights under the Mortgage, and Lender will not join Tenant as a party defendant in any action or proceeding for the purpose of foreclosing the Mortgage unless required by applicable law.

3. Tenant agrees that, in the event of a foreclosure of the Mortgage by Lender or the acceptance of a deed in lieu of foreclosure by Lender or any other succession of Lender to fee ownership, ~~at Lender's option,~~ Tenant will attorn to and recognize the transferee of Landlord's interest as its landlord, and the transferee of Landlord's interest shall recognize Tenant as its tenant, under the Lease for the remainder of the term of the Lease (including all extension periods which have been or are hereafter exercised) upon the same terms and conditions as are set forth in the Lease, subject to the terms of this Agreement, and Tenant hereby agrees to pay and perform all of the obligations of Tenant pursuant to the Lease, and the transferee shall pay and perform all of the obligations of Landlord pursuant to the Lease.

4. Tenant agrees that, in the event Lender succeeds to the interest of Landlord under the Lease, Lender shall not be:

(a) liable for any act or omission of any prior landlord (including, without limitation, the then defaulting Landlord), except to the extent that such act or omission is of a continuing nature and Lender has been given notice and an opportunity to cure as provided herein ***[Note: Landlord construction obligations may require additional arrangements – e.g., self-help rights]***; or

(b) subject to any defense or offsets which Tenant may have against any prior landlord (including, without limitation, the then defaulting Landlord), except to the extent that such defense or offset relates to a default of a continuing nature, and Lender has been given notice and an opportunity to cure as provided herein; or

(c) bound by any payment of rent or additional rent which Tenant might have paid for more than one month in advance of the due date under the Lease to any prior landlord or accountable for any other monies deposited with any prior landlord (including security deposits), except to the extent such monies are actually received by Lender; or

(d) bound by any obligation to make any payment to Tenant which was required to be made prior to the time Lender succeeded to any prior landlord's interest; provided, however, in the event Landlord fails to pay any portion of the Improvement Allowance to Tenant in accordance with the terms and conditions of the Lease, which failure is not cured by Landlord or Lender within ten (10) days after written notice, Tenant may offset any such unpaid improvement allowance against the next rentals due under the Lease; or

(e) bound by any surrender, termination, amendment or modification of the Lease made without the consent of Lender; provided, however, Lender's consent shall not be required for any amendment or modification (i) arising out of the exercise of any of Tenant's expansion, right of first refusal, renewal or other rights expressly set forth in the Lease, (ii) confirming the commencement or expiration dates of the Lease, (iii) relating to any assignment or sublease permitted under the Lease without Landlord's consent, or (iv) that does not materially and adversely affect the amount of rent payable by Tenant or landlord's or tenant's obligations and rights under the Lease.

5. Tenant agrees that, notwithstanding any provision hereof to the contrary, the terms of the ~~Mortgage~~ Lease shall continue to govern with respect to the disposition of any insurance proceeds or eminent domain awards, and any obligations of Landlord to restore the real estate of which the Premises are a part shall be limited, insofar as they apply to Lender, to insurance proceeds or eminent domain awards received by Lender after the deduction of all costs and expenses incurred in obtaining such proceeds or awards. ***[Note: If the lease requires Tenant to restore the premises following a casualty or condemnation event, it is particularly important to confirm that the proceeds will be disbursed and applied to restoration in accordance with the terms of the Lease.]***

