GP|Solo Law Trends & News

Practice Area Newsletter

A SERVICE OF THE ABA GENERAL PRACTICE, SOLO & SMALL FIRM DIVISION

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Dear Division Member:

Below is the final issue of *Law Trends* for the last bar year (2006/07). I am sorry for the delay but some snags developed which we believe are now corrected. As with prior issues, this e-newsletter includes articles, checklists, and other valuable practice information and practical tips, all from each of our substantive practice areas in the General Practice, Solo & Small Firm Division. This issue highlights some emerging areas, some interesting checklists, the use of e-discovery in various applications, and much more.

With this issue, *Law Trends* is now three years old. We hope you agree that with each edition, *Law Trends* continues to provide meaningful articles for each of you and continues to improve. We trust that this edition, like the others, continues to be helpful to you in your daily practice. I encourage you to take just a few moments to read the list of articles included below. Of course, it is yours to download and keep as a reference for the future. And, as in the past, you can either download specific articles or you may download the entire newsletter by clicking the PDF link.

There are many Division members integrally involved in putting this e-newsletter together. Their hard work and dedication are certainly present. I thank them for producing this issue for the Division.

I hope each of you enjoys this issue of *Law Trends*. The publication will continue quarterly and we hope you continue to find it a source of valuable information. If you are interested in either writing an article or participating in the production of the newsletter, please contact Jim Schwartz at attyjls@aol.com.

I hope to see you at the GP|Solo 2007 Fall Meeting in Philadelphia!

Best regards,

Keith B. McLennan
Chair, GP|Solo Division

PRACTICE AREAS

DOWNLOAD NEWSLETTER

BUSINESS LAW

» The New Standard for "All Appropriate Inquiries"

» Agricultural Exchange Issues

» Business Protection Tips, Part 1: The Telephone

» Business Protection Tips, Part 2: The Street

Scott Laufenberg
Business Law Group Coordinator

Scott received his undergraduate degree from the University of Wisconsin – Platteville, and he received his J.D. and a master's degree in public administration from Drake University. After clerking for the Kentucky Court of Appeals upon graduation, he currently practices with the firm of Kerrick, Stivers & Coyle, P.L.C. in Bowling Green, KY. He is also an adjunct professor at Western Kentucky University where he teaches an upper-level course on legal principles to students pursuing degrees in business-related majors.

ESTATE PLANNING

» When a Beneficiary Asks You to Draft a Will

» Planning & Documenting Charitable Gifts

FAMILY LAW

» Missing Links in International Child Visitation Law: Joint Custody and Due Process

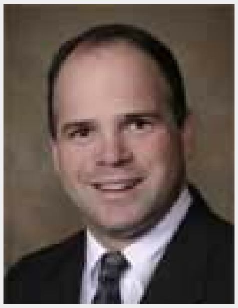
LITIGATION

» Fingerprint Evidence Criminal Practice Guide II

» How to Avoid Liability Under Federal Civil Rights Laws for Third-Party Harassment

» A Baker's Dozen of ADR Practice Pointers to Boost Your Bottom Line

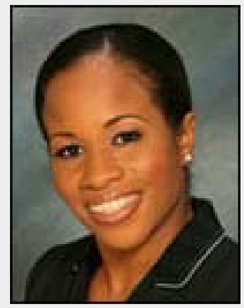
Henry M. DeWoskin
Litigation Group Coordinator



Henry M. DeWoskin is a partner at the law firm of Alan E. DeWoskin, P.C. in St. Louis, Missouri. His practice consists of wills, estate planning, military law, probate, domestic relations, social security and general civil litigation. Henry holds multiple positions in the GP Solo & Small Firm Division and the YLD of the American Bar Association and the Bar Association of Metropolitan St. Louis. In addition, he is a Major in the Judge Advocate General's Corps in the United States Army Reserves. Henry received his B.A. from Bucknell University in 1992 and his J.D. from Temple University in 1996.

REAL ESTATE

Youshea A. Berry



Youshea A. Berry is the founding member of the Law Office of Youshea A. Berry, PLLC., in downtown Washington, D.C. Her practice is focused on the areas of real estate law and small business/corporate law. Ms. Berry was recently selected to participate in the Urban Land Institute's competitive Real Estate Associate Program (REAP). She also serves on the Public Relations Committee of African American Real Estate Professionals (AAREP) organization in Washington D.C.

Ms. Berry is active in local and national bar associations. Within the ABA, she is Assistant Editor of the Young Lawyers' Newsletter, Vice-Chair of the YLD Law Practice Management Section, and a member of the West Solo Advisory Board. She was one of three attorneys in the nation selected to serve as a Diversity Fellow by the GPSolo Division of the ABA this year. Last year, she was selected as an ABA Young Lawyers' Division Scholar and served as the Deputy Chair of the Real Estate Committee of the GPSolo Division. Ms. Berry earned her J.D. from Emory University and her B.A. with honors from Xavier University of Louisiana. She is admitted to the federal and state bars of the District of Columbia and Maryland and the U.S. Supreme Court.

GP|Solo Law Trends & News
Business Law

September 2007 Volume 3, Number 2

The New Standard for "All Appropriate Inquiries"

by STEVEN A. BURNS, ESQ. & KERRY F. NELSON, ESQ.

Introduction

On November 1, 2005, the United States Environmental Protection Agency ("EPA") issued final standards for conducting "all appropriate inquiries" ("AAI") for purposes of various defenses against liability under the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"). As of November 1, 2006, a prospective property purchaser must follow the federal standards – codified at 40 C.F.R. Part 312 – when conducting pre-acquisition due diligence. Adherence to these guidelines is necessary to qualify for landowner liability protections provided by CERCLA, including, among others, the "innocent landowner" and "contiguous landowner" defenses. The AAI standard also governs the site characterization and assessment activities of any party seeking a brownfields grant under CERCLA Section 104(k)(2)(B). Additionally, the conduct of AAI can allow identification of business risks arising under other environmental laws.

PART I
Background on CERCLA Liability

Since the late 1960s, all sizes and types of real estate projects have become increasingly subject to environmental regulation, and the development and redevelopment of property impacted by soil or groundwater contamination have been particular challenges. Undertaking thorough and effective environmental due diligence prior to the acquisition of real property is essential to avoid the potential for owner/operator liability under environmental schemes such as CERCLA and to identify business risks. CERCLA is especially notable among environmental laws because it imposes a standard of strict liability on property owners and operators for the cost of remediation of "hazardous substances," regardless of whether the owner or operator actually caused the contamination. CERCLA defines "hazardous substance" broadly, but the statute excludes some pollutants, most notably petroleum.

CERCLA liability extends to all current owners and operators and to all parties who owned or operated the property at the time of disposal[1]. While well intended, this virtually unlimited imposition of liability for remediation costs imposed unacceptable risks to prospective purchasers and, in so doing, has tended to discourage property transfers and economic redevelopment.

Congress amended CERCLA to address the effects of strict liability in 1986. The Superfund Amendments and Reauthorization Act ("SARA") created the "innocent landowner defense" to CERCLA liability. Specifically, new CERCLA section 101(35)(B) provided a defense from strict liability for persons who could demonstrate that "they did not know and had no reason to know" prior to purchasing the impacted property that any hazardous substance had been disposed of or had impacted the property. In order to qualify for this defense, property owners were required to demonstrate, among other things, that "all appropriate inquiry" into the previous ownership and uses of the property had been undertaken prior to acquisition.

Congress further amended CERCLA in 2002 to provide the "contiguous landowner" defense and to establish a "brownfields" program to encourage redevelopment of contaminated sites. The 2002 amendments also required EPA to establish the standards and practices which would constitute AAI for purposes of the innocent landowner, contiguous landowner, and participants in the brownfields program. EPA discharged that requirement by issuing the final AAI rule in 2005.

PART II
How to Maintain Eligibility for CERCLA Defenses

A. Requirements for All Appropriate Inquiries

To perform AAI essentially means to conduct a Phase I environmental site assessment ("ESA"). In fact, EPA has explicitly recognized compliance with ASTM Standard 1527-05 for Phase I ESAs as sufficient for purposes of AAI under CERCLA.

1. Documentation and Qualifications of the Environmental Professional

The final AAI rule requires a written report outlining the results of the investigation into the past uses and current condition of the property. This report must contain an opinion of an "environmental professional" as to whether the AAI identified any conditions suggesting the potential for a release or threatened release of hazardous substances that could impact the subject property. The environmental professional also must identify and comment on any data gaps that impact the ability to render such an opinion. The environmental professional must provide a declaration that he or she meets EPA's definition of an "environmental professional," has specific and relevant experience, and has performed all work consistent with the rule on all appropriate inquiries. EPA requires an environmental professional, or one under the professional's direct supervision, to conduct many of the elements of AAI.

2. Investigation

The primary objective of AAI is to identify information relating to current and past uses and conditions that could have led to the release of hazardous substances on the subject property. This information will be identified in the following ways:

Interviews:
Under the final rule, an environmental professional must interview current owners and occupants, current and past facility managers with relevant knowledge of the property, and neighboring owners or occupants if the property is abandoned.

Historic Sources:
An environmental professional must search historic sources, such as chain of title documents, aerial photos, and land use records, should be searched as far back in history as there is documentation that the property contained structures or was placed into use. If documentation cannot be traced back this far, it must be noted as a data gap to the inquiries.

Cleanup Liens:
The search for environmental cleanup liens can be the responsibility of the purchaser or the landowner, but must be provided to the environmental professional for inclusion in the report.

Review of Federal, State, and Local Records:
The environmental professional must search reasonably ascertainable government records and available lists for institutional and engineering controls at the subject property. The search must also take into account such records at other properties within specified distances from the subject property.

Visual Inspection:
The environmental professional must inspect the property and adjoining properties visually.

Specialized Knowledge:
Any specialized knowledge or experience on the part of the prospective purchaser and/or the environmental professional conducting the investigation must be considered in reaching the opinion and conclusions set forth in the report.

Purchase Price:

The final rule requires a consideration of the relationship of the purchase price to the fair market value of the property, if the property were not contaminated. The environmental professional need not conduct this element of AAI.

Commonly Known Information:
Commonly known and reasonably ascertainable information may be obtained from the owner or occupant of the property; members of the community, including neighboring property owners, government officials, or local media sources; local libraries; or historical societies.

Degree of Obviousness:
Persons conducting AAI must consider all of the information obtained during the investigation to determine whether an obvious conclusion can be drawn that there are conditions indicative of a release or threatened release of a hazardous substance.

Time Frame:
All appropriate inquiries must be conducted within one year prior to the date on which a person or entity acquires a property. Prior investigations may be updated within one year of acquisition to satisfy the AAI standard. However, several components of the investigation must be updated within 180 days prior to the passage of title. These components include interviews with past and present owners, operators, and occupants; searches for recorded environmental cleanup liens; reviews of federal, tribal, state, and local government records; visual inspections of the facility and adjoining properties; and the declaration by the environmental professional.

B. Additional Requirements for Avoidance of Liability

Even after the conduct of AAI and the purchase of the property, a property owner must observe certain continuing obligations in order to qualify for the CERCLA liability defenses. Continuing obligations include complying with all land use restrictions and reporting obligations; not impeding any institutional controls implemented at the site; taking reasonable steps to prevent releases; cooperating with EPA, state, or other parties conducting response actions; complying with CERCLA information requests; and providing legally required notices.

Conclusion

The primary objective of the AAI standard is to identify any conditions indicating a release or threatened release of hazardous substances that might impact the subject property. Compliance with the AAI standard also enables the property owner to qualify for various CERCLA defenses and to avoid costly remediation obligations. The conduct of AAI may reveal other information not relevant under CERCLA but which nevertheless indicates other significant risks, such as petroleum contamination. It is critical to engage a qualified environmental professional to ensure that the full protections of these defenses are available.

[1] Although lenders are protected from CERCLA's liability provisions by the secured creditor exemption, they may still face significant losses when borrowers incur CERCLA liability. For instance, cleanup costs can exceed the entire property value, leading to loan default and leaving lenders with unmarketable property as a result of environmental impacts. In today's real estate market, this risk of default is of particular concern to the banking community. It is also likely that rating agencies will modify their own guidelines to mandate compliance with the new AAI standard.

GP|Solo Law Trends & News
Business Law

September 2007 Volume 3, Number 2

Agricultural Exchange Issues

by Max Hansen

Many Section 1031 exchanges involve agricultural operations or agricultural components. These exchanges typically include real property and improvements and personal property. The result may be a group of concurrent exchanges in one transaction. The issues which surface are interesting and the following outlines some of these issues.

Real property is not like-kind to personal property, Rev Rul 59-229, 1959 CB 180; *Comm v. Crichton*, 122 F.2d 181 (CCA5 1941); *Oregon Lumber Co. v. Comm.*, 20 TC 192 (1953). Whether property is real or personal is generally determined by state law, *Aquilino v. U.S.*, 363 US 509, 4 L. Ed. 2d 1365, 1371, 80 S. Ct. 1277, 1285 (1960); *Coupe v. Comm.*, 52 TC 394 (1969), acqd. in result only 1970-1 CB xv, although some exceptions to this general rule may exist. The words "like-kind" refer to the nature or character of the property and not to its grade or quality, Reg §1.1031(a)-1(b). The terms "nature or character", "grade or quality" and "kind or class", may sometimes be of little help in determining whether different properties will be considered like-kind.

Many personal property exchanges are undertaken on a daily basis but they substantially differ from real property exchanges. Under the Regulations for personal property exchanges, Reg §1.1031(a)-2, depreciable tangible personal property held for productive use in trade or business is considered to have been exchanged for like-kind property if it is exchanged for property that is either like-kind or like-class. Classes of depreciable personal property are referenced in the examples in the Regulations and are more specifically set forth in the North American Industry Classifications System (NAICS). This system recently replaced the old Standard Industrial Classification (SIC) system.

Examples of personal property exchanges arising in an agricultural context are the following:

1. Farm and ranch tools and machinery;
2. Livestock for livestock, provided the livestock are held for production of income (such as dairy or breeding) and not primarily for sale, *Woodbury*

v. Comm., 49 TC 180 (1967), acqd. 1969-2 CB xxv; *Wylie v. United States*, 68-1 USTC & 9286 (ND Tex 1968), *Rutherford v. Comm.*, TC Memo 1978-505;
3. Irrigation equipment;
4. Livestock handling equipment;

The procedure for determining whether the taxpayer may successfully complete an exchange of certain relinquished personal property for replacement personal property would follow the typical inquiry in any personal property exchange. First, is the property of "like-kind"? If that answer is not readily available, is the property of "like-class"? The taxpayer may need to resort to NAICS in the second tier inquiry.

There are additional problems beyond determining like-kind or like-class. The taxpayer may have no intention of acquiring another ranch or farm operation. In that event, the value allocated in the Buy-Sell Agreement to machinery and equipment will be "boot" to the extent the taxpayer is only going to acquire other commercial or investment realty. This results in an inherent tension between the taxpayer and buyer of the relinquished property with regard to allocation of values to the personal property. The taxpayer would like to allocate a negligible value to the machinery and equipment, but the buyer wants to start out with a high value for depreciation purposes.

Another issue arises in the context of livestock exchanges. Cows can be traded for cows and bulls can be traded for bulls. An exchange cannot include steers or heifers which are neutered, since they are inventory. Inventory or property held for purposes of resale is specifically excluded from 1031 treatment.

The timely identification of replacement livestock also is an issue in most livestock exchanges. The issue regularly arises since replacement livestock are typically acquired at auction sales and may not be acquired as part of the purchase of a replacement farm or ranch. If the taxpayer is not able to identify a specific herd of livestock, they are probably best served if they acquire replacement livestock prior to midnight of the 45th day to capitalize on the "deemed identified" rule.

Another potential problem area in these types of exchanges is that of exchanges out of only a portion of the bundle of rights comprising fee ownership. Transactions involving water rights, timber rights, oil, gas and other minerals, and conservation easements are just some examples. The essential inquiry is whether these types of rights are real property interests according to state law in the venue of the exchange.

This problem is exemplified in the case of water rights since some types of claimed water rights are treated by state law as a real property interest. In other instances, especially stored water that is delivered by an irrigation system from a system of dams, is an adjunct of stock ownership in the irrigation system. Acquisition of the stock shares will not qualify as like kind replacement property and care must be taken in allocating value to the shares as part of the real property exchange.

Another similar problem area is grazing rights which are typically appurtenant to ranching operations. Sometimes these grazing rights are part of a long term lease arrangement with another private party or long term permits with Federal or state governmental entities. These grazing rights are generally viewed as real property interests and therefore part of the entire real property exchange. Other grazing rights are based upon membership in a grazing association, typically involving multiple members. The association membership is evidenced by stock ownership in the association and the stock is specifically excluded from1031 treatment by the Code. As in the situations involving the irrigation company stock described above, the exchanger needs to be careful in the allocation of value to the grazing association stock.

