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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT *e*REPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Section News

The Section would like to thank all of its meeting attendees and sponsors for a successful Spring Meeting. We had a tremendous turnout in Washington D.C., including first time attendees and repeat attendees; and we introduced our 1st Annual Young Lawyers Institute. Click here for on-line program materials

The Membership Committee announces the launch of its Membership recruitment contest! Recruit new RPPT lawyer and associate members and win prizes! Click here for details

***Qualitech* and Proposed Bankruptcy Code Amendments**

The decision of the Seventh Circuit Court of Appeals in *Precision Industries, Inc. v. Qualitech SBQ, LLC,* 327 F.3d 537 (7th Cir. 2003), has been widely criticized for failing to protect the rights of a tenant in the bankruptcy of a lessor. The Section appointed a task force to address the issues raised by *Qualitech* and to look at proposed technical amendments to the Bankruptcy Code to address those issues. Pat Mears reports on the progress of the task force and a Report and Recommendations being presented to the ABA House of Delegates at the Annual Meeting. Click Here to Learn More.

Articles

Probate and Trust News

FRACTIONAL INTEREST DISCOUNT IN ARTWORK

INHERITED IRA NOT PROTECTED FROM CREDITORS

By Jim Roberts

Jim Roberts reports on two recent cases. In *Stone v. Commissioner*, the Tax the Court allowed no discounts for lack of control, marketability, or liquidity, or for the time value of money or other common discounts in valuing a fractional interest in artwork. Next, Jim reports on a recent Texas case which held that under Texas law, which is similar to the law in many other states, an IRA inherited from someone other than a spouse is not protected from creditors; regular IRAs, spousal rollover IRAs, and other forms of inherited property such as trusts are protected.

PROPOSED REGULATIONS LIMITING ESTATE TAX DEDUCTIONS FOR UNCERTAIN CLAIMS AGAINST DECEDENTS AND OTHER ADMINISTRATION EXPENSES UNDER §2053

***ERICKSON* EXTENDS §2036 TO USING PARTNERSHIP FUNDS TO PAY DECEDENT'S ESTATE TAXES**

By Steve Akers

Steve Akers also reports on two recent developments. First, he explores the new Proposed Regulations under IRC §2053 which address the issue of the deductibility of contingent or uncertain claims against an estate. Presently, some circuits allow the deduction based on facts known at death while others look at post-death payments. Next, Steve analyzes *Erickson v. Commissioner*, another §2036 case in which the IRS prevailed in a situation with facts unfavorable to the taxpayer – it was apparent that the only purpose of the partnership was to try to secure an estate tax discount, and partnership assets were used to pay the decedent's estate tax.

Real Property News

CHANGES IN THE ACORD 28 INSURANCE FORM AND LENDER REACTION

By Rod Clement

ACORD certificates have long been a common way for parties to verify the existence of required insurance coverage, whether for a loan or otherwise. These certificates have always been tricky to understand, however; and ACORD has recently thrown a new monkey wrench into the system by watering down the ACORD 28 certificate. Rod Clement has provided a good précis on the current status and problems with using these documents.

AFFINITY RELATIONSHIPS UNDER RESPA: MAKING MONEY THE "OLD FASHIONED WAY"

By Howard A. Lax

"Affiliated businesses" are all the rage today, but consumers also rage if they feel taken advantage of or steered to mortgage lending providers without appropriate disclosures. Howard Lax will take you through many of the current RESPA rules so you can avoid having "mortgage rage" become a claim against your business.

OPTIONS: FIRST REFUSAL RIGHTS COULD BE THORNY

By Harris Ominsky

As illustrated by *Bramble v. Thomas,* 2007 WL 49255 (Md., Jan. 8, 2007), the granting of a right of first refusal can lead to some *sticky* situations. Harris Ominsky chronicles this recent decision, and offers some suggestions on how to avoid getting stuck unexpectedly in drafting, enforcing and exercising rights of first refusal.

CLE Spotlight

Probate and Trust CLE

Estate Planning for the Family Business Owner

The course covers the life cycle of the closely held business, from choice of entity to estate administration, including the dynamics of dealing with the family, valuations and getting the business ready to sell. The course concentrates on tax and estate planning issues, but also addresses significant non-tax questions that require attention. The latest developments out of Congress and the courts are discussed. New topics included in this year's program address charitable contributions, life insurance and retirement benefits.

- July 11 - 13
Live/In-Person or webcast

Real Property CLE

Title Transfer & Title Insurance

The Section announces the release of the complete Title and Conveyancing Online CLE Program, which can be purchased through the ABA Web Store. This three-part series of one-hour, interactive online courses will introduce you to the basics of how real property is conveyed and explain the function of title insurance policies, including a detailed analysis of the new ALTA forms. Perfect for attorneys new to the area, these courses cover everything an attorney needs to know to guide clients through the title transfer and title insurance process. The program is also highly recommended for training paralegals involved in real estate practices.

- On Going Interactive Online Course.

June 2007

Technology

TAMING THE E-MAIL MONSTER

By Nancy Grekin

Is your email inbox making you crazy? Have you ever been the victim, or perpetrator, of an email faux pas? Nancy Grekin has advice on Taming the Email Monster.