6. Tenant hereby agrees to use commercially reasonable efforts to give to Lender copies of all notices of Landlord default(s) under the Lease in the same manner as, and whenever, Tenant shall give any such notice of default to Landlord~~, and~~. With respect to any such notice of a Landlord default that could give rise to termination, abatement, self-help, or rent set-off rights ("***Material Defaults***"), no such notice of default shall be deemed given to Landlord unless and until a copy of such notice shall have been so delivered to Lender. Lender shall have the right to remedy any Landlord default under the Lease, or to cause any default of Landlord under the Lease to be remedied, ~~and for such purpose~~within the time frames provided to Landlord for curing defaults in the Lease; provided, with respect to Material Defaults, Tenant hereby grants Lender an additional five (5) days beyond any grace period given to Landlord in the Lease for any monetary default and thirty (30) days beyond any grace period given to Landlord in the Lease for any non-monetary default~~; provided, however, if possession of the Premises is required in order to cure such default, or if such default is not susceptible of being cured by Lender, Lender shall have such reasonable period of time as is required to pursue such cure to its completion, as long as Lender, in good faith, shall have notified Tenant that Lender intends to institute proceedings under the Security Documents, and, thereafter, as long as such proceedings shall have been instituted and shall be prosecuted with reasonable diligence~~. Tenant shall accept performance by Lender of any term, covenant, condition or agreement to be performed by Landlord under the Lease with the same force and effect as though performed by Landlord. Lender shall have the right, without Tenant's consent, to foreclose the Mortgage or to accept a deed in lieu of foreclosure of the Mortgage or to exercise any other remedies under the Security Documents.

7. Tenant hereby consents to the Assignment of Leases and Rents from Landlord to Lender in connection with the Lender's loan to Landlord (the "***Loan***"). Tenant acknowledges that the interest of the Landlord under the Lease is to be assigned to Lender solely as security for the purposes specified in said assignment, and Lender shall have no duty, liability or obligation whatsoever under the Lease or any extension or renewal thereof, either by virtue of said assignment or by any subsequent receipt or collection of rents thereunder, unless Lender shall specifically undertake such liability in writing or unless Lender or its designee or nominee becomes the fee owner of the Premises, and then only with respect to periods during which

Lender or its designee or nominee is the fee owner of the Premises. Tenant agrees that upon receipt of a written notice from Lender of a default by Landlord under the Loan, Tenant will thereafter, if requested by Lender, pay rent to Lender in accordance with the terms of the Lease. Landlord consents in advance to such payment and waives all claims against Tenant for such payments.

~~8. The Lease shall not be assigned by Tenant without Lender's prior written consent in each instance, which shall not be unreasonably withheld if the conditions of the Lease have been satisfied.~~

8. ~~9.~~ Any notice, election, communication, request or other document or demand required or permitted under this Agreement shall be in writing and shall be deemed delivered on the earlier to occur of (a) receipt or (b) the date of delivery, refusal or nondelivery indicated on the return receipt, if deposited in a United States Postal Service Depository, postage prepaid, sent certified or registered mail, return receipt requested, or if sent via a recognized commercial courier service providing for a receipt, addressed to Tenant or Lender, as the case may be, at the following addresses:

If to Tenant ______________________________
____
Attention:______________________

If to Lender: ______________________________
____

9. ~~10.~~ The term "***Lender***" as used herein includes any successor or assign of the named Lender herein, including without limitation, any co-lender at the time of making the Loan, any purchaser at a foreclosure sale and any transferee pursuant to a deed in lieu of foreclosure, and their successors and assigns, and the terms "***Tenant***" and "***Landlord***" as used herein include any successor and assign of the named Tenant and Landlord herein, respectively; provided, however, that such reference to Tenant's or Landlord's successors and assigns shall not be construed as Lender's consent to any assignment or other transfer by Tenant or Landlord.

10. ~~11.~~ If any provision of this Agreement is held to be invalid or unenforceable by a court of competent jurisdiction, such provision shall be deemed modified to the extent necessary to be enforceable, or if such modification is not practicable, such provision shall be deemed deleted from this Agreement, and the other provisions of this Agreement shall remain in full force and effect.

11. ~~12.~~ Neither this Agreement nor any of the terms hereof may be terminated, amended, supplemented, waived or modified orally, but only by an instrument in writing executed by the party against which enforcement of the termination, amendment, supplement, waiver or modification is sought.

This Agreement shall be construed in accordance with the laws of the state of in which the Property is located.

The person executing this agreement on behalf of Tenant is authorized by Tenant to do so and execution hereof is the binding act of Tenant enforceable against Tenant.