An additional problem area is the sale of a personal residence as part of the exchange. Some taxpayers may be tempted to use as much of the Section 121 exclusion as possible to pull cash out of the exchange of the relinquished property or allocate that value to debt payoff. This avenue is not available if the exchanger is a business entity and not the family members who own the company but are given the residence as a benefit of their employment.

Additionally, there is substantial gray area in determining what comprises the curtilage or additional area surrounding the residence which may increase the value. Many times the taxpayer is tempted to include the value of outbuildings in the Section 121 allocation but that application is faulty since the outbuildings are part of the 1031 transaction. Many times it is possible to include with the actual residence a relatively small portion of the surrounding property and value the residential property at a higher per acre rural residential homesite value than the rest of the agricultural land. This allows the taxpayer to allocate more value to the Section 121 portion of the transaction.

The taxpayer really needs to document the reasonable value of the residence to support the value of the Section 121 exclusion since that may be challenged in an audit. This is a problem since, many times, the allocation issue does not come up until the closing date is looming on the horizon and there is no time to obtain a certified appraisal. If that is the case, the taxpayer is well-advised to have some supporting documentation of initial acquisition cost or value of improvements. In some instances an alternative would be to have a knowledgeable realtor at least provide a current market analysis of the residential tract for inclusion in the taxpayer’s files. That is undoubtedly better than nothing at all in the file.

The taxpayer also needs to discuss the Section 121 transaction with their accountant to determine that there will not be some depreciation recapture issues. They may have forgotten they claimed depreciation on some portion of their residence used as the office or some other aspect of the agriculture operation.

One final thing to consider in the area of agricultural exchanges involving personal property as part of the larger real property transaction is the availability of government programs that may provide tax relief on the personal property exchange portion of the deal. An example of this is the current relief afforded livestock producers who have sold livestock due to extreme drought conditions. Those livestock producers are allowed to use a special application of the involuntary conversion provisions of Section 1033 as the basis for a special four year period for the replacement of livestock sold due to severe drought conditions. That replacement period has been recently further extended pursuant to Notice 2006-82. Where the taxpayer qualifies for this type of relief, it may be advisable to do an exchange on the real property and use the Section 1033 rollover for the livestock in stead of a livestock exchange.

In summary, many times an exchange of farm or ranch property presents as a straightforward real estate exchange. As the transaction goes forward, however, many of the issues addressed in this article may rise to the surface. Hopefully the exchange coordinator and other professionals involved in the transaction who are aware of these potential problems will be prepared to keep the taxpayer on the right track.

GP|Solo Law Trends & News
Business Law

September 2007 Volume 3, Number 2

Business Protection Tips
Part I: The Telephone

By David Zachary Kaufman

This will be the first of a series of articles discussing business and personal protection tips for the lawyer, judge, and other professional who deals with people in emotional crises or with people who are just plain dangerous.

This column is not interested in merely telling the reader to buy a weapon or a dog or whatever. These tips are basic, they work, they are generally not expensive and they usually have a “whack!” factor. (A “whack!” is the sound of your hand hitting your forehead as you say “Why didn’t I think of that?”)

In this column let’s talk about that most ubiquitous of electronic devices, the phone.

First, the cell phone. These little devices (some think of them as the spawn of the devil) are wonderful life-saving tools when properly used (and I don’t mean as a weapon a la Rep. Cynthia McKinney (Ga. D)). The first thing anyone should do when they get a phone is to program it. I urge all people to program “9" to speed dial “911". That way you can a push of the button summons help right away. By the way, this same tip should be used for all your home and office phones, especially the receptionist’s phone and your phone.

I just love speed-dial on all the phones. That way you can call for help or advice or whatever quickly and easily. But! You have to update your speed-dial numbers regularly to be sure that they are the ones you want to use. I suggest you review your speed-dial list at least every month. That way, you can have already dialed someone you trust and all you have to do is press the “Send” key if you are in distress.

Some cell phones are flip-phones and some are not. Many of us carry the phones with a locked keyboard. If you are one who carries their phone locked, unlock the keyboard when you are carrying the phone in your hand. A locked phone cannot make quick calls and is just a hand tool--and not a very good one either.

Another tip which is gaining more popularity (or notoriety) came out of the London bombings in July 2005: establish a separate entry in your cell phone "I_C_E" (In Case of Emergency) with a specific cell phone number. The reason for this is that many of us have family members listed as "Mom" or "Dad" but these people are not the people we would want called if there were an emergency. (I know that my mother, although she is a fit 87, is not the person I would most want first notified if I were injured and unable to communicate. I suspect that I am not the only one who feels that way.) "I_C_E" is the number to use to designate the key contact person in the event that you have been injured and cannot communicate. This convention is becoming a well-established protocol in the emergency responders' lexicon.

Now, let's talk about the office phone.

When you train your staff be sure that they understand what they can and cannot say. You may not want people to know where you are. That gives someone hunting you an idea where to look. Good example: Do not say "Mr. Kaufman is in Washington D.C. Superior Court this morning." That tells people where I will be and (maybe) the route I will use to return to the office. It also tells people (roughly) a schedule of when I can be expected to be in the parking lot near my office. All of these facts are facts that someone who is stalking me would love to know. Because this is how they can identify my car, etc. The same applies if someone calls to make an appointment. I have time to meet them or I don't. But do not tell people I am in or out of the office.

Similarly, staff should never give out any other information to anyone without checking with you first. Astonishingly, even in this age of identify theft, people still give out their attorney's schedule, his cell phone number, make and model of his car and all kinds of other personal information. None of this information should be given out to anyone without checking with you first. You simply don't want people to know when you are working late, alone in the office and when the office is empty or any other information like that.

I love Caller ID. In fact I tell clients that I will not take calls that are ID-blocked. Similarly, I love *69 — the reverse dial that tells me who or what is calling me. This lets me screen all my calls. Staff should be told to do this and to keep a record of all numbers on the "proscribed list" so that they will know who cannot be put through.

I also love Radio Shack. They have the most amazing stuff there sometimes. For example, did you know that, for about $20.00, you can buy a little device that plugs into your phone and lets you record conversations on a recorder? This little thing is wonderful if you are prone to getting telephone threats--a call comes in, the threat starts, and you start recording it for evidence. Be sure to obey the law though. Some states, like Maryland, require that both sides to the conversation consent to taping. Others do not. Check for yourself before trying this. One easy place to start checking is http://www.rcfp.org/taping. This site is run by the Lawyers Committee for A Free Press and is about 3 years old. But it will let you start your research with an advantage.

Finally, a word about what to say (or do) with your phone. Establish a code phrase for you to use on the phone in case something happens (kidnapping, break-in, etc.) — something innocuous like, "I'm fine. Take care of yourself". Use it whenever you need to send a message. Depending on your level of paranoia, a 'code phrase' that is NOT used may also be a clue. In other words, if someone is holding you and telling you to read from a script, and you can't say "I'm fine, take care of yourself" then they won't know that you're in trouble. If, on the other hand, your code is, you always end the conversation with "Take care of yourself" and you don't use it, THEN the other party knows you're in trouble.

Anyway, I hope these help. Good luck and be safe.

David Zachary Kaufman, J.D., Ph.D. Websites: KAUFMAN LAW, A Professional Corporation; www.karatelaw.com; and Qui Custodes, the Personal Protection Blog.

GP|Solo Law Trends & News
Business Law

September 2007 Volume 3, Number 2

Business Protection Tips
Part II: The Street

By David Zachary Kaufman

I hate to think about how many of us are vulnerable once we set foot on the street outside our home or office. These tips will help you avoid trouble as you go to and fro. They should be considered supplemental to the Business Protection Tips also provided.

Let me share with you the following scenario which I recently read on the ABA listserve Solosez (the names are changed to protect the protagonists). A woman lawyer wrote:

> One day I was walking in the courthouse downtown LA on the 6th floor. I was running late so I was walking pretty fast while wearing somewhat high heels and, of course, carrying a purse, a briefcase, and some heavy files.

I see this all the time. I see it in Court, out of court, walking around Washington, D.C. And it's not just lawyers. It's not women either. Other than the heels (more on that later) I see just this scenario frequently. In fact, how many times have you, gentle reader, seen just this scenario where the person is also checking their Blackberry or talking on the phone?

Now in the real-life event described above, our attorney lost her dignity and was embarrassed. No true damage. But imagine that same scene on the street. Or at night? Imagine what would have happened to her if there was someone about with bad intentions. Or a local opportunist. So, these tips will help you stay alert, undistracted, and alive.

Look around. And keep looking around. Don't let yourself get distracted by the phone or Blackberry. It can wait. Which leads to my next point: Watch behind you. It is possible that an attacker will approach you from the front — unlikely but possible. More likely is that any problem will approach you from the side or rear. It's harder for you to detect an attack then and respond. So stay alert. Listen for running steps approaching from behind. When you stop, check the reflection in the glass to see what's behind you. When you have to stop at a corner to wait for traffic, look around.

I hate headsets, earbuds, phones, IPODS and MP3 players on the street. They distract you. They keep you from hearing what is going on around you. You don't hear the car or bicyclist coming up behind. Do not use them.

On a similar note, I hate high heels, flip flops, women's backless sandals, and other foot gear (I won't call them shoes) that prevent the wearer from running away from a threat. Ladies, gentlemen, you wouldn't wear hobbles on the street. Why wear foot gear that has the same effect? I don't understand it and oppose it. There are perfectly adequate, professional-looking foot gear that won't do these things. I just don't get it and urge people not to do it.

When you are walking around, walk calmly and with good balance. Don't swing your arms like a track meet, take normal steps, watch your footing. People who walk "funny" tend to be targets for muggers and other attackers.

As you walk down the street (or anywhere else) don't walk between groups of people. When you do, you are surrounded. Not a good idea at all.

As the lady lawyer in the initial scenario learned, it's a bad idea to carry a purse, a briefcase and files. Add a phone and it's an absolute recipe for disaster. But there is a simple cure: Use a cart or wheeled briefcase, not multiple briefcases, purses etc. This lets you keep your balance and avoid problems. It also helps avoid back problems. I use them all the time.

They also have another use. I strongly recommend that you always have 1 hand free at all times. If our lady lawyer had done this, she might have avoided falling (or avoided getting hurt) when she tripped in her high heels. She could then have grabbed for support, had less trouble opening doors or pushing elevator buttons etc.

When you are looking around, listen to your instincts. Humans have evolved over millions of years and our survival instincts (if we actually pay attention to them) are strong. Pay attention to them. It is fashionable to criticize people for making snap judgments of others. But safety doesn't have time to think and analyze and do a detailed investigation. By the time to complete your lawyerly investigation it's too late.

Finally (at least for today) learn this tip, teach it to your children, preach it to all who can hear: Drop your stuff & run! One of the saddest things I ever heard was a little girl who was grabbed off the street. When we got her back I had a chance to talk to her. One thing we talked about was running away. She had tried, she told me but she couldn't get away because she was carrying her backpack. And she knew that if she lost her backpack she would be in trouble – her parents had told her that. Don't you make the same mistake.

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GP|Solo Law Trends & News
Estate Planning

September 2007 Volume 3, Number 2

WHEN A BENEFICIARY ASKS YOU TO DRAFT A WILL

Kenneth L. Jorgensen

Today's elderly population and its unprecedented wealth have heightened the need for lawyers to sharpen their focus on the legal ethics of estate planning and specifically on ethical issues linked to undue influence, which is often the source of will contests or other instrument challenges.

Much has been written about the legal ethics of drafting instruments naming the lawyer or a member of the lawyer's family as beneficiary. Minnesota courts have condemned this practice for almost a century.[1] Legal ethics prohibitions have existed for over 20 years and lawyers who run afoul of these provisions have been publicly disciplined.[2]

Far less has been mentioned about conflicts associated with drafting instruments at the request of an intended beneficiary.[3] Last year the ABA Committee on Professional Ethics outlined the ethical concerns associated with a request by a client to draft a testamentary instrument which names the client as a beneficiary.[4] The opinion concludes that it is ethically permissible to draft instruments on the request of a beneficiary who is also a client. Nonetheless, it cautions lawyers about conflicts between multiple clients (beneficiary and testator or donor and donee) and conflicts stemming from the client/beneficiary recommending the lawyer's services or paying the lawyer's fee.

CONFLICTS BETWEEN MULTIPLE CLIENTS

Where the beneficiary is already a client, Rule 1.7(b), Minnesota Rules of Professional Conduct (MRPC), prohibits representing the testator if the representation will be materially impaired by the lawyer's duties to the beneficiary as a client. Multiple client conflicts come about under two different scenarios: (1) the lawyer jointly represents the beneficiary and the testator in preparing the testator's estate plan; or (2) the lawyer already represents the beneficiary in another matter when he or she undertakes to represent the testator. In either situation, Rule 1.7(b) requires the lawyer to determine whether obligations owed to the beneficiary (e.g., confidentiality) will substantially interfere with the ability to competently advise the testator.

Although beneficiaries, especially children, often participate in the estate-planning process, lawyers less frequently undertake to jointly represent both the testator and the beneficiaries. In fact, joint representation of a beneficiary and the testator in drafting an estate plan is likely improvident unless the beneficiary will receive no more than he or she is entitled to under intestacy laws. Even then joint representation is sometimes ill-advised.

If Junior's lawyer jointly represents Junior and his mother in amending Mom's will, Mom's decision to change her will and leave Junior's sister's share to the church could be attacked due to Junior's participation. Likewise, joint representation of Junior and Mom in devising Mom's estate equally to Junior and his siblings may create a legal presumption of undue influence if Junior had been disinherited under his mother's prior wills.[5]

Ordinarily, a lawyer's concurrent representation of the testator in estate planning, and the beneficiary in an unrelated matter(s), will not materially impair the lawyer's estate planning advice. Yet under the right circumstances it can. Assume Junior brings Mom to his lawyer because he has convinced Mom to begin gifting her stock portfolio to Junior. Mom is inclined to make the gifts but tells the lawyer she is concerned about Junior's financial irresponsibility due to a failed real estate project several years ago. Unbeknownst to Mom, Junior's lawyer is currently representing him in another failing real estate development that Junior hopes to rescue with the stock gifts. Unless Junior consents to disclosure of the failing real estate project and his intended use of the stocks, the lawyer's confidentiality duty will materially impair her ability to competently advise Mom about the gifts. Conversely, if the lawyer and Junior have already discussed using Mom's stocks to salvage the project, any advice to Mom about restrictions on the stock transfers or placing them in trust will materially impede the lawyer's representation of Junior in the real estate matter.

PAYING THE LAWYER'S FEE

With client consent, persons other than a client can pay the lawyer's fee provided they do not interfere with the lawyer's professional judgment and client confidentiality is maintained.[6] Similar conditions are attached to employment that results when a client/beneficiary recommends the lawyer's services. The ethics rules permit the lawyer to assist the testator with his or her estate as long as the client/beneficiary referral does not interfere with the exercise of the lawyer's professional judgment.[7]

As the ABA opinion indicates, none of these obstacles are insurmountable, nor do they stand for the proposition that a lawyer can never draft a will for a beneficiary who is a current client, recommended the lawyer, or paid the lawyer's fee. The caveats within the ethics rules to ignore the desires of persons other than the client appear simple enough. At the same time, thwarting the intermeddling attempts of a son or daughter who tries to direct, control, influence, or manipulate a parent's estate plan is, at a minimum, an uncomfortable task when the son or daughter has generated the legal business. This delicate situation becomes even less palatable if he or she is paying the lawyer's fee. These situations are fruitful grounds for undue influence claims if they are not adequately addressed.

CONFLICTS AND UNDUE INFLUENCE

Compliance with professional ethics rules is an obvious starting point since a lawyer's unprofessional conduct by itself can create a presumption of undue influence.[8] If the beneficiary will pay the lawyer's fee, consent must be obtained from the testator and the lawyer should advise the beneficiary that fee payment does not confer client status to the beneficiary. Similar disclosures are appropriate for beneficiaries who recommend the lawyer's services or otherwise are responsible for the retention of the lawyer.

Where the beneficiary is a client, the lawyer must analyze the potential for conflict of interest and determine if the representation is in the testator's best interests. Waivers of confidentiality should be obtained where it is likely information will need to be shared between the representations to avoid conflicts.

Competent estate planning representation necessitates limiting the opportunity for successful undue influence claims. Factors which contribute to judicial inference of undue influence include: (1) the existence of a confidential relationship between the testator and a beneficiary who receives a disproportionate benefit under the will; (2) whether the testator was dependent upon this beneficiary; and (3) whether the will was prepared and executed under circumstances in which the beneficiary was instrumental or had substantial participation.[9]

Lawyers can control neither of the first two factors. The existence of a confidential relationship and a disproportionate benefit are simply facts of the representation that must be considered in anticipating undue influence claims. Lawyers can, however, dictate the degree to which beneficiaries take part in the preparation and execution of estate planning instruments, and thereby reduce the client's exposure to undue influence attacks.