For Young Lawyers

RPPT YOUNG LAWYERS NETWORK

The inaugural Young Lawyers Institute (YLI) was a huge success at the 2007 Spring Symposium in Washington, DC. Both the Real Property and Probate & Trust Divisions presented a day-long program, focusing on the CLE needs of young lawyers**.** Click here to learn more.

For Law Students

Law school debt is something that affects almost every law student today. Many law schools have Loan Repayment Assistance Programs (LRAP); but there are still some law schools and states that have not adopted

this program. The ABA Law Student Division is committed to advocating this loan assistance program for law students. Please click here to read its Educational Toolkit.

New RPPT Book

Current Condemnation Law,
Second Edition

By Alan T. Ackerman
& Darius Dynkowski

Condemnation of property is a very topical subject after the U.S. Supreme Court's controversial decision in *Kelo v. City of New London.* This completely revised edition of **Current Condemnation Law** examines the many complexities of eminent domain law to assist lawyers in best protecting their clients' interests in these cases. The book brings together leading experts to analyze both major and specialty areas of condemnation law, providing "how to" tips along with current discussions of case law and theory.

Group and Committee News

Join an RPPT Section Committee

If you do not belong to a group or committee, you are not taking full advantage of the opportunities offered by the Section. Group membership is free of charge to all RPPT members. Once you sign up for a group, you may then sign up for a specific subject matter committee within the group. RPPT committees are lively forums where you can learn about, analyze, debate and act on matters that affect you and your peers, as well as the profession at large. Many RPPT committees offer free periodic telephone conferences to discuss developments in the law and committee business. There is no limit on the number of committees to which you can belong.

Click here to sign up

Printable Versions

Now you can print out the RPPT eReport to read offline. Available in three versions:
- All articles and columns
- Real Property Articles only
- Probate and Trust articles only

About RPPT eReport

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

The materials contained herein represent the opinions of the authors and editors and should not be construed to be those of either the American Bar Association or The Section of Real Property, Probate and Trust Law unless adopted pursuant to the bylaws of the Association. Nothing contained herein is to be considered as the rendering of legal advice for specific cases and readers are responsible for obtaining such advice from their own legal counsel. These materials and any forms and agreements herein are intended for educational and informational purposes only. The authors and other contributors to

RPPT eREPORT are solely responsible for the content of their submissions, including the accuracy of citations to legal resource materials.

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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW
RPPT eREPORT
NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Tech Article

This Issue's Table of Contents

Taming the E-Mail Monster
By Nancy Grekin

E-MAIL BASICS AND FORMATTING

E-Mail No-Nos

If you use e-mail as most of us do, it is a substitute for a phone call and for most if not all of your business letters. Make it look like a business letter! Turn on the spell checker in your e-mail client, and re-read every e-mail before you send it as you used to re-read your letters. Don't type e-mails all in caps – it's like shouting! Don't use colors for your text (would you do that on your letterhead?). Punctuate and use appropriate paragraph breaks to make it readable just as you would in a contract or formal letter.

Signatures

Use a "signature" at the bottom of all of your e-mails. Every e-mail client allows you to create a signature which includes your contact information and to have it inserted at the bottom of every message – some mail clients let you decide if you want it or not with each message you send. A signature might look like this:

~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Nancy N. Grekin

McCorriston Miller Mukai MacKinnon

5 Waterfront Plaza, 4 th Floor

500 Ala Moana Boulevard
~~~~~~~~~~~~~~~~~~~~~~~~~~~~

Honolulu, Hawaii 96813

808.529.7419 (Direct Dial/Voice Mail)

808.535.8015 (Direct Fax)

815.642.0088 (Internet Fax/Internet Voice Mail)

ngrekin@m4law.com

http://www.m4law.com

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Why do this? We all get a lot of e-mail from other lawyers or contacts whose contact information we lack. It is annoying and frustrating to get an e-mail from someone who does not use a signature and whose e-mail address does not identify who he or she is. And even more annoying to have to call the sender and not have his or her telephone number.

It's OK to Use the Phone

Do you get looooong e-mails which take a lot of your time to read and which require a detailed verbal discussion in response? Do you wish the sender had just picked up the phone and called you because now you've got lots to say? I follow what I call my 3-paragraph rule: if an e-mail or a response takes more than 3 paragraphs I do it the old-fashioned way – I pick up my phone and call. Do you send e-mail to your partners and associates down the hall? Get off your okole 1(cite) and go to their offices! Face to face is always more productive.

Reply to All

That "Reply to all" button is so tempting. Resist it. You know how much e-mail you get. And how much of it you delete without a second thought. Think about whether everyone who got the message you received needs to hear the reply before pushing that button. Just this week my IT department sent a message to all lawyers informing us that a new program which had recently been installed on some computers was being removed because it wasn't working right. Several lawyers responded to all and sent their message to all lawyers in the firm (most saying that they didn't know what the message was talking about!).

V-Cards

One way to get all of your contact information to all recipients is to tell your mail client to always attach your "v-card." A v-card includes all of the contact information which you have entered in your mail client and set as your v-card. The good news is that it is easy to always get all of your contact information to all of your mail recipients and they can easily save it to their mail client. The bad news is that your recipients are going to get the same information every time you send them a message if you automatically attach the v-card! Consider using your v-card only when you choose to do so, and only the first time you communicate with a mail recipient.

Attachments

One of the most useful features of e-mail for all of us is the ability to attach documents but oh the woes this wonderful ability can generate.

Format of E-Mail. If you want to format your e-mails using bold, underline or bullets you will have to format it as either HTML or RTF. But if you use RTF and you are an Outlook user and have an attachment, the format of that attachment will be converted to a format which a recipient who does not use Outlook cannot open. Use HTML if you want formatting such as bold and bullets.

Format of Attachments. Like the long e-mail sent to all who were on the original message, the temptation to
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send a lot of documents to a lot of people is rampant and we all suffer from its consequences. Worse, how many times have you gotten a lot of attachments and the files had names like “Scan.pdf” or “87465QT” which meant you had to open every one in order to figure out which ones you needed to see and save. I still run WordPerfect (I believe I am the only remaining lawyer in America who does) and occasionally get documents from law firms running it. I can open them. But those running only Word cannot – it cannot convert WP documents to Word format. Make sure the documents you send have names which indicate what they are, that they are in a format the recipients can open, and that you think about who needs to get what.

Pagination is Printer Dependent. If you send a document in Word format to three people and they have three different printers, the pagination will likely be different for each of them. The longer the document the greater the differences in pagination. If you are sending documents to multiple parties for execution, first convert the documents to an image format such as PDF which will retain pagination by converting the words to image.

MANAGING E-MAIL AS IT APPEARS

Run Your Mail Client Constantly?

We all have a love-hate relationship with e-mail. We love it because it makes it possible to instantly communicate with multiple people all over the world and it is a great substitute for telephone tag. We hate it because it is a constant intrusion on our attempts to concentrate on one thing for any length of time. Do you keep your mail client running constantly all day? Do the messages from your mail client telling you that you have e-mail distract you?

Consider whether you have to keep your mail client running constantly. You might reduce the distraction by checking your e-mail when you come in, then shutting it down for a couple of hours while you get some work done. Perhaps set aside certain times during the day when you will read and return e-mail.

Filtering

The most powerful e-mail management tool is filtering. Even if you decide that you must keep your mail client running all day, if you filter your mail you will know immediately which messages you must deal with, and which can wait.

All e-mail clients permit you to set up rules for disposition of e-mail as it arrives. The most typical rules tell the mail client that when mail is received from a recipient it is to be saved in a particular folder. This allows you to save all mail from everyone relating to a particular case to the same folder. If you subscribe to listservs you can filter those messages into their own folder where you can deal with them at your leisure. There are a huge number of criteria available in most clients upon which to base your filtering including such things as a sound alert when you receive a message marked as high priority.

MANAGING E-MAIL ONCE IT IS THERE

Printing It

If you receive a huge volume of e-mail the first issue you’ll face is whether to print it. If you print it all, you will need an army of clerical help to deal with it and get it filed. And if you file it, the biggest question you’ll face is whether you will ever look at it again! Chances are not great that you will spend time thumbing though the file to find it and read it.

Mail clients have searching capabilities which permit a full text search (and there are some terrific add-ons which add capabilities) and allow you to sort mail by name of sender, date received, subject or any of the other fields you’ve chosen so you can easily find a message. And if you are filtering your mail, looking for it is even simpler. Why bother to print when you can find messages so readily? Go paperless and save a few trees and the strain on the size of your physical files.

Saving It

If you are a litigator or you have litigation partners, they are probably telling you not to delete any of your e-mail. But you don't have to let it clutter up your in box. If you filter, Outlook allows you to save a folder one at a time as a file. Adobe Acrobat allows you to print an entire folder of mail to PDF and save it as a file. This permits you to archive all the mail in a mailbox once a deal or a case is done together with all of the documents you used and burn it all to a CD.