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[Signature and notary blocks omitted from Appendix B]

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

eReport

A Bi-monthly Electronic Publication for Section Members October 2008

Group and Committee News

Hospitality, Timesharing and Common Interests Development Group

The most recent conference call held by the Hospitality, Timesharing and Common Interests Development Group generated a great deal of interest on the part of a number of group members who participated in the call and resulted in the exchange of additional information and cases by the participants. The Hospitality Group intends to continue with these hot topic conference calls on a quarterly basis. The next call is scheduled for January 5, 2009 from 12:00 noon to 1:00 pm EST. The topic to be discussed has not been determined; however, we are looking at the possibility of addressing the retooling of common interest community documents to meet the requirements of Freddie Mac and Fannie Mae.

Through its monthly administrative conference calls with committee chairs and vice-chairs within the Hospitality Group, plans are being finalized for CLE presentations at the Spring Symposium. Topics actively being worked on include co-sponsorship of a program on the Interstate Land Sales Act and the recent cases under it and an additional program on federal regulation, specifically RESPA and concepts relating to retrofitting of condominium documents to make them compliant with Freddie Mac and Fannie Mae requirements. Speakers for these programs are currently being contacted and more information will be available on those programs later in the month.

The group intends to present a brief update on Interstate Land Sales case law at the Montreal Leadership Meeting. The next committee administrative conference call will be on December 8, 2008 from 1:30 to 2:30 pm EST.

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Delaware Alternative Entity Law Update

Tuesday, August 26, 2008

Chancery Court Enforces Provision in LLC Agreement Waiving the Right to Petition for Judicial Dissolution

The Delaware Court of Chancery recently issued its decision in *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC,* CA No. 3803-CC (Del. Ch. August 19, 2008), enforcing a waiver, contained in a limited liability company agreement, of a member's right to petition for judicial dissolution and for appointment of a receiver. This case deals with an issue of first impression under Delaware law and further highlights Delaware's strong policy in favor of freedom of contract in limited liability company agreements.

Petitioners R&R Capital, LLC and FTP Capital, LLC (collectively, "Petitioners") are members of seven Delaware limited liability companies (the "Waiver LLCs") and are also members of the sole member of another two entities (together with the Waiver LLCs, the "LLCs"). Petitioners sought judicial dissolution of the LLCs or, alternatively, the appointment of a receiver to wind up the affairs of the LLCs.

The Waiver LLCs moved to dismiss Petitioners' law suit on the grounds that Petitioners waived their rights to petition for judicial dissolution and the appointment of a receiver under the Waiver LLCs' limited liability company agreements. In addressing whether such waivers were enforceable, the court first emphasized that limited liability companies are creatures of contract and that the Delaware Limited Liability Company Act (the "LLC Act") specifically provides for giving maximum effect to the principles of freedom of contract and to the enforceability of a limited liability company's operating agreement. The court rejected Petitioners' statutory arguments and found nothing in the statute to indicate that waiver of a member's right to petition the court for dissolution or the appointment of a receiver violates the LLC Act. The court also rejected Petitioners' arguments that the waivers at issue in this case should be unenforceable because they violate public policy. It pointed to freedom of contract and opined that there are legitimate business reasons why a limited liability company would want to set up its governance structure so that its members could not petition the court for dissolution, including protecting the company from a "disgruntled member." Finally, the court stated that there is no threat to equity associated with such waivers because the LLC Act provides the "unwaivable protection of the implied covenant [of good faith and fair dealing] that allows the vast majority of the remainder of the LLC Act to be so flexible." (Op. at 20).

In sum, the court, in granting the motion to dismiss as to the Waiver LLCs, concluded that the "allure of the limited liability company would be eviscerated if the parties could simply petition this court to renegotiate their agreements when relationships sour." (Op. at 21). Thus, the court fortified Delaware's policy of giving maximum effect to the freedom of contract in limited liability company agreements by holding that where members of a limited liability company "knowingly, voluntarily, and unambiguously waived their rights to petition [the] Court for dissolution or appointment of a receiver under the LLC Act… [such waiver will be] enforceable because it contravenes neither the LLC Act itself nor the public policy of the state." (Op. at 21).