Many of these ethical quandaries evolve from failure to establish or clarify the client's identity at the outset of the relationship. More importantly, many are likely avoidable if the client's identity is clarified and conveyed to those involved in the representation.

Where a beneficiary is an existing client, it is vital that the testator be regarded or identified as the client, and that the lawyer maintain as normal an attorney-client relationship with the testator as is possible. Before executing any instruments, the lawyer should meet individually with the testator to confirm testamentary intent. When deciding undue influence claims, courts often look at the degree to which a beneficiary participates in the estate planning process,[10] especially if there is a preexisting attorney-client relationship with the scrivener and the beneficiary stands to increase his or her share under the new or amended instrument.[11] A lawyer's disproportionate reliance upon a beneficiary for testamentary instructions begs conflict of interest claims and expands the opportunity for undue influence challenges.[12]

Lawyers dealing with worrisome beneficiaries who persist in being involved in preparation and execution of testamentary instruments should educate them about the consequences of their involvement. Those who mistakenly believe the lawyer is protecting or safeguarding their interests in the estate plan should be promptly disabused of the notion. Rule 4.3, MRPC, entitled "Dealing with Unrepresented Person," requires lawyers to make reasonable efforts to correct such misunderstandings.

A necessary component of estate planning is forecasting perils and advising clients how to avoid these disasters. While not every undue influence claim can be predicted, many are clearly foreseeable. Where they are, lawyers must closely scrutinize their own involvement, as well as that of others, to limit the opportunity for successful undue influence challenges.

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[1] In re Estate of Keeley, 167 Minn. 120, 208 N.W. 537 (1926).

[2] See e.g., In re Smith, 654 N.W.2d 659 (Minn. 2002); In re Astleford, 404 N.W.2d 798 (Minn. 1987); In re Pruetter, 359 N.W.2d 613 (Minn. 1984).

[3] The term "beneficiary" is used in this article to denote a potential or intended beneficiary, since until a will or other instrument is drafted, there technically is no beneficiary. The most common example is a son or daughter who refers or brings a parent to his or her lawyer for estate planning representation. Much of the analysis herein is equally applicable to inter vivos gifts between donor and donee.

[4] See Formal Opinion 02-428 (August 9, 2002) entitled "Drafting Will on Recommendation of Potential Beneficiary Who Also is Client."

[5] In re Olson's Estate, 227 Minn. 289, 35 N.W.2d 439 (1948).

[6] See Rule 1.8(f), MRPC.
[7] See Rule 5.4(c), MRPC.
[8] See e.g. In re Estate of Reiland, 292 Minn. 460, 462, 194 N.W.2d 289, 290 (1972).
[9] See In re Olson's Estate, supra n. 4, 35 N.W.2d at 445.
[10] In re Estate of Holden, 261 Minn. 527, 113 N.W.2d 87 (1962).
[11] See e.g. In re Estate of Koch, 849 P.2d 977 (Kan. Ct. App. 1993).
[12] See e.g. Haynes v. First National State Bank, 432 A.2d 890 (N.J. 1981). See also In re Estate of Jessman, 197 Ill. App.3d 414, 554 N.E.2d 718 (1990).

GP|Solo Law Trends & News
Estate Planning

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Planning & Documenting Charitable Gifts

by Alan F. Rothschild Jr.

Many of today's donors desire to designate their charitable contributions for specific purposes or to impose other conditions on their gifts. Such conditions and restrictions are usually well-intended, but careful thought and planning are required to ensure these limitations do not endanger the deductibility of the contribution by the donor while ensuring proper use of the gift by the charity.

Conditions and Restrictions

A contribution is deductible only if it is made "to or for the use of" a charitable organization under Code § 170(a). A donor may earmark a contribution to charity for a particular use without jeopardizing the charitable deduction, provided the restriction does not prevent the charity from freely using the transferred assets, or, at a minimum, the income therefrom, in furtherance of its charitable purposes. If the gift is earmarked for a noncharitable purpose, or even a charitable purpose that is outside of the donee organization's charitable mission, the gift is not deductible. Treas. Reg. § 1.170A-1(e) provides examples of permissible restrictions, including the contribution of land to a city to be used as a public park, when the city intends to use the land for such purpose at the time of the gift; the creation of an endowment fund for a particular university department; and the donation of funds for the construction of a building sought to be built by an exempt organization.

If a restriction or condition is placed on a gift, it must be done at the time of the gift. Otherwise, the retained right to place conditions on the property after the gift could render the gift incomplete. A donor, however, can retain the right to make nonbinding recommendations regarding the distribution of previously *54 contributed property. This is why contributions to donor-advised funds that allow post-gift recommendations are fully deductible.

Reverter Clauses

Reverter clauses are sometimes used by donors to ensure their gift conditions are followed. For example, in the city park example above, if the city ceased to use the donated property as a public park, the gift agreement or deed of gift might have provided that ownership of the land would revert back to the donor's family. Such reversionary provisions must be used with caution because they will cause the charitable transfer to be nondeductible unless the reversion is "so remote as to be negligible." Treas. Reg. § 20.2055-2(b)(1). In Briggs v. Commissioner, 72 T.C. 646 (1979), the Tax Court defined "so remote as to be negligible" as a "chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction" and "so highly improbable and remote as to be lacking in reason and substance."

In Rev. Rul. 2003-28, 2003-11 I.R.B. 594, an individual transferred a patent to an educational institution on the condition that a designated faculty member remain on the faculty during the patent's 15 years of remaining life. The IRS determined that the possibility that the faculty member might not remain was not so remote as to be negligible. Therefore, no charitable deduction was allowed. On the other hand, the city park example illustrates that when the circumstances at the time of the gift indicate a strong likelihood that there will be no reversion, the charitable deduction will be permitted.

Conditions Precedent

A charitable deduction will also be disallowed if a transfer is dependent on the performance of some act or the happening of an event before the transfer becomes effective, unless the possibility that the event will not occur meets the "so remote as to be negligible" test.

In Rev. Rul. 79-249, 1979-2 C.B. 104, a gift to a public school system to build a school contained a reverter clause if the remaining funds were not raised to complete the project. The IRS ruled that until it was certain there were adequate funds to construct the building, the possibility the donation would be returned to the donor was not so remote as to be negligible. Therefore, the deduction had to be deferred by the donor until it was clear that the building would be constructed.

Benefiting Individuals

To be deductible, a donation must be "to or for the use of" a charitable organization, not a designated individual, no matter how deserving the individual may be. A donor cannot avoid this result by flowing his or her contribution through a charitable organization and earmarking a gift for a particular individual.

The IRS uses two tests to determine if a gift is earmarked and therefore nondeductible:

1. Does the donee organization have discretion and control over the contribution notwithstanding the donor's desire to benefit a specific individual? If the charity has the option to apply the donated funds to other purposes, this supports deductibility of the contribution.

2. Does the donor intend to benefit the charitable organization or the designated individual? A written agreement between the donor and donee provides the clearest evidence of how each side understands its rights and responsibilities. In addition to a gift agreement or correspondence between the donor and the donee organization, the donee organization's fund-raising literature and the donor's receipt for the gift will be considered by the IRS in determining whether an earmarked gift is made.

A number of cases and rulings involve family members who desire to provide funds for a relative's living expenses while doing missionary work. If the gift is earmarked, the charitable deduction is denied. Facts that have supported a deductible gift include statements in the missionary organization's fund-raising material that the organization retains full discretion over the donated funds and will assess all of its current needs before distributing any funds.

To ensure deductibility, the IRS suggests the following language in the donor's receipt: "This contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds." Donors should consider including such language in their gift transmittal letter and donee organizations' fund-raising materials and gift receipts ought to contain similar language to bolster the deductibility of contributions.

Artwork

In a series of 2002 private letter rulings, the IRS highlighted the special issues that must be considered when placing restrictions on gifts of art and other collectibles. In these rulings, the donor bequeathed paintings to a museum, subject to conditions, including their continuous display and the requirement that the proceeds from the sale of any of the works be used to purchase other works of art. The IRS allowed the charitable deduction because the only limitation on the museum's sale of the art was a requirement that it purchase other works of art with the proceeds.

Restrictions on deaccessioning, including required holding periods before the sale of donated artwork, are more troublesome and can negatively affect the amount of the donor's charitable deduction. For example, collectors Samuel and Norma Silverman contributed 148 paintings to various exempt organizations with the restriction that the paintings could not be sold for three years. The Tax Court found that the Silvermans were entitled to an income tax charitable deduction, but the three-year restriction had an adverse effect on the value of the paintings and reduced the charitable deduction. Silverman v. Commissioner, 27 T.C.M. (CCH) 1066 (1968).

In PLR 200418002, a husband and wife amassed an important art collection that was housed in a gallery attached to their home. The couple planned to bequeath their home, gallery, and funds sufficient to maintain the facilities to a museum.

*55 The couple entered into an agreement with the museum to transfer the collection to the museum at the last of their deaths, subject to certain conditions. The museum agreed to display the collection permanently at either the gallery or the museum. The agreement prevented the museum from selling, transferring, or disposing of any of the works. In the event the museum did attempt to sell any pieces from the collection, ownership immediately and automatically vested in the donors' private foundation.

In this case, the IRS ruled that because the collection would not under any circumstances revert to the donors or inure to the benefit of any private individuals, the value of the charitable deduction would be equal to the collection's estate tax value included in the donors' gross estate for estate tax purposes.

Naming Opportunities

Many donors desire to establish lasting memorials through the funding of named scholarship funds, professorships, or capital projects. So long as these gifts further the organization's charitable mission, the deductibility of a gift conditioned on the naming opportunity should not be questioned. Recent corporate scandals, however, serve as a reminder that exempt organizations must protect their integrity by establishing "un-naming" policies and procedures in their gift acceptance policies or gift agreements to address unexpected future developments.

For example, it is unclear what will become of the University of Alabama--Birmingham's Scrushy Hall, named after the dethroned CEO of HealthSouth, or the University of Missouri--Columbia's professorship named after former Enron CEO Kenneth Lay. Absent un-naming rights in the gift agreement or gift acceptance policy, the donee organization may not be able to remove the donor's name, or may be required to return the contribution if it does.

Investment Management

In PLRs 200445023 and 200445024, the IRS ruled that a donor's retention of the right to manage the portfolio of publicly traded securities given to charity would not preclude the donor's income and gift tax charitable deductions. In these two rulings, the donors gave cash and marketable securities to a college, subject to an agreement that the gifted assets be placed in a brokerage account in the name of the charity for its exclusive benefit, with management authority retained by the donors. The account could be invested only in U.S. equities, mutual funds and fixed-income securities, offshore/onshore hedge funds, real estate investment trusts, and private placements and could not be invested in any company in which a donor held, directly or indirectly, more than 5% of the stock. The college could withdraw the assets from the accounts or terminate the management agreement at any time. If not earlier terminated, the management agreement would end in 10 years. The IRS determined that the donors retained no economic interest in or power to direct the beneficial enjoyment of the accounts and that their investment management control, as limited in these facts, did not preclude an income or gift tax charitable deduction.

Valuation

Generally, the amount of an income or estate tax charitable deduction is equal to the contributed property's fair market value on the date of the gift or bequest. If a donor places a restriction on the marketability or use of the contributed property, the charitable deduction must be reduced to take the restriction into account.

Rev. Rul. 2003-28, 2003-11 I.R.B. 594, discussed above, also addressed the deductibility of the contribution of a patent that the donee was prohibited from selling for three years. The IRS ruled that although the three-year sale prohibition could never cause the patent to revert to the donor, or otherwise benefit the donor, the restriction reduced the fair market value of the patent and the donor's corresponding charitable deduction.

In Rev. Rul. 85-99, 1985-2 C.B. 83, an agricultural college sought to acquire a parcel of land for research purposes. A landowner agreed to donate the property and did so by deed containing a restrictive covenant limiting the land's use to agricultural purposes. Although the highest and best use of the land was commercial development, the IRS ruled that the income tax deduction must be determined in light of the restriction, not based on highest and best use. A very similar conclusion was reached in PLR 8641017, in which a donor restricted mining on property in the deed conveying it to an exempt organization. In both cases, the donor could have received a significantly greater deduction by first granting a conservation easement to restrict development or commercial activity on the land, then contributing the property, subject to the easement, to the exempt organization.

When evaluating gift restrictions, advisors also must consider the significantly different outcomes in inter vivos and testamentary gift situations. Although a donor's income tax deduction will be reduced if a lifetime gift is deemed to have restrictions affecting valuation, a particularly bad result arises if the donor owns fee simple title to property at death but places restrictions in the testamentary charitable gift of the property that reduces its fair market value. In that case, the estate tax charitable deduction may be significantly below the property's value for estate tax purposes. Rather than jeopardize the value of a charitable deduction, donors should consider whether precatory language expressing their wishes regarding the donated property will achieve the desired result.

Standing to Enforce

Once a gift is complete, courts have historically held that the donor no longer has standing to enforce the terms of the charitable gift. Instead, this right inures *56 to the benefit of the public, usually enforceable by the state attorney general's office.

That began to change in 2001 when a New York State appellate court ruled that Adele Smithers-Fornaci, the personal representative of her late husband's estate, could sue St. Luke's-Roosevelt Hospital Center for failing to abide by the terms of her husband's $10 million, 30-year-old gift. Smithers v. St. Luke's-Roosevelt Hospital Center, 723 N.Y.S.2d 426 (App. Div. 2001). In Smithers, Mrs. Smithers-Fornaci alleged that St. Luke's had misappropriated $5 million from her husband's endowment fund and planned to put the proceeds from the sale of a townhouse, also given by her husband, into its general operating funds. The New York court held that the donor's estate had standing to sue St. Luke's to enforce the terms of the gifts. Since Smithers, some courts have opened to the idea that donors, their estates, or their descendants have the right to rescind gifts or to take legal action if gift conditions are not honored.

In another case, Sybil Harrington, a wealthy Texas oil businesswoman, gave $33 million to the Metropolitan Opera to support opera "in the traditional manner." The Met used part of her gift to televise an abstract Wagner production. Relying on Smithers, Harrington's estate sued the Met to recoup the funds expended on its television production and to obtain veto power over how the remaining funds were spent.

In 1996, Paul Glenn's Foundation for Medical Research donated $1.6 million to the University of Southern California for the study of aging. Glenn sued USC in 2001, alleging that it did not honor its oral and written contracts. This case received significant media attention and reaffirmed the post-Smithers trend of allowing private legal action when charitable gifts do not turn out as planned.

Although these recent cases have begun to alter the traditional concept that the donor has no standing to sue, these decisions are quite new and not the law in every jurisdiction. As such, donors may seek to create standing to enforce their gifts by including provisions in their gift agreement giving themselves, their estate, or some other identifiable party the power to enforce the gift.

Using Gift Agreements

Many of the practical and tax problems discussed above can be addressed or eliminated in a well-drafted gift agreement signed by the donor and donee at the time of the gift. Ideally, the gift agreement will ensure:

- The donor's wishes are clearly understood and articulated.
- Changes in circumstances are anticipated and addressed, including:
    - The potential conflict between a donor's desire for specificity and the donee's desire for flexibility.
    - Mandatory alternative uses are a modern alternative to the old-fashioned reversionary provisions. Sample language might include:
      "If due to changed circumstances it is impracticable to carry out the above purpose, the gift will be used for...:
    - [specific alternative use]
    - purposes as nearly as possible akin to the original purpose as possible."
    - A donor can even specify another charitable organization as an alternative beneficiary if the gift conditions are not met.
    - Most testamentary donors may be satisfied with precatory language ("It is my wish...").
    - Buildings do not last forever, so what happens to the donor's name? More progressive donors should consider permitting the charity to allow alternate uses after a fixed period of time.
- For deferred gifts, it is important for the written gift agreement to address the following issues:
    - Enforceability of the pledge.

    - A specific payment schedule.
    - Whether naming will be withheld until gift completion.
    - Whether the name can be removed if the gift is not completed or if the donor gets into trouble.
    - Who pays for project cost overruns.
    - Clarification the donor's wishes regarding confidentiality of donor and amount of gift. Consider how state sunshine laws apply if confidentiality is desired by the donor or the charity.
    - The Uniform Management of Institutional Funds Act (UMIFA) governs the management of many endowed funds. The donor should understand the provisions of UMIFA and how it may affect the use of the contributed funds.
    - All too many agreements are drafted by nonlawyers, such as development officers, and fail to address basic contract issues, such as
        - the governing law,
        - that the agreement may be amended only in writing signed by authorized persons, and
        - that the written agreement is the entire agreement between the parties.