Attachments

One of the most frustrating aspects of doing business by e-mail is trading documents with other lawyers. You save the document in your document management system and give it a name, trying to keep track of versions. The lawyer on the other side revises it and sends it back with a different name or perhaps its name is its number in her document management system. If you save all of these drafts in your DMS you've got a nightmare of version control and figuring out what the last draft was. Here are a couple of suggestions for taming this monster:

Use the version control naming conventions of your DMS. If you don't use a DMS but store your documents in folders on your hard drive or network, adopt a naming convention to keep track of versions such as Agreement v1.doc, Agreement v2.doc and Agreement rd1.doc and so forth. And use a logical folder naming protocol such as name of client or type of document.

When you get back a revised draft with a different name, either import it into your DMS as the next version, or if you store on your hard drive and use a naming convention, rename it so that it follows your naming convention – you can include information about the sender whose draft it was in the name since file names can be any length.

THE WONDERS OF OUTLOOK

Since most of us use Outlook, no mail management discussion would be complete without information on its advanced features. It is not the only mail client out there, but it certainly is the most ubiquitous.

Rules

Click on Tools/Rules and Alerts and the E-Mail Rules tab. Click "New Rule" and you will be taken through a series of steps which allows you to specify a rule to filter mail, and where to send the message when the rule is applied. There are 27 possible rules to apply to messages and you can apply more than one in the same rule. Create a folder to send the messages to when the rule is applied, specify that folder and you are done. Most of your rules will probably be based on who the sender is and it is easy to get the addresses into the rule – you can have as many addresses in the rule as you like. When you click on "People or distribution list", your Outlook address book will open and you can select a name to add the rule. After creating a rule, you can immediately run it and it will move all the messages which satisfy the rule in your Inbox to the specified folder.

Use Word as Your E-Mail Editor

To use Word as your e-mail editor, click on Tools/Options and the "Mail Format" tab, then check the boxes in the "Message format" list. The advantage of using Word as your e-mail editor is that you will have all the functionality you have in Word: styles, numbering styles, and autocorrect entries and autotext functionality. The disadvantage is that your styles might not translate to the recipient of the message, particularly if they don't use Outlook and/or Word so you might send some unreadable or sloppy looking messages. A further disadvantage is that using this feature disables some add-on functions such as programs which integrate Outlook with document management systems.

Saving and Printing Attachments

You can save and print attachments directly from an Outlook message by opening the message and right-clicking on the attachment. There are sophisticated add-ons to Outlook which allow you to integrate with your document management system saving attachments directly to the DMS or even saving an attachment as a new version of an

existing document in your DMS.

Drag Messages to Notes, Calendar and Tasks

If you get a message calling a meeting you can simply drag it to Calendar and a calendar entry for the current day will open. The message will appear in the notes screen at the bottom of the calendar entry. Set the correct date and time in the calendar and you have your meeting in calendar.

If you get a message asking you to do something, drag it to Tasks and you'll have it in your task list.

If you get a message with information you need to keep track of, drag it to Notes, add a title and you'll have it saved.

Now having done any of those things with messages, delete them! If you think about the content of most of your messages there is little need ever to have very many of them in your Inbox. If you filter, you'll have many of them in other folders where they won't bother you every time you open Outlook. If you've dragged meeting messages to calendar, things to do to Tasks and information to Notes, many of the messages remaining will be either messages with attachments, or copies of messages to someone else. Save the attachments from those messages and delete the message. If they are copies of messages sent to someone else chances are you can delete them.

Your goal: to end every day or week with few or no e-mail messages in your Inbox. Think about how often you go back and actually look at those messages and you'll probably start to realize that this is one way to make it all seem far less overwhelming.

Meeting Invitation

If you want to invite others to a meeting, click on File/New/Meeting Request, and the message you send will have buttons at the top to accept, decline or suggest another date. If the recipient accepts the meeting, it is automatically inserted into their calendar.

Add a Sender to Your Contact List

To add a sender to your contact list simply open the message, click on the name to select it, right click and select "Add Sender to Outlook Contacts." Easier yet, you can drag the message to Contacts and Outlook will automatically open a contacts window with the sender's name and e-mail address.

View Messages Without Opening Them

You can view the contents of messages without opening them in Outlook in two ways. You can view the message at the bottom or right of the screen by clicking on Reading Pane and Bottom or Left. You can also view the first few lines of a message by clicking on AutoPreview.

SPAM

What is It?

You've received one of those messages from the poor woman in Africa whose father died leaving her a fortune and asking you to hold her money for her. All you have to do is give her your bank account number so she can make the deposit. There are solicitations to buy ethical drugs on line, stock recommendations, and the latest form of spam "phishing" messages which seek bank or password information and appear to be messages from legitimate businesses. All of them are dangerous and all of them can eventually lead to more spam.

How Do Spammers Get Your Address and What Can You Do About It?

Have you ever gotten an annoying message which appears to be advertising and which includes an invitation to reply if you don't want to receive any more messages? DON'T REPLY. When you reply you verify to the sender that your address is real and you will now receive lots of spam. Do you buy stuff on the Internet and notice that

there is a little box you can check if you want to get e-mails from the vendor? DON'T CHECK IT. Many of those vendors will send you their advertising and also sell your address to others who turn out to be spammers. Indeed any time you buy anything on the Internet you run the risk that someone you don't want to will get your address. Instead of using your usual address, get a Yahoo or HotMail address and use that. Then any spam which might result will go there instead. Is your e-mail address on a Web site somewhere? It is simple for spammers to harvest such addresses. So use HTML hyperlinks or avoid having your address on the Web site.