Gift Acceptance Policies

Many exempt organizations need to update their gift acceptance policies to establish criteria for all naming opportunities and for the removal of names from endowment funds, buildings, and so on. Donors and their advisors should look for provisions that address

- what happens 30 years from now if the named building is demolished or completely renovated, and
- what rights the charity has if the donor goes to jail or defaults on its pledge.

Professional Ethics

Attorneys who render charitable planning advice must be ever mindful that charitable gift planning is governed by the same rules of professional conduct as other areas of law practice.

Oregon Formal Ethics Opinion No. 1991-116 (subsequently readopted as Formal Opinion 2005-116) involved a very typical fact pattern. The attorney was a long-serving member of the charitable organization's board of directors and had provided legal advice to the organization on a continuing basis. An individual donor, likely a fellow board member, asked the attorney to represent the donor and the donor's spouse in two estate planning projects: an inter vivos charitable remainder trust in which the charitable organization would be the remainder beneficiary and the preparation of wills under which the charity also would be one of the beneficiaries.

The Oregon Ethics Opinion specifically addressed three questions:

1. May the attorney represent both the donors and the charity in the charitable remainder trust transaction?
No. Because of the potential differing interests or positions between the charity and the donors concerning the terms of the transaction, representation of both the charity and donors in this CRT transaction would constitute a conflict of interest.

2. May the attorney represent only the donors in the CRT transaction?
Yes. With full disclosure and the consent of both the charity and the donors.

3. May the attorney prepare the donors' wills?
Yes. With full disclosure to and consent from the donors. The consent of the charity was not required in this situation because its interests were deemed not to be adverse under this document, unlike the charitable remainder trust transaction.

In Maryland Ethics Docket 2003-08, the Committee on Ethics of the Maryland State Bar Association ruled that a lawyer who encourages parishioners of his church to leave bequests to the church in their wills may not also prepare their wills because of Rule 1.7 of the Maryland Rules of Professional Conduct governing conflicts of interest. This rule (which is similar to Rule 1.7 of the ABA Model Rules of Professional Conduct) prohibits a lawyer from representing a client if that representation will be directly adverse to another client or may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest.

In this situation, the lawyer chaired the church's development committee and offered to prepare estate planning documents on a pro bono basis for church members interested in leaving bequests to the church. The Maryland Committee on Ethics ruled that the lawyer's interest in helping his church's planned giving efforts compromised his independent professional judgment. The lawyer could not represent both the interest of the client and the development committee at the same time.

Attorneys, and other professional advisors, with ties to charitable organizations must carefully evaluate their relationships with the organization to determine whether it creates a conflict of interest or concerns about undue influence with a prospective client who is considering gifts or other transactions with the charitable organization. Full disclosure of the advisor's relationship with the charitable organization, in writing, is well advised. The advisor also might consider obtaining a written acknowledgement and waiver of any potential conflicts.

Conclusion

Planned giving advisors must be sensitive to the new breed of donors and their desire to control or restrict their charitable gifts. Many of these desires can be addressed in a well-drafted charitable gift agreement. Failure to properly design and restrict donor control and gift restrictions, however, can cause practical and tax implications that both the donor and the charitable recipient would like to avoid.

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GP|Solo Law Trends & News
Family Law

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Missing Links in International Child Visitation Law: Joint Custody and Due Process

by June Edvenson, Esq.

In our growing global village, love continues to cross national borders, bringing with it children, long-distance visitation and custodial crises. Enter the Hague Convention on the Civil Aspects of International Child Abduction ("Hague Convention" or "Convention"), which also covers the problem of the non-custodial parent's "access" to the child. The usual problem is in securing cooperation on visitation from the custodial parent, a problem recently called "as difficult as it is urgent and important."[1]

As more nations join both the Convention and the Rights of the Child Treaty, the tandem concerns of due process and custody of the child bare their international baby teeth. In a recent case involving a Norwegian mother and American father, these issues were found to be difficult to raise, both administratively and judicially, in part because the Convention itself fails to contemplate them in a more effectively global and jurisdictional way, and in part due to the natural reticence of Member nations to enforce against their own.[2] The Norwegian case exhibited the same lapses in enforcable activity as other international jurisdictions, thus robbing the Convention of its effectiveness and pointing to the need for practitioners to press for further development. I suggest that the Convention's access goals are better reached by focusing on custody and due process concerns.

Interference with visitation as a ground for modification of custody offers an opportunity to level the playing field. The Norwegian Child Law includes such a provision, as well as the "right" of the non-custodial parent to visitation. Specifically, in a case where the custodial parent hinders visitation, the non-custodial parent "can demand a new custody order as to who shall have custody or who the child shall live with."[3] The Norwegian court did not reach the issue on the merits. Unfortunately, this case resulted in an agreed visitation order nearly forced on the father, and a best interests of the child analysis that looked surprisingly like the mother's delaying but preferred travel calendar.

In general, due process standards vary by nation, and are variably applied. Thus, in Member states, a custody cause of action's separation from the visitation case brought in a Hague Convention suit for access is not just an inconvenience, but a four-lane highway for obfuscation of the international law's goals and objectives.

The international law tries to provide more: the Convention includes the supplication – to both administrative and judicial authorities – to "take all appropriate measures" to accomplish its goals. These can include provisional measures, as well as outreach "to make arrangements for organizing or securing the effective exercise of rights of access," a broad perspective found throughout the treaty.[4]

In this example, the U.S. State Department was prompt in its handling of the application submitted on the father's behalf, and the Norwegian Ministry of Justice, in a generous gesture, suggested to the mother in writing that there appeared to be some merit to the father's claim, requesting she contact the father and come to an agreement for visitation. Stillness was then the mother's best friend, and a fjord full of quietitude fell upon the scene. Fall turned into Winter, Winter into Spring and Spring into Summer before the mother was forced to show her hand. The emotional toll was that of the child who loves his father and was used to seeing him regularly, and of the father whose determination and patience were rewarded with little official activity. The lack of any follow-up on the Ministry's orders and the mother's apparent snubbing of the international process were something easily accomplished, but difficult for the Norwegian authorities to confront and respond to. Despite the Norwegian custody law's threat to consider custodial changes for hindered visitation, an option even pointed out by Norway in its international reporting[5], general due process was impeded, even after filing suit, beyond what would be expected in the U.S. before two preliminary hearings resulted in the 'agreed' visitation order, no consideration of custody, and questionable compliance. As a good American would say, "There oughtta be a better way."

The Custody and Due Process Issues

There would be 'a better way' if the playing field were leveled. Custody holds that potential, not just on the national playing field, but as a lever for international enforcement. The Convention does not consider the merits of the custody determination and, thus, does not guarantee a custody hearing in the case of a non-custodial parent.[6] What is needed is a greater interest in awarding joint custody, and a standard consistent with wrongful retention that would meet U.S. notions of due process under the Uniform Child Custody Jurisdiction Act (UCCJA).[7] Despite U.S. jurisdictional variations in the application of UCCJA standards, nations utilizing these concepts, in addition to their own domestic law, would bring about a greater number of timely and equitable results.

As for due process in our increasingly global village, when the wheels of justice are turning so slowly that the child is growing through important periods without shared parental contact, the rights that should be realized *are not* realized. Yet the custody issue is a scary monster in a country whose own bad-behaving national is the custodial solace-seeker. It is time to consider that determination more relevant to the international visitation case.

Consider custody the chips. The custodial parent will quite often have custody by default and has a huge pile of chips, while the non-custodial parent has no chips, and must not only fight the good visitation fight, but fight it with one hand tied behind his back, and half-way 'round the world.

While it is fair to admit, as U.S. courts have done, that 'the frustration of visitation alone will not justify a change in custody',[8] a broader conclusion should more often be made. Where other 'values are equal' and the child's paramount right to share time with both parents is considered - either through domestic law or the international Rights of the Child Treaty, the frustration of visitation should rise to the level necessary to obtain an examination not only of the best interests of the child but of the better enforcability of the visitation order within the context of joint custody. Utilizing the custodial battle should, therefore, conceptually, also be a context for achieving better due process on the issue of hindered access.

Practical considerations of real people trying to accomplish real rights, the natural inequality of parties from different countries, and a re-evaluation of the significance of the human rights involved in these cases, scream for the inclusion of the custody connection in the access case, as well as the right of children to more urgent activity to secure due process as a right resulting from the Convention's administrative and judicial exercise.

The role of nationalism, protectionism and xenophobia will continue but must give way, something perhaps only accomplished if the Hague Conference involves itself more fully in developing international legal standards for Convention actions. Certainly, the Convention's access goals are better served by using custody and due process considerations to create a more dramatic, more realistic and more effective composition of the 'access' case.

We've seen an historical shift from due process as a jurisdictional issue to due process as *in rem*.[9] Now, we see due process moving from a procedural right to a human right - in the sense that human rights are often intentionally stymied by the *lack* of it, and not accomplished *without* it. What we should therefore see is a similar shift in international practice to prioritize the child custody issue as a necessary compliance tool of the Hague Convention in 'hindered access' visitation disputes, and increased attention to matters of timeliness in Member states' responses.

Delays of judicial and administrative authorities can be easily disguised as bumbling bureaucracy, and will usually protect the local 'national' to the detriment of both the non-custodial parent's and the child's international legal rights. It is therefore also important to restate the Convention's admonition to take "all appropriate measures" to secure its objectives.

Children are waiting to meet their fathers and mothers. The timeframe for their development, and the usefulness of accomplishing shared visitation is limited. The stage for the parents' relationship is, more and more, the world. The international procedure must be structured and usable in a way that bridges easily-recognized legal concepts and commonly-found testing hurdles to achieve the goals of the law.

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[1] From Report And Conclusions of the Special Commission Concerning the Hague Convention of 25 October 1980 on the Civil Aspects of International Child Abduction, 27 September – 1 October, 2002, by the Permanent Bureau, available online.
[2] A good introduction to these issues can now be found at 38 U.C. Davis Law Review 1049 (April, 2005), "Interpreting the Hague Abduction Convention: In Search of a Global Jurisprudence," by Linda Silverman.
[3] Norwegian Barneloven, Sec. 43, as amended April, 2004. Translated into English by the author.
[4] Silverman at 38 U.C. Davis Law Review 1080-1085 (April, 2005).
[5] United Nations CRC Convention on the Rights of the Child, 39th Session, Summary Record of the 1037th Meeting, Geneva, 24 May 2005, Consideration of Reports of States Parties, Third Periodic Report of Norway, available online.
[6] On point, but older, 26 Vand. J. Transnat'l L. 865 (November, 1993), "Due Process Rights of Parents and Children in International Child Abductions: An Examination of the Hague Convention and its Exceptions," by Dorothy Carol Daigle.
[7] Ibid. I agree generally with this suggestion, but am not updated on its status, an area for continued work.
[8] An excellent new resource in this area is found at 11 Causes of Action 1 (2006), "Cause of Action for Transfer of Child's Custody Based on Parent's Interference With Visitation Rights," by Kurtis A. Kemper, J.D.
[9] ie: having to do with property distribution.

GP|Solo Law Trends & News
Litigation

September 2007 Volume 3, Number 2

Table of Contents

Fingerprint Evidence Criminal Practice Guide II

Checklist: The Evidence Behind the Fingerprint Match

In discovery and the investigation, make every effort to obtain the following about how the fingerprints were lifted and preserved:

1. reports made by police relative to the lifting, preservation, or identification of the latent prints;

2. reports sent to or received from other law enforcement agencies regarding the lifting, preservation or identification of prints;

3. items that yielded alleged fingerprints of the defendant;

4. photographs of the latent prints, including negatives, as well as documentation of any other means of latent print preservation or reproduction (e.g., lasers);

5. known prints of the defendant, not limited to only those taken upon his arrest in connection with this case;

6. witness affidavits, notes, and reports prepared in connection with the fingerprint evidence;

7. the process involved in the lifting of the latent prints; and

8. the process that preserved the latent prints.

Law Enforcement and Expert Witnesses

You will need information about the experts who have examined the prints, those who will testify--whether prosecution or defense, your own or your adversary's--and law enforcement personnel who had any involvement with the latent or rolled prints. The following information is geared toward the qualifications of the witness to testify and opportunities for cross-examination at trial:

1. résumé of all expert and fingerprint witnesses;

2. forensic experience;

3. extent to which the witness works for the police and/or prosecution;

4. salary and/or fee per job;

5. past history of errors in photographing fingerprints;

6. past history of misconduct, including but not limited to falsification of fingerprint evidence;

7. past history of destruction of fingerprint evidence;

8. training and education in preservation techniques, such as attendance at training course sponsored by law enforcement or the International Association for Identification (IAI);

9. membership in any professional organizations associated with preservation of fingerprint evidence;

10. professional papers published;

11. teaching positions held;

12. the preserver's knowledge of the methodologies available for the preservation of prints to demonstrate the limitations of his or her technique or experience;

13. steps taken in application of the methodology to the prints in this case;

14. documentation of disciplinary action, suspension, termination, or lawsuits against anyone who participated in the lifting, preservation, or identification of the prints;

15. documentation of disciplinary action, suspension, termination, or lawsuits against anyone who will appear as prosecution fingerprint witnesses;

16. documentation of any prior training or experience of law enforcement personnel who lifted and/or preserved the prints;

17. documentation of training or experience of any expert or expert witness who compared the latent and rolled prints;

18. prior testimony given by any of the prosecution's fingerprint witnesses as to their prior conduct of fingerprint-related investigations and/or identifications. How many cases has the witness testified in? What was the name, subject

matter, and result of each case with respect to the role that fingerprint evidence played?

Testing and Methodology

To ensure that the lifting, preservation, and comparison of the fingerprints were conducted properly and to determine whether the matching of the prints was suspect, find:

1. documentation of any tests or experiments made with respect to the fingerprint evidence, and their results; and

2. documentation of the use of each methodology employed in lifting, preserving, and identifying fingerprints followed in the jurisdiction.

Notice of Local Practices and Trial Evidence

With the attitude that surprises at trial are not good and that a bad surprise may mean a missed plea negotiation opportunity for the defendant or the government, try to obtain notice and copies of any demonstrative exhibits that the adversary intends to use at trial.

An effective line of cross-examination may be to compare rules for each step in the fingerprint evidence process and how it was actually conducted in the case. To determine whether the rules were followed and whether this type of witness examination is appropriate, obtain copies of local law enforcement manuals, as well as manuals used by the Federal Bureau of Investigation (FBI) and the IAI.

Go to the Federal Bureau of Investigation's web site to determine whether prints were properly lifted, preserved, and examined. See www.fbi.gov. The site has a Handbook of Forensic Services. Unfortunately, a valuable publication about digital imaging of fingerprints, entitled "The Legal Ramifications of Digital Imaging Technology" (discussing the technology and cases in which it has been challenged) is no longer available from the web site. For more information about fingerprint training and services for law enforcement agencies, see http://www.fbi.gov/hq/cjisd/cjis.htm and http://www.fbi.gov/hq/lab/org/lpu.htm.

GP|Solo Law Trends & News
Litigation

September 2007 Volume 3, Number 2

HOW TO AVOID LIABILITY UNDER FEDERAL CIVIL RIGHTS LAWS FOR THIRD-PARTY HARASSMENT

by Allison Fetter-Harrott

Most people are familiar with Title VII of the Civil Rights Act of 1964 and its prohibition on sexual harassment that creates a hostile work environment. Several courts have also found that federal law prohibits workplace harassment based on race, religion, disability, and age. Although many of you are aware that you can be held liable for a supervisor's or even a coworker's harassment of an employee, you may not realize that under certain circumstances, you also can be held liable for a third party's harassment of an employee. That potential liability can create a trap for the unwary. Some recent federal court decisions provide helpful guidance on when employers may be liable for the harassing actions of third parties like independent contractors or customers.

General background

Under Title VII, you can be held responsible for a discriminatory "tangible employment action" like hiring, firing, or refusal to promote. You also may be held liable for any other discriminatory term or condition of employment that you failed to take reasonable care to prevent or redress. When a supervisor engages in inappropriate conduct, you can defend yourself by showing that you took reasonable care to stop it. Otherwise, the employee must show that you knew about the inappropriate conduct but failed to reasonably address it. Using those principles of employer liability, some federal courts have recently considered whether an employer can be held liable for the acts of nonemployees like independent contractors or other third parties.

Recent decisions

In one recent case, Lisa Dunn, who worked as a nurse at a hospital, claimed that the head of obstetric and emergency services subjected her to sex discrimination. The doctor wasn't a hospital employee but did have staff privileges that allowed him to provide direct medical services at the hospital.

The district court dismissed Dunn's discrimination claim under Title VII, finding that the hospital couldn't be held liable for the physician's actions because he was an independent contractor rather than an employee. Dunn appealed that decision.

The Seventh Circuit reversed the district court's decision in favor of the hospital. The court explained that when it comes to liability for discrimination under Title VII, "it makes no difference . . . whether the person whose acts are complained of is an employee, an independent contractor, or for that matter a customer."

The court went so far as to hypothesize that an employer could be held liable for discriminatory conduct by a nonhuman source. For example, if a macaw kept in a patient's room attacks women but not men and the hospital does nothing to remedy the situation, it could be held liable for the unequal conditions caused by the macaw. According to the court, the hospital could be liable for the unequal treatment even though its source isn't an employee -- or even human.

Because an employer is responsible for providing employees with nondiscriminatory working conditions, it doesn't matter where the inequality comes from, said the court. What matters is how the employer handles the problem. In determining whether the employer is liable under Title VII, a court must examine whether it created or tolerated discriminatory working conditions for its employees.

Because Dunn alleged that the hospital knew the independent-contractor physician had "made life miserable" for female employees but failed to address the discriminatory working conditions, she had made a claim that could render it liable under Title VII. *Dunn v. Wash. County Hosp., 429 F.3d 689 (7th Cir., 2005)*.

More recently, in a November 2006 decision, the Seventh Circuit affirmed a jury verdict in favor of an employee who filed a harassment claim against a prison where she had been sexually assaulted by a male inmate. Because the employee had complained about unsettling behavior by the inmate in the past and the employer failed to take any steps to remedy his behavior, there was a basis for holding it liable for his actions, said the court. Although the inmate wasn't a prison employee, the prison's knowledge of his behavior and failure to correct it warranted the jury finding in the employee's favor. *Erickson v. Wisconsin Dep't of Corr., ___ F.3d ___, 2006 WL 3290202 (7th Cir., 2006)*.

A federal district court in Indiana also recently recognized in an unpublished opinion that an employer may be held liable for the discriminatory acts of nonemployees in a race discrimination case under Title VII and 42 U.S.C.) 1981. In determining whether the employer is liable, explained the court, a court will commonly look at its actions and consider whether it took steps that were reasonably calculated to end any discrimination. *Fulmore v. Home Depot, U.S.A., Inc., 2006 WL 839459 (S.D. Ind., Mar. 30, 2006); Fulmore v. Home Depot, U.S.A., Inc., 2006 WL 839464 (S.D. Ind., Mar. 30, 2006)*.

Bottom line

As those court decisions demonstrate, you could be held liable if a customer, a client, an independent contractor, or another nonemployee subjects one of your employees to unlawful harassment in your workplace. The courts have made it clear that the source of the discriminatory treatment doesn't matter. What does matter is what you do to prevent or address the discriminatory treatment. Here are some important steps you can take to ensure that you're meeting your obligations to prevent third-party harassment:

/ Consider adding a provision to your discrimination or harassment policy that encourages employees to report inappropriate behavior from any source, including third parties.

/ Clearly communicate to your employees your discrimination and harassment policies and the corresponding complaint procedures. Make sure you encourage employees to come forward with complaints of harassment or other discriminatory behavior.

/ Consider whether the nature of your business operations makes it wise to communicate the expectations in your harassment or discrimination policy to third parties like independent contractors, clients, customers, students, or others.

/ Train your employees to recognize and deal appropriately with harassment and other discriminatory behavior, including misconduct by nonemployees. Appropriate responses will depend on the nature of the contact your employees have with third parties. For example, school employees might benefit from training on how to set appropriate boundaries for students. Sales representatives or cashiers might benefit from training that addresses how to recognize and respond to harassment or discrimination by customers. Managers and supervisors might need specific training on how to address employee complaints about discriminatory behavior by clients or customers. The cases discussed in this article demonstrate that those types of complaints shouldn't be ignored.

/ Once you become aware of harassing conduct by a third party, regardless of how you found out about it, you must undertake a proper investigation. The extent of the investigation will depend on the circumstances, of course. Reports that a regular client routinely behaves inappropriately toward employees he has contact with will warrant a more extensive investigation than a complaint about one-time customer who engages in similar conduct. Of course, if the investigation supports the allegations, you must take appropriate action to remedy the situation.

/ When determining what kind of action to take in response to harassing conduct, consider what you would reasonably expect to end the harassment. You may find that it's appropriate to let the third party know that the alleged harassment is inappropriate and then communicate your expectations for appropriate behavior. Under other circumstances, it may be better to simply alter the situation so the employee doesn't deal directly with a particular client or customer. It's imperative, however, that any corrective measures you take don't have an adverse effect on the victim.

Some of you might find it overwhelming to think that an employee could have a valid harassment claim based on the actions of a nonemployee. The most important thing to remember, however, is that your actions matter. Following the recommendations above will allow you to establish boundaries and provide your employees with the essential skills for preventing or ending unlawful harassment by third parties. They'll help you avoid liability for harassment claims as well.

GP|Solo Law Trends & News
Litigation

September 2007 Volume 3, Number 2

A Baker's Dozen of ADR Practice Pointers to Boost Your Bottom Line

By Philip B. Ytterberg

"A trial is not always the best way to resolve a dispute. Lawyers have to know when mediation, negotiation and arbitration are the best use of resources to achieve a just solution."
- Robert J. Grey, Jr., Former ABA President

According to the National Center for State Courts, only about 7.6 percent of civil cases go to trial in the United States, and only 0.6 percent receives a jury trial. That's not surprising given that the costs of fully litigating a civil case are conservatively estimated to be at least $15,000. The high cost of litigation affects businesses and individuals. In fact, the American Bar Association estimates that 100 million Americans are locked out of court by high legal costs.

The high costs of litigation also affect America's "main street" lawyers. A small law practice operates like any other small business: on income and cash-flow. Timing is important. If it takes two or three years for income to come in, problems associated with irregular cash-flow can cripple the business.

Lawyers therefore try to be very selective about the cases they will take to trial. The ABA Journal reported that an attorney cannot take a lawsuit worth less than $20,000 on a contingent fee basis, and the National Work Rights institute states that for an employee, the case must be worth $60,000. Despite their selectivity, however, statistics show that in employment cases, for instance, employee plaintiffs only win 14.9 percent of lawsuits. (Source: Arbitration Now, "Private Justice: Employment Arbitration and Civil Rights," American Bar Association.) Yet the same study found that employees bringing claims in arbitration win 63 percent of cases.

In a study comparing litigation and arbitration of contract disputes, empirical data shows that arbitration cases are significantly speedier than lawsuits. The median case durations from filing to final disposition ranged from four to six months in arbitration. In court litigation, the duration for similar types of contract cases ranged from 15 to 20 months (see http://www.metrocorpcounsel.com/pdf/2006/July/32.pdf). Similar duration results have also been obtained in the context of employment arbitration versus litigation.

That's a tremendous advantage both for the client and his or her attorney, and a benefit to all of the parties given the greatly reduced time and costs of arbitration compared to litigation.

As to case duration and cost, William Paul, past-president of the ABA estimated, "a ratio of 3 or 4 to one, litigation versus arbitration, is a fairly realistic estimate and a reasonable expectation is that the cost of arbitration will not be in excess of half the cost of litigating."

Since alternative dispute resolution reduces the cost and shortens the time it takes for claims to be resolved, the practitioner can potentially accept more client matters than would be feasible in litigation and can receive more regular cash flow when enforcing clients' rights to compensation.

Mediation also gives lawyers the opportunity to represent their client but in a forum that is much less expensive than litigation. In the U.S. parties spend $50,700 on average on each litigated case, and only $7,500 ($3,500 per party) for resolving their case by mediation, a cost-savings of approximately 85%. Trials in the traditional litigation process are not only lengthy and expensive, they are also public. Mediation like most ADR is entirely confidential.

A survey of the GPSolo Division conducted in 2005 found that GPSolo members use ADR frequently in their practice. The Survey (available on the Division Website at http://www.abanet.org/genpractice/sponsors/gpsolo-naf-survey.pdf) assessed the usage and preferences regarding negotiation, mediation and other forms of alternative dispute resolution (ADR) among the membership of the GPSolo Division of the ABA. Among the findings were the following:

• Regarding mediation, more than 80% of ABA GPSolo respondents value mediators who are lawyers or former judges. Of the ABA GPSolo respondents, 76% reported that half, or more than half, of their mediations are private mediation and not court ordered. ABA GPSolo respondents are most likely (37.5% of respondents) to mediate a case when the amount in dispute is up to $25,000, with 27.5% most likely to mediate a case when the amount is more than $100,000.

• Regarding arbitration, the overwhelming majority of ABA GPSolo respondents (72.9%) value arbitrators who are learned in the law (attorneys/former judges), as opposed to lay arbitrators and arbitrators who are required to apply substantive law (60.3%). A wide range of features would encourage ABA GPSolo respondents to use arbitration more frequently: More than two-thirds of ABA GPSolo respondents (68.6%) would use arbitration more often where arbitrators are required to follow the law (67.5%) and where arbitrators are lawyers or former judges (55.4%).

• Most ABA GPSolo respondents want additional information about ADR including: empirical studies comparing litigation to ADR; effective contract drafting techniques; and education about the laws governing mediation and arbitration. More than one in three ABA GPSolo respondents would value opportunities to learn more about the distinctions and implications of the rules and panels of national ADR providers.

Overall, the Survey found that a decided majority (over 85%) of ABA GPSolo respondents believe that their clients' interests are at least sometimes best served by offering ADR solutions. More than half of respondents also believe that: (1) their practice will include offering ADR solutions in the future; (2) offering ADR solutions is an ethical obligation as a practitioner; and (3) ADR use will increase in the future.

So, in light of the continued growth of alternative dispute resolution by lawyers worldwide, here is a round up of some time-tested practice pointers for taking your client matters into ADR:

Mediation Practice Pointers:

A skillful initial presentation is not necessarily "conciliatory." It is appropriate to provide the reasons that you are prepared to proceed to litigation or arbitration of the disputed issues. Effectively use what you have developed in prior proceedings: prior rulings, deposition testimony, key documents, and any admissions.

When opposing counsel is giving their initial presentation, let them speak without argument or interruption and consider this an opportunity to learn new facts, true interests, common ground, and even the other party's weaknesses.

The style and tone of your approach will have a substantial influence in persuading the other side to listen and to seriously consider what you are saying. Don't prevent the mediator from talking to your client or from talking with all the parties. At the same time, don't be afraid to ask for a moment during the mediation to speak privately with your client. Finally, given the uncertainties of outcomes in litigation, don't base your settlement strategy on how well you are going to do in court. (see, e.g., http://www.ca11.uscourts.gov/documents/pdfs/medguideAUG05.pdf)

Arbitration Practice Pointers

"If you prefer binding arbitration, put a provision for it in the contract, up front and before the dispute arises and then, and only then, will you have assured arbitration as the preferred dispute resolution mechanism."

- William Paul, Former ABA President

Attorneys drafting arbitration agreements should ensure that the necessary elements are present. A review of agreements that have failed to meet court challenges—and those that met such challenges—is a logical first step. But that's just a start.

Crafting an agreement that meets the client's needs requires a mixture of talents—legal know-how, common sense, a clear sense of objectives, and in some cases, a touch of constructive imagination. Below are tips toward drafting better agreements:

Grease the Wheels: Typically in business disputes, neither party wants to destroy the relationship, and pursuing the least abrasive approach can be advantageous for both parties. Consider creating a agreed dispute resolution process that begins with good faith negotiation for a period of time, followed by mediation, followed by arbitration. To avoid delay, be sure to specify time frames for mediation. The goal is to end the dispute as quickly, fairly and amicably as possible. Here is some sample language:

> *ARBITRATION. Whether or not mediation is requested by any party, any claim, dispute or controversy between us or arising from or relating to this agreement or the relationships which result from this agreement, including the validity of this arbitration clause or the entire agreement, including any that remain unresolved 120 days after an agreement for mediation, shall be resolved by arbitration by the National Arbitration Forum, under the Code of Procedure then in effect. The arbitrator shall be empowered to enter equitable as well as legal relief, to provide all temporary and/or provisional remedies and to enter equitable orders that will be binding upon the parties. Any award of the arbitrator(s) may be entered as a judgment in any court having jurisdiction.*

Specify What's Covered: To ensure that the arbitration agreement governs all disputes, clearly specify that in the contract. Also, indicate that the arbitrator has the authority to decide whether the arbitration agreement is valid and enforceable.

Take Advantage of the Federal Arbitration Act: Different states have different laws governing arbitration. This can be confusing, especially where the agreement is to be used in multiple jurisdictions. To avoid doubts, consider invoking the Federal Arbitration Act (FAA):

> *This arbitration agreement is made pursuant to a transaction involving interstate commerce, and shall be governed by and interpreted under the Federal Arbitration Act (FAA), 9 U.S.C.*

Sections 1-16.

The FAA affords parties the flexibility to structure their agreement, as they deem appropriate, while at the same time providing assurance that the arbitration agreement will be uniformly enforced.

Specify What Law Applies: If it's important that the arbitrator apply the substantive law of a specific jurisdiction, state that clearly in the agreement. Clearly designate both the body of law that governs the arbitration agreement—typically the FAA—and the body of law that governs the substantive agreement.

Require Law-based decisions: Depending upon the procedural rules of the ADR forum selected by the parties, the arbitrator who will render the decision may or may not apply the relevant substantive law. Make sure that the ADR forum you select authorizes the arbitrator to award all remedies allowed by applicable substantive law. In addition, during he contracting process, parties have the right to specifically define which occurrences will give rise to arbitral remedies of replevin, injunction, foreclosure and damages. Case law, as well as the rules of select arbitration organizations, is clear that arbitrators have authority to order provisional remedies, interim relief, and permanent relief.

Remedies Available under Law: Depending upon the choice of arbitration rules and clause drafting, parties to leases and secured lending agreements can have the benefit of arbitral awards granting damages plus interim and permanent possessory relief according to the terms of the parties' contract. As an example, a typical remedy available under UCC Article 2A is the recovery of the goods (in addition to the rights to all contractual rents), and this can be more easily accomplished with the requisite arbitral order.

Select a Reputable ADR Administrator: The best way to ensure that an ADR agreement and the arbitral award will be enforced in court is to specify that the proceedings will be handled by a reputable ADR administrator with court-tested rules and fees.

Check Whether Your Arbitrator Will Be a Legal Professional: When selecting an arbitrator or administrator, find out whether the arbitrators will be legal professionals or laypeople. Even though you have a legal dispute, some arbitration providers use arbitrators who have no legal background.

Philip B. Ytterberg is Vice President and Assistant General Counsel for the National Arbitration Forum (FORUM).

GP|Solo Law Trends & News
Real Estate

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The Nuts and Bolts of a REX™ Agreement

By Barry A. Abbott and Peter S. Muñoz

Imagine a financial product that allows a homeowner to tap into the equity accumulated in his or her residence without having to take a home equity loan or a reverse mortgage, and without the burden of having to sell the home. This is the idea behind the REX™ Agreement, a relatively new home equity product now available in nine states (California, Colorado, Florida, Illinois, New York, New Jersey, North Carolina, Virginia, Washington).[1] As explained in more detail below, REX Agreements form a financial product that is based upon a real estate purchase option, and which allows homeowners to receive an initial payment of cash, in exchange for giving up a portion of the *future* value of their home. REX & Co. believes this is the first equity (as opposed to loan) product that has ever been available for owner-occupied residential real estate in the United States. The purpose of this article is to explain the legal underpinnings of this new concept to Section members, so as to assist them in advising their clients on this new home financing alternative.

What is a REX Agreement?

A REX Agreement, which is slightly modified for each state's specific laws, is in the form of a coordinated group of four operative legal documents: an option agreement; a covenant agreement; a recorded memorandum of option, list of covenants running with the land and power of attorney; and a recorded security instrument (a deed of trust or mortgage, depending on the state).

By executing the four REX Agreement documents, the homeowner gives REX & Co. a right (an "Option") to buy a specified percentage interest in his or her home (typically between 10% and 50%) at some time in the future for a price ("Option Exercise Price") that is set at the time the REX Agreement is executed. The Option Exercise Price is equal to REX & Co.'s percentage interest times the current value of the home. At the time the homeowner executes the REX Agreement, REX & Co. pays the homeowner three amounts: first, a fee of 0.5% of the Option Exercise Price ("Option Fee") for granting the Option; second, a flat fee of $1,000 ("Covenant Fee") for executing the covenant agreement; and, third, a large down payment ("Advance Payment") on the Option Exercise

Price. The Advance Payment is typically between 20% and 30% of the Option Exercise Price. The balance of the Option Exercise Price is paid if, and when, under a defined set of circumstances, REX & Co. exercises the Option in the future, and then actually becomes a part owner of the home (usually in conjunction with the sale of the property as explained below).