Phishing

One of the most dangerous forms of spam is "phishing." A "phish" is a message which appears to come from a legitimate business such as a bank, or very commonly eBay or PayPal. The message states that there is a problem with your account and that your password or account number is required. Many of the messages include the logo of the business they purport to come from and appear to direct the user to that business' actual Web site. They typically provide that you have to verify an account, or state that if you don't reply your account will be closed.

The consequence of these spams is identity theft, bank account fraud and similar harsh results, and it is phenomenal how many people fall for them. If you get a message from a bank or financial institution where you do not have an account, or from eBay or PayPal indicating that there is a problem with your account, don't reply. Go to the actual Web site and check your account information. Don't ever reply to one of these messages because like any spam it will prove that your e-mail address is valid.

Spam Filtering

Unless you want to be overwhelmed, you have to use spam filters. Outlook has a fairly elaborate "junk" filter built in and you can add rules of own to search for words like "viagra" and filter such messages to a junk mailbox. Go to Tools/Options/Preference and click the "Junk E-Mail" button. Spam filter programs abound. There are spam screening services which filter mail, but there is a danger that good mail will be filtered. And there are "white list" and "black list" services. White lists allow you to specify who you can receive mail from and usually require new senders to go through a verification process with you. Black lists name senders that you don't want to receive from. Any law firm with its own mail server should use an enterprise spam filter which filters at the mail server.

CONCLUSION

You can control the e-mail monster by using filtering, immediately deleting what you don't need and not printing any of it. Be smart about spam by using alternate addresses in your commercial transactions on the Internet and resisting "Reply to all." Make it your goal next week to leave on Friday with nothing in your In box!

1. Hawaiian for the part of your anatomy you sit on.

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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW
RPPT eREPORT
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For Young Lawyers

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RPPT YOUNG LAWYERS NETWORK

Young Lawyers Institute a Great Success!

The inaugural Young Lawyers Institute (YLI) was a huge success at the 2007 Spring Symposium in Washington, DC. Both the Real Property and Probate & Trust Divisions presented a day-long program, focusing on the CLE needs of young lawyers.

Approximately 90 people attended the sessions covering subjects like: the Purchase and Sale of Commercial Real Estate; Review of Estate Tax, Gift Tax and GST Tax; Choice of Entity Issues in Commercial Real Estate Transactions; Planning with Grantor Trusts; Commercial Real Estate Leasing; Planning for Retirement Assets; Financing, Insurance and Title Insurance in Commercial Real Estate; Asset Protection Planning; Life Insurance; Charitable Giving; and Ethics.

All of those involved in planning and presenting the YLI should be commended on such a wonderful program. We look forward to many more to come!

Planning for the ABA Joint RPPT/Tax CLE Meeting in Vancouver 2007

The Young Lawyers Network is pleased to co-sponsor several programs at the 2007 Joint Fall CLE Meeting with our Tax Section counterparts in the Young Lawyers Forum. If you will be in Vancouver and want to assist in planning, please contact me. Our tentative schedule includes the following programs:

- Young Lawyers Orientation (to assist in navigating the meetings and networking);
- Associate Marketing: What Every Young Lawyer Needs to Know; and
- A Young Lawyers and Diversity Networking Reception (always a favorite).

There is no formal Dine-Around scheduled for the Fall Meeting. However, if there is a group interested in dinner perhaps we can put something together.

Opportunities

YLN Page in Probate & Property Magazine:

We are in need of a panel to assist with the bi-monthly Young Lawyers Network page for *Probate & Property* Magazine. Since its inception, the YLN page has consisted of a short, substantive article, written to provide very practical advice for young lawyers. Additionally, there is an "Ask the Mentor" section, which has questions and answers involving participation in RPPT and general practice management.

If you are interested in assisting with the YLN page, or otherwise if you have a substantive article that you would like to submit for the page, please let me know.

FOR ANY QUESTIONS REGARDING THE YOUNG LAWYERS NETWORK PLEASE CONTACT: HUGH DRAKE, YLN Chair at hdrake@bhslaw.com

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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

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Law Students

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Law school debt is something that affects almost every law student today. Many law schools have Loan Repayment Assistance Programs (LRAP); but there are still some law schools and states that have not adopted this program. The ABA Law Student Division is committed to advocating this loan assistance program for law students.

Educational Toolkit

ABA Law Student Division Homepage

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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

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NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Real Property Law Book

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Current Condemnation Law: Takings, Compensation & Benefits, Second Edition

By Alan T. Ackerman & Darius Dynkowski

http://www.abanet.org/abastore/index.cfm?section=main&fm=Product.AddToCart&pid=5430464

Condemnation of property is an especially topical subject after the U.S. Supreme Court's controversial decision in *Kelo v. City of New London.* This completely revised edition of **Current Condemnation Law** examines the many complexities involved in the practice of eminent domain law in order to assist lawyers in best protecting the clients' interests in these cases. The book brings together experts in the specialty to provide analysis of both major and specialty areas of condemnation law, providing "how to" tips along with current discussions of case law and theory.

The chapters in **Current Condemnation Law** provide a thought-provoking mix of articles covering the key topics of business valuation, contamination issues, the right to take, and payment for business damages. Written by some of the ablest practitioners in condemnation law, this book will assist both new and veteran practitioners to develop and maintain a successful condemnation law practice.

While the first edition considered the offer process and procedural and valuation issues, this new edition also addresses emerging issues that relate to some areas outside pure procedure and focuses on the constitutional basis of the process and compensation, including the growing issue of inverse condemnation. Among the topics covered include:

- Eminent domain and public purpose in the Kelo decision
- Rules of federal eminent domain proceedings
- Public use limitation in eminent domain

- Valuation analysis and approaches for contaminated property
- Temporary taking valuation process
- Entrepreneurial profit
- Valuation for utility corridors
- Inverse condemnation actions, including ripeness and abstention, the risks of delayed condemnation, and condemnation blight
- Changes to the statue of limitations for inverse condemnations
- Takings of private ways
- Relevance and admissibility of rezoning and incomparable sales after the date of taking
- Public use acquisitions in England and Wales

Practical guidance in these chapters provides pointers and approaches for determining just compensation and benefits in a condemnation case. Current case law is referenced throughout to assist in evaluating the best course of action. A survey of state statutes of limitations in inverse condemnation actions is included as an appendix.

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Real Property Article

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Changes in the ACORD 28 Insurance Form and Lender Reaction

By Rod Clement

When lenders make loans secured by real estate, they usually require the borrower to provide proof that the borrower has property insurance in an amount sufficient to pay off the loan in case the improvements are destroyed by casualty. The traditional proof of the existence of property insurance has been certificates of insurance on forms promulgated by the Association for Cooperative Development, or ACORD . In 2006 ACORD made changes to the standard proof of property insurance form that have arguably reduced the usefulness of these certificates to lenders and have left lenders searching for alternatives to the current ACORD form.

Background

Certificates of insurance are important to lenders whose loans are secured by real estate because, while lenders typically require the borrower to provide property insurance identifying the lender as an additional insured, the policy itself usually is not available at closing. So a certificate of insurance is usually the only proof of insurance that is available to the lender.

In order to appreciate the 2006 changes to the ACORD, it helps to review the changes made to the history of the relevant ACORD forms. Prior to 2003, if an insured asked his or her agent for a certificate of insurance, the agent usually would provide an ACORD 24 Certificate of Property. The Form 24 provided, among other things, that "This certificate is issued as a matter of information only and confers no rights upon the certificate holder. This certificate does not amend, extend or alter the coverage afforded by the policies below." The Form 24 also provided that if the policy was cancelled, the issuing agent would endeavor to mail notice to the certificate holder,

but that the failure to give the notice would not impose liability on the company. Savvy lenders would insist on the ACORD Form 27, which provided that it was “evidence that the insurance as identified below has been issued, is in force, and conveys all the rights and privileges afforded under the policy.” The Form 27 also provided that the issuer would give notice to the lender prior to cancellation of the policy. The Form 27 left blank spaces for the description of the coverages that existed, leaving the person completing the certificate considerable discretion about how to describe the types and amounts of coverage. The differences between the ACORD Form 27 and a predecessor of the ACORD Form 24, and the problems with the Form 24 in the context of a commercial real estate loan, were the subject of an article by Alfred S. Joseph III & Arthur E. Pape, “Certificates of Insurance: The Illusion of Protection”, Vol. 9, No. 1, *Probate & Property* 55 (Jan./Feb. 1995).

In 2003, at the request of the Mortgage Bankers Association and others, ACORD issued a new ACORD 28 Evidence of Commercial Property Insurance. The 2003 Form 28 among other things, contained the same language from the old Form 27 that the form “conveys all the rights and privileges afforded under the policy” and that the issuer would give the lender written notice prior to cancellation of the policy. The 2003 Form 28 also contained check boxes for the existence of coverages and specific places for limits and deductibles to be listed, making it easier for lenders to know what the policy provided. ACORD and the Mortgage Bankers Association issued a joint press announcement regarding the new form. A “frequently asked questions” article about the 2003 form by the Mortgage Bankers Association explains the changes in greater detail. The old ACORD Form 27 was revised for use for residential and personal property transactions. The “matter of information only” and “endeavor to mail” language was added to revised Form 27.

Then in July 2006, ACORD issued a revised form of the ACORD 28. The 2006 form provides, “This evidence of commercial property insurance is issued as a matter of information only and confers no rights upon the additional interest named below.” The form also provides that “Should any of the above described policies be cancelled before the expiration date thereof, the issuing insurer will endeavor to mail __ days written notice to the additional interest named below, but failure to mail such notice shall impose no obligation or liability of any kind on the insurer, its agents or representatives.” In other words, for practical purposes the form was changed back to the Form 24. One reason for the change was a concern by the insurance industry that the 2006 Form 28 arguably expanded the insurer’s obligations beyond the terms of the policy. This concern is compounded by the fact that the certificates are usually issued by insurance brokers or agents rather than by the insurance companies themselves.

Lenders have criticized the changes, primarily because of the absence of notice of cancellation of the policy. The Mortgage Bankers Association has issued a statement criticizing the changes. Freddie Mac and other lenders have refused to accept the 2006 Form 28 because the language of the form conflicts with the standard mortgagee loss payment endorsement requiring notice to the lender in case of policy cancellation.

The changes to the form are particularly troublesome for lenders making non-recourse loans, since the property is the only source of repayment of their loans. The 2006 changes in Form 28 also are particularly problematic for the commercial mortgage-backed securities industry. According to the statement of the Mortgage Bankers Association, rating agencies are excluding loans that rely on the 2006 Form 28 from pools of loans that are being securitized.

Attempted solutions

ACORD, recognizing the conflict between the lending and insurance industries regarding the changes to the form, has formed a working group of representatives of the lending and insurance industries to study possible changes to the 2006 Form 28. This group has been meeting weekly since February 2007.