The homeowner is not required to repay any portion of the Option Fee, the Covenant Fee or the Advance Payment, or to pay any interest on those amounts, whether or not REX & Co. finally decides to exercise its Option. In addition, the homeowner can use this money for any purpose (although, as discussed below, the hope is that it will be used for asset diversification or major life event purposes). And, while the homeowner has the right to continue living in the home, he or she is not required to pay any form of rent, and should continue to enjoy all the tax advantages (such as, property tax and mortgage interest deductions) of owning the home.

The Option is initially for ten (10) years and, if the Option is not exercised, it can be extended at REX & Co's request in 10-year intervals for up to a total of 50 years (40 years in Illinois and 30 years in North Carolina). With each extension, REX & Co. will pay the homeowner another Option Fee and another Covenant Fee in the same amount as initially paid.

REX & Co. recognizes that many homeowners have existing home loans secured by the home. The REX Agreements permit these home loans to remain secured by the home as long as they are kept current. REX & Co. also agrees to subordinate it interests to these liens and to any refinancing of these liens for up to 70%-80% of the home's *original* agreed-upon value.

It is anticipated that typically the Option will be exercised when the home is sold by the homeowner. Upon that sale, REX & Co. can exercise its Option and receive at the time of closing its share of the sale proceeds based on its partial interest in the home. In doing so, REX & Co. will share in any appreciation or depreciation in the value of the home. (Please note that the REX Agreement has been designed for homeowners who intend to remain in their homes for a significant period of time, and if the homeowner sells his or her home in the first five years of entering into the REX Agreement, there is a decreasing "early exit cost" (in the form of a lower Option Exercise Price) which will reduce the amount paid to the homeowner. Typically this "early exit cost" equals 25% of the Advance Payment in the first year. It declines in equal annual increments over five years and is zero in the sixth year and beyond.)

The other circumstances, not involving the home sale, under which REX & Co. will be able to exercise the Option are: (1) the homeowner ceasing to use the property as the homeowner's principal residence; (2) the homeowner jeopardizing the value of the home or REX & Co.'s rights in the home under the REX Agreement; (3) the homeowner permitting a lien on the home other than as agreed to by REX & Co.; or (4) 50 years (40 years in Illinois and 30 years in North Carolina) after the homeowner enters into the REX Agreement (assuming the REX Agreement is still in effect). If under any of these circumstances, REX & Co. should exercise its Option and thus become a partial owner of the home, REX & Co. would then be able to take action as a co-owner of the home and sell the home under a limited power of attorney granted in the covenant agreement. At that time, as with a sale initiated by the homeowner, REX & Co. and the homeowner will share in the sale proceeds according to their percentage ownership interests.

If, at any time prior to REX & Co.'s exercise of the Option, the homeowner decides to terminate the Option, the homeowner is free to do so by paying REX & Co. the value of REX & Co.'s interest in the home at that time. By doing so, the homeowner is essentially "repurchasing" the Option. (Please note that if the homeowner "repurchases" the Option *in the first five years*, and if the home value has depreciated, the homeowner would have to pay REX & Co. its percentage based on the home's *original* agreed-upon value, not the depreciated current value.)

Finally, if the homeowner proposes to sell the home for a price that REX & Co. considers to be too low, REX & Co. will have the right of first refusal to purchase the home for the sales price proposed by the homeowner. Likewise, if at any time after REX & Co. exercises the Option and becomes a co-owner, REX & Co. proposes to sell the home for a price the homeowner considers to be too low, the homeowner will have the right of first refusal to purchase the home for the sales price proposed by REX & Co. (These provisions are intended to discourage non-arms' length transactions, not to impede the marketability of the property. Achieving the best possible sales price is in the interest of both REX & Co. and the homeowner.)

How Does a REX Agreement Actually Work?

A practical example of how the program actually works may help explain the legal issues involved:

Assume that when the REX Agreement is entered into, the homeowner's home has an agreed-upon value of $750,000, and assume that the homeowner would like to gain access to $100,000 of his or her equity in exchange for *sharing 50% of the future change in value* of the home. REX & Co. would enter into an option agreement to purchase 50% of the home in the future upon exercise of the Option. As part of the option agreement, REX & Co. would make a $100,000 Advance Payment to the homeowner today, and REX & Co. would receive a 10-year option (renewable at REX & Co.'s discretion for up to 40 additional years -- 30 years in Illinois and 20 years in North Carolina) to purchase 50% of the home. If the Option is exercised six years or more after it has been given, REX & Co. will have to pay the homeowner an additional

$275,000 to exercise its Option, which would be the balance of the Option Exercise Price. (The total payment would equal $375,000, including the $100,000 Advance Payment. Note, as discussed above, that if within the first five years the homeowner sells the home, or REX & Co. exercises its option, the additional payment (and thus, the total Option Exercise Price) would be less. In this example, if the homeowner should decide to sell the home early, within five years of the grant of the Option, the additional payment paid upon exercise of the Option in the first year would be $250,000 (i.e., $275,000 less 25% of the $100,000 Advance Payment in the first year), increasing to $270,000 by the fifth year, and thereafter $275,000, all as stated in the executed option agreement.)

For granting the option to REX & Co., the homeowner will also receive an Option Fee of 0.5% of the Option Exercise Price ($1,875), and a flat Covenant Fee of $1,000. These fees paid to the homeowner at origination should roughly equal the title insurance, appraisal, and closing costs for completing the transaction.[2] The same Option Fees and Covenant Fees are paid every 10 years, if REX & Co. decides to renew its Option for another 10-year period. As noted above, the transaction has been structured as an option contact, and thus the amounts received for the Option (the $100,000 and the $1,875) should not be taxable until the option transaction closes (typically, when the home is sold).

If the homeowner in this example sells his or her home six years later for $900,000 (a 20% increase in value), $750,000 (unchanged value), or $600,000 (a 20% decrease in value), the resulting payments are as follows:

AFTER 6 YEARS HOME VALUE HAS INCREASED 20% TO $900,000

	Homeowner receives	REX receives
Sale proceeds	$450,000*(50%)*	$450,000*(50%)*
Additional payment (remaining portion of the Option Exercise Price)	$275,000	-$275,000
Net at closing	**$725,000**	**$175,000**
Advance Payment	$100,000	-$100,000
Net for transaction	**$825,000**	**$75,000**

Note: These sums do not include the $1,875 Option Fee and $1,000 Covenant Fee REX & Co. paid to the homeowner, nor any closing costs paid by the homeowner.

AFTER 6 YEARS HOME VALUE IS UNCHANGED AT $750,000

	Homeowner receives	REX receives
Sale proceeds	$375,000*(50%)*	$375,000*(50%)*
Additional payment(remaining portion of the Option Exercise Price)	$275,000	-$275,000
Net at closing	**$650,000**	**$100,000**
Advance Payment	$100,000	-$100,000
Net for transaction	**$750,000**	**$0**

Note: These sums do not include the $1,875 Option Fee and $1,000 Covenant Fee REX & Co. paid to the homeowner, nor any closing costs paid by the homeowner.

AFTER 6 YEARS HOME VALUE HAS DECREASED 20% TO $600,000

	Homeowner receives	REX receives
Sale proceeds	$300,000*(50%)*	$300,000*(50%)*
Additional payment(remaining portion of the Option Exercise Price)	$275,000	-$275,000
Net at closing	**$575,000**	**$25,000**
Advance Payment	$100,000	-$100,000
Net for transaction	**$675,000**	**$-75,000**

Note: These sums do not include the $1,875 Option Fee and $1,000 Covenant Fee REX & Co. paid to the homeowner, nor any closing costs paid by the homeowner.

Of course, since REX & Co. is receiving a percentage of the home's value, any gain made by REX & Co. on the sale has the effect of reducing the homeowner's gain on his or her property. And, assuming the option tax treatment noted above, after the sale the homeowner would recognize his or her gain based on his or her original cost basis and net proceeds from the sale. Of course, depending on the homeowner's basis and marital status, any gain up to $500,000 may be exempt from taxation and, even if taxable, should be taxable at the capital gains tax rate.

What are the Homeowner's Obligations?

The homeowner's obligations are specified in the covenant agreement. That agreement has a number of detailed provisions that a homeowner and his or her attorney will need to review carefully. However, the principal homeowner obligations are as follows:

1. The homeowner will be obligated to take the following actions in order to protect REX & Co.'s rights in the home and its value:
    a. to live in the home as his or her principal residence;
    b. to maintain the property in good condition (ordinary wear and tear excepted);
    c. to maintain replacement-value property insurance;

d. to pay all property taxes and assessments;
e. to pay all loans promptly and not incur any unauthorized liens; and
f. to avoid incurring loans that exceed the "Maximum Authorized Debt" (usually 70%-80% of the original agreed-upon value) or that have a risk of doing so (such as negative amortizing loans). (As noted above, REX & Co. contractually agrees to subordinate to loans or refinancings that will not do so.)

   The covenant agreement specifically provides the homeowner a 30-day cure period following REX & Co.'s notification of the homeowner of the homeowner's failure to comply with these requirements.

2. The homeowner also has a number of miscellaneous obligations, such as notifying REX & Co. when he or she plans to sell the home and allowing inspections of the property upon reasonable notice.

When Can REX & Co. Exercise its Option or its Other Rights in the Home?

1. If the homeowner proposes to sell or otherwise dispose of the home:
   a. REX & Co. can exercise its Option and be paid its percentage of ownership, and
   b. REX & Co. also has a 3-business-day right of first refusal to purchase the home at the agreed-upon sales price, in order to avoid sales at an unreasonably low price.
2. If the homeowner fails to protect REX & Co.'s rights in the home or its value (as discussed above), REX & Co. can exercise its Option.
3. Upon the expiration of the Option period (as noted above, this is generally 50 years, but it may be a shorter period of time in some states).
4. If the homeowner, a court, or a bankruptcy trustee blocks REX & Co's exercise of the Option, REX & Co. can enforce its security interest over the entire home.

The Purpose of the Recorded Documents

As noted above, in addition to executing the covenant agreement and option agreement, the homeowner executes (a) a recorded memorandum which reflects the existence of the Option, the covenants that run with the land and a limited power of attorney, and (b) a recorded security instrument. Both documents are recorded in the real property records of the county in which the property is located.

Simply put, the recorded memorandum (i) provides assurance that no later lienholders or buyers will take an interest in the home without notice of REX & Co.'s rights in the home and of the obligations of whoever acquires title to the home, and allows REX & Co. to obtain title insurance, and (ii) includes a limited power of attorney which allows REX & Co., upon becoming a co-owner of the home, to sell the entire home, and then split the proceeds with the homeowner. The security instrument is designed for the unlikely event that the homeowner declares bankruptcy and the trustee in bankruptcy rejects the option contract. It allows REX & Co. to assert a secured claim in the homeowner's bankruptcy with a lien against the home and in that bankruptcy case to receive the same percentage of the home's value that the homeowner had agreed to, as if there had been no bankruptcy and REX & Co. had been permitted to exercise its Option.

For the Homeowner: Safety and Diversification

The REX Agreement has been designed to allow the homeowner to stay in his or her home for up to 50 years and to retain substantially all benefits of home ownership, while being able to diversify part of the home's value and risks. Currently, the median United States homeowner holds 70% to 80% of his or her net worth in their principal residence's equity,[3] and many financial advisers suggest that holding too much of one's net worth in any asset, no matter how apparently conservative, is not wise.[4] In fact, some business writers go further. Most notably, David Crook wrote an article in *The Wall Street Journal* on March 12, 2007 entitled: "Why Your Home Isn't the Investment You Think It Is: Too many people rely on their home as their primary savings strategy. That's a mistake." In that article, Mr. Crook states that "houses are not very good investments" and that "[a] house is an inefficient way of building wealth."

It is essential for practicing lawyers to review and to advise their clients on the economics of a transaction, as well as its legal documentation and implications. Part of that review for a REX Agreement may include the purposes for which the Advance Payment is to be used. These purposes may be anything the homeowner wishes, but will hopefully be for significant reasons, including: diversification of asset class ownership; lowering home debt and concomitant lowering of a related mortgage and mortgage payments; use in connection with the purchase of a new home or as a down payment for a second or retirement home; purchase of long term care insurance or an annuity; payment of college tuition for children or grandchildren or setting up 529 plans; or making a major charitable donation or charitable annuity donation. The reasons for using a REX Agreement are only limited by imagination. However, the ability to unlock home equity without the incurrence of debt is an idea that has been long overdue.

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[1] See *The Wall Street Journal*, May 8, 2007, at D3. REX Agreements are a proprietary product of Real Estate Equity Exchange, Inc., dba REX & Co., a Delaware corporation located in San Francisco.
[2] In addition to the title insurance costs, a full appraisal from an independent third-party appraiser typically costs between $500 and $1,000, and there are usually some fees paid for notaries, wire transfers, document recording, and similar items.
[3] *Net Worth and Asset Ownership of Households: 1998 and 2000*, U.S. Census Bureau.
[4] See, e.g., Professor Harry Markowitz, "Portfolio Selection”, *The Journal of Finance*, Vol. VII, No. 1, March 1952.

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How Secure Is That Lease?

Beyond deposits and guaranties, don't forget about letters of credit

By Christopher Combest

Your client, a commercial landlord, calls to tell you that its tenant has filed a bankruptcy case. Fortunately, the debtor-tenant posted security for its lease obligations, "so, we'll be paid in full; we don't have to worry about the bankruptcy. . . uh . . . right?"

The client had two primary goals in obtaining security for its tenant's obligations: (1) to ensure payment of damages and (2) to get that payment with as little delay as possible. Unfortunately, those goals can conflict with protections provided to debtors and other creditors by the U.S. Bankruptcy Code, 11 U.S.C. §§101-1532 (the Bankruptcy Code) (section references are to the Bankruptcy Code unless otherwise indicated).

This article will examine:

- first, cash security deposits and third-party guaranties, with particular attention to (a) obstacles to executing on such security under the Bankruptcy Code and (b) such security's ability to make the landlord whole for its lease damages;
- next, letters of credit as security, including the intersection of letter-of-credit law with bankruptcy procedures and with the Bankruptcy Code's limitation on the amount of lease damages a landlord may assert against a debtor in bankruptcy;
- strategies suggested by recent cases for enhancing the power of letters of credit as security; and
- finally, practice pointers for landlords' counsel in drafting lease documents and letters of credit.

At the threshold, the reason these issues challenge landlords and their counsel in the first place is the Bankruptcy Code's peculiar treatment of landlord damage claims.

A debtor-tenant may deal with an unexpired real property lease in one of two ways: The debtor may *reject* it — that is, surrender the leased premises and choose not to be bound by the lease — or the debtor may *assume* it — that is, retain the premises and choose to continue to be bound by the lease, either for the debtor's own use or for assignment to a third party.

If the debtor-tenant chooses to reject the lease, then the landlord, in addition to pre-bankruptcy arrearages, will have a damages claim against the debtor for *lost future rent*. Because such leases can run for years beyond the debtor's actual use of the premises, such damage claims can amount to millions of dollars.

However, the Bankruptcy Code restricts a landlord's ability to obtain payment on its full damage claim. To keep such large claims from diluting distributions to other unsecured creditors, and in recognition of a landlord's ability to mitigate its damages by re-letting the debtor's premises, Section 502(b)(6) limits a landlord's claim arising from lost future rent under a rejected real property lease to the greater of (a) one year's rent and (b) 15 percent of the rent reserved for the remaining term of the lease (up to a maximum of three years' rent) following the date of the filing of the bankruptcy petition (or, if earlier, the date the landlord repossessed the premises).

The landlord's claim also includes all arrearages existing as of the date the tenant's bankruptcy petition was filed. This capped claim is deemed a general unsecured claim; such claims receive a percentage distribution, if at all, only at the end of the bankruptcy case.

A landlord with security for its tenant's obligations will be looking to circumvent Section 502(b)(6) and to do so well before the bankruptcy case trudges to a close. Cash security deposits and third-party guaranties vary in their ability to achieve these goals.

Consider first a landlord with a traditional cash security deposit. The security deposit is a type of collateral — that is, property of the debtor-tenant's bankruptcy estate in which the creditor-landlord also has an interest, and the landlord is, therefore, treated as a secured creditor under the Bankruptcy Code.

Usually, a cash security deposit will not cover the full damages sustained by a landlord whose tenant has rejected a multi-year lease. Therefore, like any secured creditor, under Section 506(a) of the Bankruptcy Code, that landlord's claim against its debtor-tenant will be, in effect, two claims: a secured claim up to the amount of the security deposit and an unsecured claim for the remainder. As to the secured portion, the landlord might achieve reasonably quick partial payment by seeking bankruptcy court permission to take the security deposit and apply it to its claim.