Meanwhile, how are real estate lenders who currently making loans getting comfortable about the existence of property insurance? First, and by far the most common, lenders are requiring the use of the 2003 ACORD form. One potential issue with this practice is whether these forms are approved forms under state regulatory laws. Another potential issue is, if this form is issued by an insurance broker or agent rather than an insurance agent, whether the broker has the authority to issue the 2003 form on behalf of the insurer. Second, lenders are pushing to get the original policies at closing. Certificates are substitutes for the policies themselves, and so if the borrower can get the insurer to get the original policy delivered at closing, there is no need for a certificate. Lenders are generally having mixed success with getting the original policies at closing, however. Third, some lenders making non-recourse loans are adding as a carve-out to the non-recourse any losses caused by the cancellation or amendment of the coverage prior to the delivery of the original policies. There has been pushback from borrowers on this point since the borrower is usually not the reason for the delay in getting the insurance policy. Fourth, some lenders and servicers have been attaching specific provisions of most concern to the lender to the insurance binder.

Conclusion

The extent of resistance to the 2006 changes to the ACORD 28 form makes it likely that some changes eventually will be made to the form that will balance the need of real estate lenders to verify the existence of insurance protecting their collateral with the need for insurers to not expand their liability beyond the terms of their policy. If changes are not made, then the demand for proof of insurance will be generate alternatives to the ACORD form.

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AFFINITY RELATIONSHIPS UNDER RESPA: MAKING MONEY THE "OLD FASHIONED WAY"[1]

An Introduction

Affinity relationships are a wonderful means of developing a supplemental income stream. Unfortunately, many affinity relationships are implemented outside of the framework of Section 8 of RESPA.[2] Many times, this is the result of misunderstanding what RESPA requires, and what it does not. This is evident from the settlements[3] entered into by real estate brokers, mortgage brokers, lenders, title agencies, and title companies that were found by HUD to have violated Section 8 of RESPA. Section 8 of RESPA prohibits certain "kickbacks," but that does not explain when a "kickback" is illegal and when it is not.

Consumers understand "kickbacks" as rebates. You buy a product from a retailer, and the manufacturer gives you some of your money back. Businesses understand kickbacks as "referral fees." You work as my employee to find a customer for my goods and services, and you earn a commission. Both of these examples are "kickbacks," but neither example is prohibited by RESPA. Therein lays the confusion. A reasonable person does not understand why "scratching someone's back" can be an illegal kickback if it benefits both parties, and what "magic bullet" makes it a legitimate relationship.

Section 8(a) of RESPA[4] prohibits paying or receiving any fee or other thing of value (even a referral) in return for the referral of "settlement services" in a "federally related transaction." Section 8(b)[5] of RESPA states that a person cannot accept a settlement service fee, or a split of a settlement service fee, in a "federally related transaction" without providing "settlement services." Just as the commandment, "Thou shall not kill" does not elucidate the exceptions for self defense, military action, and police action, the above prohibitions do not describe the exceptions to the rule.

Most real estate professionals and home builders are looking for supplemental sources of income. Section 8(c) of RESPA[6] gives us a number of exceptions to the prohibition against kickbacks that permit such compensation. The most useful exception in Section 8(c) of RESPA is the "goods and services" exception.[7] A settlement service provider may pay for substantive goods and services, even when the payee refers consumers to the provider for settlement services. The payment must be earned for goods and services, not for the referral of mortgage loan customers, and not for services that duplicate services already provided as part of the loan origination process. Just as lenders "bundle" settlement services, real estate agents, builders, and other referral sources may "bundle" their services to benefit mortgage brokers and lenders, and receive fair compensation for these services. Mortgage brokers and lenders, to a lesser extent, may bundles services and sell these to title agencies. There are a number of ways for mortgage brokers and mortgage lenders to interact with real estate professionals, title agencies, residential builders, and others, to earn additional income by utilizing this exception. The keys to developing these affinity relationships are (a) to find a "bundle of services" that benefits both parties, and (b) to identify the market rate payable for these services. The parties

must then identify the goods and services provided in a written agreement, and to pay no more than market rates for the goods and services. Any amount in excess of market rates will be inferred to be an illegal kickback for the referral of business.

Adding services to a transaction, or providing cash rebates to the borrower as part of the "bundle," gives the borrower an incentive to choose to receive mortgage origination services or title and escrow services through the affinity relationship.[8] This drives additional compensation to the affinity partners. The result is a win-win arrangement for the mortgage professional, the affinity partner and the consumer.

Does RESPA Apply?

The first question a law professor would ask is whether the transaction is subject to RESPA. RESPA only applies to "federally related transactions." Any person or entity originating one million dollars or more of residential mortgage loans in a calendar year that is also subject to disclosure requirements of the Truth in Lending Act (TILA) generates "federally related transactions." Any transaction that is assisted with money from the federal government, or is insured or guaranteed by the federal government, or is sold to FNMA or FHLMC, is a "federally related transaction." Hence, we perceive all mortgage transactions as subject to RESPA, but that is not the case. The following are exempt from RESPA:

- Typical one-time seller financing that is not valued at over one million dollars, or the seller does not engage in a sufficient number of transactions to be a "creditor" subject to TILA.[9]
- Business purpose credit transactions that are exempt from TILA. For example, a mortgage loan to an investor to acquire residential rental property is a business purpose loan that is not subject to TILA or RESPA.[10]
- Cash transactions are not subject to RESPA.

HUD also carved out other loans from RESPA by rule[11]:

- Loans secured by 25 contiguous acres are not subject to RESPA.
- Loans secured by multi-family housing (5 or more units).
- Loans secured solely by land that will not be developed for at least two years.

In contrast, some transactions that we might assume are exempt from RESPA are still subject to the anti-kickback rule:

- Construction loans if the lender makes the end loan, or the borrower buys the lot with the first draw.
- Home equity lines of credit even though certain disclosures are excused.
- Loan modifications if the note is replaced or the mortgage is amended.
- Mortgage assumptions if the lender must approve the assumption.

Discussion of these exceptions is largely an academic exercise. RESPA applies to the