But, to what "claim," exactly? In theory, the deposit might be applied to the landlord's full claim for actual damages sustained as a result of the lease rejection, leaving the Section 502(b)(6) cap to be applied to whatever damages remain after offsetting the security deposit. This rule would give a landlord its maximum capped claim — on which the landlord would receive a distribution in the bankruptcy case — *plus* an additional payment, from the security deposit, of some portion of its damages that would otherwise not have been paid out of the bankruptcy estate's assets.

The bankruptcy courts have rejected this position. A landlord's cash security deposit must be applied to the landlord's claim *as capped* according to Section 502(b)(6), because the intent of the section is that the capped claim be the maximum amount for which property of the debtor-tenant's bankruptcy estate — which property includes the security deposit — should be liable. Moreover, in the rare circumstance where the security deposit exceeds the amount of the landlord's capped claim under Section 502(b)(6), the landlord must return the excess security deposit to the estate, even though the landlord's actual damages exceed the capped claim.

Therefore, while a cash security deposit may enable a landlord to receive payment of a portion of its claim more quickly than otherwise would be the case, such a deposit will not permit the landlord to circumvent the claim cap of Section 502(b)(6).

Conversely, third-party guaranties can sidestep the landlord claim cap. Under the Bankruptcy Code, a third-party guarantor of a debtor's obligation is not discharged from its guaranty simply because the primary creditor may no longer enforce some or all of the debt against the debtor directly. Therefore, a landlord may seek payment of all amounts owed to it — up to the full amount of its uncapped damages — froma nondebtor guarantor of the debtor-tenant's lease obligations.

Note, however, that a landlord's claim against a guarantor who is also a debtor in bankruptcy remains subject to the Section 502(b)(6) cap — for example, where a parent and subsidiary are both in bankruptcy, and the parent is the guarantor of the subsidiary-tenant's obligations.

While a nondebtor guaranty might seem to promise full payment of a landlord's claim, the guarantor who pays on demand is a rare legal bird, indeed. Collecting on a guaranty may require months of negotiating, followed by litigating in state courts outside the landlord's jurisdiction. Moreover, bankruptcy courts — relying on their broad injunctive powers under Section 105(a) — have occasionally prevented claimants from suing nondebtor guarantors on their guaranties.

Though rare, such relief may be granted on a showing that the guarantor — often a key shareholder or officer of the debtor — is so critical to the debtor's reorganization that permitting a suit against the guarantor would risk irreparably harming the chances of that reorganization, to the detriment of all of the debtor's creditors.

Third-party guaranties of a tenant's lease obligations, then, may provide the opposite set of protections from those provided by cash security deposits: A landlord may obtain payment of its total damages, beyond what Section 502(b)(6) would otherwise permit, but at a significant cost in time and effort spent trying to collect. The landlord's dilemma: Should it limit its recovery on its claim or its recovery costs?

Perhaps it need do neither: Letters of credit appear designed to resolve the landlord's dilemma. The typical letter-of-credit (LC) transaction involves three parties:

- *Applicant* (the customer of the issuer and the debtor of the beneficiary): the entity whose obligation is to be paid by a draw on the LC; the applicant applies to the issuer to issue the LC in favor of the beneficiary.
- *Issuer*: the entity that pays when the LC is drawn on; the issuer has a claim for reimbursement against the applicant for any amounts drawn on the LC.
- *Beneficiary*: the entity for whose benefit the LC has been issued; the beneficiary is entitled to draw down on the LC under circumstances set forth in the LC itself.

The genius of the LC is that it divorces the creditor-beneficiary's right to payment from the debtor-applicant's obligation — and ability — to pay. So long as the beneficiary complies with the payment terms of the LC — typically, the presentment of certain described documents — the issuer will pay, because its obligation to pay is independent of any disputes between the beneficiary and the debtor regarding the debtor's underlying obligation.

This *independence principle* is the linchpin of letter-of-credit law. Honoring the independence principle, courts have long recognized that LCs arranged for by a debtor-applicant, and the proceeds thereof paid out by the issuer, are not property of a debtor-applicant's bankruptcy estate. Payment to the beneficiary of the LC comes from assets of the issuer, not assets of the debtor.

For a landlord, LCs appear to provide security that is the best of all worlds. Because of the principles described above, courts treat LCs in some ways like nondebtor guaranties, in that the applicant's bankruptcy and its failure to pay the landlord's claim in full affect neither the issuer's liability on the LC nor the guarantor's obligation on its guaranty. Moreover, unlike foreclosing on a security deposit, which requires a bankruptcy court order, collecting on an LC requires no court action, because the assets that pay the LC come, not from property of the debtor's estate, but rather from property of the issuer. Finally, unlike third-party guarantors, LC issuers rarely need to be sued to compel payment (although, in unusual cases, courts have granted injunctive relief to bar a draw on an LC).

However, the intersection of LC law and the Section 502(b)(6) cap on landlord claims has been treacherous for landlords. Because LCs are essentially cash substitutes, some courts have treated LCs and their proceeds as a form of cash security deposit, requiring such proceeds to be applied, like an ordinary cash security deposit, to pay off only the capped amount of the landlord's claim and no more.

Leading cases supporting this line of analysis are *Solow v. PPI Enterprises (U.S.) Inc. (In re PPI Enterprises (U.S.) Inc.)*, 324 F.3d 197 (3d Cir. 2003), and *Redback Networks Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (B.A.P. 9th Cir. 2004). It is worth noting that in each of these cases, the court placed some reliance on the fact that the lease at issue described the LC as comprising all or part of a "security deposit" or "security" for the lease.

In Mayan Networks, however, the court also drew an important distinction between *secured* and *unsecured* LCs. The LC in that case was secured: The debtor-applicant had posted its own property as collateral to secure its obligation to reimburse the issuer for any draws made by the beneficiary.

Because a draw on the secured LC would immediately result in the issuer seeking to reimburse itself from the collateral, the *Mayan Networks* court found that the proceeds of the LC could be applied, like a cash security deposit, only to the landlord's capped claim. However, the court observed that *unsecured* LCs are more akin to third-party, nondebtor guaranties and that a landlord may draw down an unsecured LC to cover its full damages, regardless of the Section 502(b)(6) cap.

This holding suggests an important caution to lawyers who represent issuers of LCs. Once an issuer pays a landlord's claim in full under an unsecured LC, what is the amount of the issuer's claim for reimbursement? Revisions made in 1995 to Article 5 of the Uniform Commercial Code, which governs letters of credit, support the rule that an issuer is a secondary obligor on an applicant's debt, just as an ordinary guarantor would be, and that the issuer may be subrogated to the beneficiary's right to payment whenever it pays the beneficiary in full.

However, a *landlord*-beneficiary's right to payment is limited by Section 502(b)(6) of the Bankruptcy Code. An issuer's reimbursement claim, then, may be limited to the amount of the landlord-beneficiary's capped claim under Section 502(b)(6).

Late last year, the Fifth Circuit also had an opportunity to rule on the application of LC proceeds to landlord bankruptcy claims. The landlord in *EOP-Colonnade of Dallas L.P. v. Faulkner (In re Stonebridge Technologies Inc.)*, 430 F.3d 260 (5th Cir. 2005), relying on the debtor-tenant's agreement to reject its lease, had drawn on a secured LC two weeks before the bankruptcy court actually entered a lease rejection order.

The LC proceeds exceeded what would have been the amount of the landlord's Section 502(b)(6) capped claim, but not the landlord's total uncapped damages under the lease. The landlord did not file a proof of claim in the debtor's case and sought to retain all of the LC proceeds.

The bankruptcy court ruled that the landlord should have applied the LC proceeds to its capped claim under Section 502(b)(6) and that it had to return the excess (some to the issuer and some to the debtor). The court also ruled that, because the landlord drew on the LC before the rejection order was entered and without providing the tenant with the default notice required by the lease, the landlord was not entitled to draw on the LC when it did and was guilty of negligently misrepresenting otherwise to the issuer.

The Fifth Circuit reversed, holding for the landlord. The appellate court found that the landlord's draw was not premature, because it was premised on payment defaults, not on the rejection of the lease, and that a motion to compel payment of rent, filed by the landlord before the draw on the LC, satisfied the landlord's obligation to provide notice of default to the debtor-tenant.

Although the Fifth Circuit ducked the issue of how to apply the LC proceeds, the court suggested what might sometimes be a useful strategy. The court noted that Section 502(b)(6) limits a landlord's claim, but does so simply by disallowing any *filed* claim to the extent the filed claim exceeds the cap.

The *Stonebridge Technologies* landlord, however, had never filed a claim in the debtor's case, which meant that Section 502(b)(6) had nothing to act on; the court held that the section does not permit a court to require disgorgement of LC proceeds, absent a filed claim. Therefore, a landlord with an LC that covers a substantial part of its damages should consider "opting out" of the debtor-tenant's bankruptcy case by not filing a proof of claim.

The *Mayan Networks* and *Stonebridge Technologies* cases suggest how landlords, with the cooperation of their tenants, might shift to issuers the risk of being stuck in a tenant bankruptcy with a statutorily capped claim for less than full damages. How issuers view that risk will depend, in part, on how generally the holdings of those cases are adopted and how other circuits deal with these issues. While it seems unlikely that issuers will eliminate unsecured LCs, they are likely to adjust the pricing of such instruments — at least when used as security for real property leases — to reflect whatever increased risk the issuers perceive to be associated with them.

From a drafter's perspective, to increase the efficacy of LCs as security for landlord clients and to avoid the strictures of Section 502(b)(6), try to negotiate leases (a) to require any LCs intended as security to be *unsecured* by property of the tenant; and (b) to separate any requirement or option for posting an LC from any requirement for a cash security deposit.

The lease should not describe the LC as a security deposit, but, rather, should include the tenant's acknowledgment that the LC is meant as a third-party guaranty of the tenant's obligations under the lease and is posted to protect the landlord's right to receive its full, unlimited damages, as calculated under state law. The lease should also provide that the landlord may draw on the LC without notice to the tenant (even if the exercise of other default remedies requires prior notice). Some courts may ignore such drafting as "form over substance," but some may honor the expressed intent of the parties to the contract.

If a landlord has negotiating room, it should also consider asking for the following provisions in an LC provided as security:

- Provide for the simplest possible draw requirements — preferably, just a request stating that the amount sought does not exceed the amount owed under the terms of the lease, without any certification that notice or demand has been served on the tenant.
- Do not require the submission of documents over which the landlord would not have sole control (for example, a certificate that must be signed by the tenant).
- Allow for partial or multiple draws.
- Provide for presentment of all draw documents by fax.
- Avoid requiring documents to be signed by specific, named individuals (if such persons are dead or otherwise inaccessible, the landlord might *never* be able to draw).
- Provide for automatic renewal if the issuer does not, in writing, by a date certain, decline to renew (60 days before expiration is not unusual).
- Provide for a right to draw the LC completely if the issuer refuses to renew.

Appropriate security for lease obligations will vary with the nature of the parties, their relative negotiating leverage, and the landlord's priorities. Familiarity with the risks and benefits of various forms of security, and with the efficacy of letters of credit in particular, will help lawyers better prepare their landlord clients for the uncertainties of the bankruptcy process.

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Before You Grab That Property ...

By Francesca Jarosz

The timing just wasn't right for Sarah and Robert Hudson.

In November 2003, village officials from Lake Zurich, Ill., met with the Hudsons to tell them the town was interested in purchasing their gray stucco house with a scenic view of the lake and sunset.

The home had been in Sarah Hudson's family for three generations. In 1979, she purchased it from her dad, who had grown up there. She and Robert lived in the house right after they were married. Though at the time they were renting its two apartments, the Hudsons had given thought to retiring there.

"It had been in the family and we wanted to keep it in the family," Sarah Hudson said. "Price was not an issue."

The Hudsons told the village they weren't interested in selling. In response, village officials mentioned their power to file a condemnation for the property under eminent domain, but they didn't think it would come to that.

More than two years later, it did. Today, the lot is only an expanse of light brown dirt covered in rocks and rubble and a sign depicting what will be built there: A five-story retail and condominium complex. After a 15-month legal battle, the Hudsons began to crumble under the costs, which amounted to about $75,000 out of their own pockets. They became the last of the five property owners in the area to give in and settled with the village for $390,000.

"It was like a slow death," Hudson said. "I'd wake up in the middle of the night and I'd just be thinking about this stuff."

The village took possession of their property this past May. It had to be evacuated by the end of June, a month before Illinois Gov. Rod Blagojevich signed a bill enacting legislation to reform the state's eminent domain laws.

Prior to the new legislation, Illinois dealt with eminent domain by case law since there were no statutes in place to regulate it. State Sen. Susan Garrett, who helped sponsor the legislation, said that under the previous system, eminent domain laws were lopsided in favor of condemning authorities.

The new statutes, which go into effect in January, give property owners greater rights by measures such as requiring that land be proven blighted before it is condemned and compensating owners for relocation.

Garrett said the decision to take action came after hearing stories like that of the Hudsons. "For a lot of people, it's just too late," Garrett said. "We acted as fast as we could."

Illinois politicians aren't alone in their haste to act. Since the U.S. Supreme Court issued its decision in the June 2005 eminent domain case *Kelo v. New London*, legislatures in 31 states have passed bills that range from organizing committees to study their states' eminent domain practices to banning eminent domain for economic development. The legislation has been enacted in 26 states, according to the National Conference of State Legislatures (NCSL). In two states, legislation was vetoed by the governor.

"It's a remarkable response so quickly," said Larry Morandi, director of state policy research for the NCSL.

In *Kelo*, the court ruled 5-4 that New London, Conn., could use eminent domain to condemn five nonblighted investment properties and 10 nonblighted homes for a waterfront development project designed to bring jobs and revenue to the distressed town.

The Fifth Amendment states that land condemned by eminent domain must be for public use. Under a strict interpretation, that means projects such as parks, roads and hospitals. In *Kelo*, it means private economic development intended to financially boost a community.

More than a year later, as the gush of legislative action calms to a trickle, activists and more neutral experts on both sides of the eminent domain battle are stepping back to assess how the new measures are affecting each side's chance for victory. Many are calling what's happened post-*Kelo* a gain for property rights advocates. Others say that despite the tighter restrictions, landowners remain susceptible to eminent domain abuse.

What's clear at this point is that states have taken the Supreme Court up on the invitation issued in the decision to examine and, in many cases, change their eminent domain policies.

"The Kelo court suggested that states could have power as they saw fit. That's what's happening," said Dwight Merriam, a Hartford, Conn.-based land use lawyer who co-edited the ABA publication *Eminent Domain Use and Abuse: Kelo in Context*.

Many say the measures taking place are an outpouring of the post-*Kelo* backlash. Alan Weinstein, associate professor of law and urban studies at Cleveland State University in Cleveland, compared the negative response to *Kelo* to that of *Roe v. Wade* in 1973.

Cincinnati lawyer Timothy Burke said he's experienced it firsthand. He represented the city of Norwood, Ohio, in *Norwood v. Horney*, the first major eminent domain case in a state supreme court since *Kelo*. In the June 2006 decision, the Ohio Supreme Court unanimously ruled that the municipality could not take property for an economic development project. The court also specified that classifying an area as "deteriorating" does not justify condemnation.

Burke said that without the attention *Kelo* drew to eminent domain, he doubts that *Norwood* even would have made it to Ohio's Supreme Court. "*Kelo* hit and the political firestorm erupted," he said. "*Norwood*'s timing couldn't have been worse."

After *Kelo* was issued, media outlets posted nonscientific online polls allowing readers to share their opinions on eminent domain. One conducted by MSNBC showed 97 percent of about 130,000 respondents said cities should not be allowed to seize homes and buildings for private economic development projects designed to benefit the public. A similar CNN poll showed 66 percent of about 180,000 respondents said the government should never be able to seize private land; another 33 percent said it should only be able to do so for traditional public use.

"Eminent domain is a gut issue that affects everybody," said Morandi of the NCSL. "You're concerned if you think local government can take your property to put up a big box."

Such concern runs high among property rights advocates, who say the Supreme Court went further in its interpretation of *Kelo* than it had before. Steven Anderson, a lawyer at the Institute for Justice, which represented property owner Susette Kelo in the *Kelo* decision, said the court had never justified eminent domain use on the basis of "pure, naked economic development" without the condition of blight.

"Everyone's homes and businesses are up for grabs," Anderson said.

But others say the anti-*Kelo* frenzy is unwarranted in light of the decision's effect. Michael Allan Wolf, who teaches local government and land-use planning at the University of Florida's Levin College of Law in Gainesville, Fla., said the court began expanding its definition of public use 100 years before *Kelo*.

Wolf and others who argue that *Kelo* followed precedent point to two decisions in which public use was broadly interpreted.

In the 1954 *Berman v. Parker*, the Supreme Court ruled against Washington, D.C., department store owners who argued that their store, which wasn't considered blighted, should not be overtaken by a government-commissioned redevelopment project designed to improve the run-down area where the store was located. The court upheld the redevelopment on the basis that it served a public purpose.

In a 1984 case, *Hawaii Housing Authority v. Midkiff*, the court ruled that it could use eminent domain to take away land from the 72 people who owned 47 percent of the land and redistribute it to other private owners. Through the decision, the court defined public purpose as bringing overall benefit to the market by breaking up an oligopoly.

Merriam, who represents both condemners and the condemned in land use cases, said *Kelo* caused a stir because of its emotional effect, which was amplified by several well-publicized accounts of eminent domain abuse leading up to the decision. Among them was the Lancaster, Calif., City Council's decision in 2000 to expand the local Costco by ousting a smaller retailer, a 99 Cents Only store.

When *Kelo* came around, it was the first Supreme Court eminent domain case in which "little people were getting displaced from their little houses so that the government could do a project that was a little selfish," as Merriam put it.

"Because it drew the attention of the average citizen to the eminent domain power of government, it did draw some measurable change," Merriam said.

The change is particularly striking in states like South Dakota, where eminent domain use is now limited to traditional public use projects. No economic development venture will qualify.

The new legislation's sponsors, Rep. Larry Rhoden, majority leader in the South Dakota House, and state Sen. Jim Lintz, said it passed unanimously with support from the state's municipal leagues.

Rhoden said *Kelo* struck a nerve in South Dakota, where property rights are closely held. "There were a lot of people that were pretty upset," he said. "Legislation was a reassurance to citizens that the same thing wouldn't be allowed to happen in South Dakota that happened in Connecticut."

Other states also are seeking reassurance, though few go as far as South Dakota. Most legislation tackles issues such as limiting eminent domain to "blighted" areas, which, in the strictest sense, are zones that pose a detriment to public health or safety. Other states deal with matters not addressed in

Kelo, such as how much a property owner is compensated and how much public notice is given when a property is to be condemned.

Experts on both sides of the eminent domain debate say the legislation will bring about some positive change.

In Connecticut, where *Kelo* happened, legislation was enacted this past spring to establish a system where landowners have a means of mediating with local governments and can avoid facing the expenses of litigation.

Utah, the only state to use the system currently, has had it in place since 1997, and Craig Call, lead lawyer at the state's Office of Property Rights Ombudsmen, said it's been successful. The Utah Department of Transportation, which acquires more property than any single agency in the state, has seen the percentage of property it has to acquire through court drop from 23 percent in 2002 to 7 percent this year, Call said

David Parkhurst, principal legislative counsel for the National League of Cities, which represents 18,000 municipalities across the country, said it's good that *Kelo* has brought eminent domain under the light of state examination.

"As a state-derived power, eminent domain is best handled at the state and local level," Parkhurst said. The projected benefits of change are accompanied by more concerns, though.

Merriam said one issue that's been neglected in legislative discussions is the social equity effect of eminent domain. Low-income tenants often suffer serious blows when where they live is taken, since landlords are the ones compensated. "The people most likely to lose their homes are the ones that can't afford it," Merriam said.

Compensation for small businesses also has been neglected. Call said the federal government caps the amount that businesses can be compensated at $10,000, plus moving expenses. That's often not enough to cover hidden costs of relocation, such as re-establishing business reputation.

At the same time, some say states have acted too quickly in their haste to ease constituents' concerns about *Kelo*. Patricia Salkin, associate dean and director of the Government Law Center at Albany Law School in Albany, N.Y., is heading up the New York State Bar Association's task force on eminent domain. The group examined the definition of public use under New York's constitution as well as bills proposed in New York's state legislature before suggesting policies that should be adopted in the state.

Salkin said legislators need to carefully examine their states' practices before creating new laws. No comprehensive, scientific research has been done to determine how eminent domain is used state by state, Salkin said. These quick reactions can lead to ineffective policy.

"Most (legislators) throw the baby out with the bathwater, and I don't think most of them know exactly what they've done," Salkin said. "They just want to be able to tell voters on Election Day, 'I did something.'"

A big fear even among those who express neutrality on the eminent domain question is that fast-enacted legislation will be overly restrictive.

Merriam said that the most successful redevelopment happens under partnerships between the government and a private developer. Laws that prohibit private development leave the government as the sole developer, which might not be the most effective method. "It's a matter of expertise," he said. "The government may be very good at policing and fire protection but may not be good at providing a development project."

Banning eminent domain for economic development has other damaging effects, some say.

David Barron, a professor at Harvard Law School, who has researched local government and property law, believes that without the ability to use eminent domain for economic development, cities would be forced to pay buyers exorbitant amounts to acquire property.

Economic development projects are necessary, he said, citing the success of ventures such as Baltimore's Inner Harbor and the Dudley Street Neighborhood Initiative in Roxbury, Mass. "Cities don't want to build a lot of highways that lead only to post offices," Barron said.

Burke said the power is particularly important for revitalizing urban centers and inner-ring suburbs. If governments don't have the power to take chunks of land for redevelopment, development projects will take place on tracts of land further from the city, which leads to urban sprawl.

"Developers are not going to look at putting together a lot of different lots," Burke said. "They're going to look up the Interstate at the next vacant farm."

David Snyder, a Philadelphia-based litigator for Fox Rothschild who represents both those condemning property and those whose property is condemned in eminent domain cases, said that, since *Kelo*, he's seen a general reluctance among federal, state and local governments to use eminent domain unless it's as a last resort. Even a transportation agency, which uses eminent domain for traditional public uses, told Snyder they were concerned about the reaction to *Kelo* inhibiting their ability to use it.

But experts say that the extent of change that will come as a result of legislation remains to be seen. Morandi of the NCSL said that even in states like Georgia, where some of the toughest legislation has been passed, the statutes might not make much of a difference because eminent domain hasn't been used for economic development to a great extent there.

"Some of the legislation looks very sweeping," Morandi said. "But until you know how eminent domain has been used in that state, you don't know if you're going to get up to that threshold."

Other legislation leaves room for flexibility in dealing with eminent domain, and that has some property rights advocates concerned.

In Oklahoma, a bill written by Rep. Mark Liotta to tighten ambiguity about eminent domain use in the constitution's language failed to pass the legislature. The final vote came after the state's Supreme Court ruled in May 2006 in *Board of County Commissioners of Muskogee County v. Lowery* that economic development is not a valid reason to use eminent domain in Oklahoma. As a result, many of Liotta's fellow legislators thought stronger constitutional language was unnecessary.

Liotta disagrees. "They closed the door but they didn't lock it — the amendment would have locked it," he said. "There will always be folks that want to take advantage of broadening the public use definition even further. You're always going to have someone pushing the envelope."

Anderson, of the Institute for Justice, said his main concern with much of the legislation is that the definition of "blighted" will be interpreted loosely to justify economic development.

Since *Kelo*, the Institute's grassroots advocacy group, the Castle Coalition, has tracked both the number of eminent domain condemnations filed for private use and the number of preliminary actions taken to file condemnations for private use. These include steps such as examining an area for blight or stating that eminent domain can be used in an area.

The group gathered information from news stories, public documents and court decisions. Their report, which was released in June 2006, shows that local governments filed 354 condemnations for private use in the year after *Kelo*, compared with about 3,700 filed between 1998 and 2002, the last period in which they conducted such a study. In the same year, about 5,400 preliminary actions were taken, compared with about 6,600 from 1998 to 2002.

Another survey of about 1,600 local officials drawn from the National League of Cities' database, conducted in March 2006, showed that 76 percent of about 500 respondents reported that they have not used eminent domain in the past three years in connection with an economic redevelopment project. However, 87 percent of the same group said they would not delay an eminent domain project because of the *Kelo* outcry.

For property-rights advocates, that 87 percent helps drive home a fear of what they consider misuse of eminent domain. Regardless of legislation, they say that fear has been amplified since *Kelo*.

"As a rule, governments tend to look out for themselves," said Rhoden, the South Dakota representative. "If it's in the best interest of governments to use eminent domain for economic development, then I'm afraid they might use it to the abuse of citizens."

That's a big concern in Lake Zurich, where Illinois' new legislation has done little to curb some residents' fears that the Hudsons' property may not be the last one condemned under eminent domain. In house after house on the two streets near the sparkling waterfront, residents display signs in their windows that say, "Eminent domain abuse," with the words circled and slashed through.

These homes are in the three-block area that the town in 2002 made into a Tax Increment Financing (TIF) district, in which redevelopment is funded by the future tax revenues it will generate. In Illinois, an area must have a set of blight factors, which range from excessive vacancies to inadequate utilities — such as storm sewers — to become a TIF district. The Hudsons' home, also part of the TIF district, was eligible because of concerns with the structure of a stairway, blocked exits and its use for two apartments even though it was a single-family home, said John Dixon, Lake Zurich's village administrator.

Dixon said because the three-block area qualifies as a TIF district, village officials believe it would meet the new blight standards required to use eminent domain under Illinois legislation. And the village might need to use that power to carry out its redevelopment plan expanding the number of retail outlets and condos in the area, though Dixon said he doesn't anticipate it. He added that the village board decided it will not use eminent domain to take property occupied by its owners.

But that decision didn't help Sarah Hudson, who compared the July 9 demolition of her rental property to an "execution in the public square." She owns another property on a stretch of lakefront land that the village has agreed not to condemn, but she's still fearful. She's been distrustful of the village since her first struggle.

"Eminent domain was a threat, but I never thought it would come down to that," Hudson said. "I was wrong."

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REAL ESTATE FRAUD 101:
Would You Know It if You Saw It?

By Youshea A. Berry

Real estate practitioners must be vigilant of red flags that may signal that they are in the midst of a legal matter that involves real estate fraud. In most cases, attorneys are tipped off by fact patterns that clients or potential clients provide that don't add up or are completely unsupported by the documentation they present. In some cases, clients may be the victims of the real estate scam, but sometimes they may be consciously participating in the tangled web of a real estate fraud that they themselves have initiated.

Unscrupulous individuals can do inconceivable things with personal –and public--information ranging from the relatively minor infraction to the abhorrently mind-boggling scam. Attorneys for real estate clients may have to put on their Sherlock Holmes hat when they find that their client's explanations of events or circumstances do not seem to hold water.

What should an attorney do when he or she believes that his or her client is involved in a real estate scam? The first step is understanding the types of real estate fraud that are popular with these scammers. The second step is following the paper trail to get to the bottom of the situation. The attorney may find that there are a number of active and unwitting participants – a list of players that may include mortgage brokers, loan officers, closing attorneys, buyers, sellers, straw men, investors, bankers, and title companies.

Real estate scams can lead to individuals having their houses stolen from underneath their feet, bankruptcy, damaged credit reports and credit ratings—not to mention the incredible attorney fees that will amass as you try to help them escape from the tangled web of a real estate scam. Worse yet, your clients may find themselves stuck between a rock and a hard place since the scam may cloud their title. This could prevent them from being able to sell their house or take out another mortgage or equity in the current house to use as collateral for a new home.

While anyone may fall prey to one of these scams, the groups most targeted by real estate scammers are usually the elderly, homeowners already in foreclosure, and individuals with low incomes.

The following list is a set of examples (by no means all-inclusive) of the types of real estate scams that are pervasive across the country. Of course there may be completely legitimate real estate transactions that have similar circumstances as the scams outlined below, but an attorney should do his or her due diligence to confirm his or her hunch that something may be awry. If the hunch proves to be true, the attorney should be sure that the client understands what he or she is getting into or that s/he needs to get out of the transaction immediately.

- Foreclosure Rescue. These companies prey upon people who are behind on mortgage payments and whose mortgage company has commenced foreclosure proceedings. The companies tell desperate mortgage holders that they can *save* their home if the borrowers enact a "temporary" title transfer to the rescue company. The companies promise that the borrower can stay in the home and pay rent during the temporary title transfer time—what they claim is a "leaseback." Often these "rescue companies" sell the homes once they obtain the title from the real owner. Because the rescue companies claim it is a leaseback, they often only pay the owner a minimum amount that rarely reflects what the owner would have made if they had sold the property on the market. In the meantime, the owners remain on the hook for the original mortgage payments on their home.

- Mortgage Elimination. These programs offer borrowers a way out of their mortgages in a relatively quick period of time (for example, eradication of a full mortgage in less than a year). They convince borrowers that there are loopholes that will allow the borrowers to escape the mortgage, and these companies charge a premium price for this "service".

- Home Improvement Fraud. This involves real estate agents or other individuals who obtain home improvement loans in the name of completely fictitious people. These real estate agents can also use the personal information of unsuspecting individuals to obtain these loans.

- Equity Skimming. Equity skimming happens when a buyer who wants to take out a large mortgage convinces the seller to re-list the house for an extraordinarily high amount (for instance, twice the original amount) so that the buyer can obtain a larger mortgage from his/her bank. Often times in these situations, the buyer will take out the larger mortgage, pay the seller the original asking price for the house, and then disappear with the rest of the mortgage money. The house usually ends up in foreclosure as a result of this scheme.

- Illegal Flipping. Flipping involves buying a property and then quickly selling it at a price that is *well above* its appraised value. There is a fine line between flipping for a profit (which is legal) and illegal flipping. Check the rules of your local jurisdiction for more specific information.

- **Equity Fraud.** This is old-fashioned theft. The criminal in this situation actually obtains the personal information of the victim and uses this information on mortgage or loan origination documents. In addition, the criminal physically forges the victim's name on the deed and steals the equity from the property involved.

- **Fraudulent Loan Origination.** This happens when real estate professionals help unqualified buyers get the money necessary to purchase a home with an FHA-insured mortgage. Real estate professionals in this situation promise potential homebuyers that they will qualify for mortgages that are much larger than the buyers' ability to repay, and many times falsify official documents to assist homebuyers in obtaining these properties.

- **Land Fraud.** This happens when companies obtain information about potential homebuyers and sellers from mailing and call lists. The companies then engage in a direct mail and telemarketing campaign, promising huge profits and gifts if the sellers agree to buy land from the company. These companies sometimes sell unimproved, recently purchased lots of land that they purchased for $1,000 or $2,000 to unsuspecting buyers for up to $50,000.

- **Rental Fraud.** Rental fraud occurs when a person files false "satisfaction of loan" documents with the local court. In order to file this paperwork, the renter has to forge the owner's signature, the bank officers' signatures, and bank seals. This document shows no encumbrances on the home, and the criminal is free to take out new loans on the property (which s/he does). They usually vanish shortly thereafter.

- **Straw-Man Scheme.** A straw man scheme is when a sophisticated criminal uses the credit history of another, less sophisticated "straw man" to obtain a mortgage on a property. The more sophisticated criminal convinces the straw man to sign over the deed to the property, and the straw man usually gets a very small percentage of the proceeds from the sale. The straw man is also the one who usually gets arrested.

- **Counseling Agencies.** Some companies engage in targeted marketing campaigns that convince homeowners that they can perform certain mortgage-saving services for a substantial fee. These are usually relatively simple tasks, such as negotiating a new payment plan with a mortgage company or discussing interest rates and possible qualification for rate reductions. These companies may also charge for information that can be found free on government agency websites!

- **Predatory Lending.** These schemes often occur in the form of a door-to-door sales person or telemarketers promising loans for “no money down” and “no credit check”. Predatory lending often preys upon the elderly, the unsophisticated, and the desperate. Signing the paperwork involved with these loans subjects the borrower to exorbitant fees and interest.

• Aggressive Sales. Those involved with this practice generally market their services to the elderly and those in danger of foreclosure. This practice involves aggressively calling unsophisticated homeowners. Often these homeowners are led to believe that the service that the criminals are selling is the only option available to them, and the homeowner signs paperwork detrimental to their true interests.

Many homeowners do not know anything about any of these common and simple scams. Attorneys should warn their clients that they should not sign documents that they do not understand and to get all details in writing. Attorneys should let clients know that if something sounds suspicious, they should ask questions and proceed with caution. It is easy for clients to get caught up in the moment of a real estate transaction in which they could stand to make a significant amount of money; however, clients should be reminded to always verify the information that they are being told. Often, clients get entrapped in a scam because they are told one thing while the documents reflect something different or because they are pressured into signing a document that they do not understand.

An attorney may not be certain whether a client or potential client is involved in a real estate scam or whether the client simply has a case of sour grapes over a real estate transaction in which the client has buyer’s or seller’s remorse. If the situation does not pass the “smell test,” the attorney should proceed with caution and diligently gather information about the various players and keep in mind the scenarios outlined above.

If after some fact-finding, the attorney suspects that a client has been the victim of a real estate scam, he or she should encourage the client to contact the local police department immediately. The initial step towards recovery is to report the problem to the proper authorities so they may begin a criminal investigation while the trail is still hot and the players may still be in the area.

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