majority of residential mortgage transactions. For the remainder of this article, we will ignore transactions that fall outside of the scope of RESPA, and concentrate on core businesses dependent upon residential mortgage transactions.

<u>What is an Illegal Kickback?</u>

To understand what RESPA prohibits, you must grasp and thoroughly digest the definition of an illegal kickback. Section 8(a) of RESPA states:

> ***"No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person."***

There are three elements to an illegal kickback: (1) a "thing of value," (2) an "agreement or understanding," and (3) a "referral." If any of these three essential elements is missing, the activity is not illegal under RESPA. Section 14 of HUD's Regulation X[12] defines each of these three elements:

Things of Value

First, a "thing of value" "includes, without limitation, monies, things, discounts, salaries, commissions, fees, duplicate payments of a charge, stock, dividends, distributions of partnership profits, franchise royalties, credits, future opportunities, chances, retained or increased earnings, increased, accounts, special or unusual contract terms, reduced rates for goods and services, increased payments for goods and services, lease or rental payments based in whole or in part on the amount of business referred, payment of another person's expenses, or reduction in credit against an existing obligation."[13] When HUD refers to a "payment," it means the giving of anything of value, whether it is money, a chance to win a prize, a referral, or some future consideration.

Lesser known examples of a "thing of value" include:

- Defraying costs that a party would ordinarily have to pay, such as the cost of mandatory continuing education courses.
- Promising to provide a referral in the future (an agreement for mutual referrals).
- Chances in a lottery or raffle (the ticket has a value, win or lose).
- Providing something that has a dual use may be a thing of value if used for two purposes (e.g. a non-dedicated fax machine).
- Promising an appraiser that he will perform the appraisal for each borrower the appraiser refers to a related lender.

There is no "de minimis" kickback that escapes scrutiny under RESPA. Contrary to popular belief, a gift under $25 is not exempt from being a "thing of value," and charitable contributions are not exempt from the rule. Nevertheless, there is a point at which the "thing of value" becomes too attenuated to identify. For example, a referral to

an affiliate cannot be directly compensated. However, the referral contributes to the overall profitability of the combined enterprise, and increases the pool from which all employees are paid a bonus. The incremental increase in the referring employee's bonus is too attenuated from the referral to be a "thing of value" paid for the referral. The point of "no return" must be evaluated on a case by case basis.

Agreement or Understanding

You know an agreement exists when you see it. An agreement or understanding for the referral of settlement service business can be oral, written, or established by a practice, pattern or course of conduct. When a thing of value is received repeatedly and is connected in any way with the volume or value of the business referred, the receipt of the thing of value is evidence that it is made pursuant to an agreement or understanding for the referral of business. Requiring the borrower to use a particular service provider infers that an agreement or understanding exists for the referral of business.[14]

There are several exceptions to this definition. First, the borrower cannot be a party to a kickback in his own loan transaction. Defraying the borrower's closing costs to persuade the borrower to take a loan is not a kickback. Paying a borrower to refer friends and family is an illegal kickback. Second, some Federal Appellate Courts have ruled that unilaterally increasing the price of a third party service fee (and keeping the difference) is not an illegal kickback because there is no agreement.[15] There is a split of opinion on this issue, with HUD and state regulators opposing this practice.

Referral

"Referral" is defined two ways. First, a referral includes any oral or written action directed to a person that has the effect of affirmatively influencing the person to use a particular settlement service provider and pay a fee for the service. Second, a referral also occurs whenever a person paying for a settlement service is required to use a particular provider of a settlement service. "Required use" means a situation in which a person must use a particular provider of a settlement service and pay their fee in order to have access to some distinct service or property.[16]

There are exceptions that do not constitute a "referral." First, providing a bundle of services that is significantly discounted from the cost of the individual services does not constitute a "required use" of the provider of the services. For example, a lender that negotiates with settlement service providers for substantially reduced charges so that an origination fee of $300 covers the automated underwriting system fee (AUS), credit report, and appraisal services does not require the use of the AUS service, credit bureau and appraiser if the ordinary actual cost of the services provided individually would be $400.[17]

Second, a mortgage originator can buy leads if the person selling the leads does not mention the name of, or do anything to influence the consumer to contact, the broker, lender or other settlement service provider. No endorsements, no hints, no nothing. The

broker or lender does all the soliciting of the lead. There are several important caveats to buying leads, such as the requirement that financial institutions must maintain the confidentiality and security of non-public consumer information (with certain exceptions).[18]

Illegal Kickbacks Are Like a Three Legged Stool

Think of an illegal kickback as a three legged stool. If any of the three legs are missing, the stool falls over. The same is true under RESPA. If any of the three elements of a kickback is missing, or an exception exists for one of the elements, the transaction is not illegal. Each element must be evaluated individually.

No Agreement

It is easy to presume that an agreement exists when the person making the referral receives a benefit from the recipient of the referral. It is difficult to prove that an agreement exists if (a) the thing of value does not directly benefit the party providing a referral, or (b) the thing of value does not originate from the person receiving the benefit of the referral. You need to show the existence of some independent action by one of the parties tying the payment to the referral when there is an indirect benefit. Take the example where a mortgage lender offers to pay for the cost of the title commitment for any borrower referred to him by a real estate salesperson. The lender's payment of a title premium, defrays the seller's cost, not the realtor's costs. The real estate salesperson is making the referral, not the seller. If there is no agreement or understanding tying the seller's benefit with the referral by the real estate salesperson, the payment is legal. However, if the real estate salesperson used the mortgage lender's payment to negotiate his commission (with the lender's knowledge), that action ties the payment to the referral, and the payment is an illegal a kickback.

Let's try this one more time. A mortgage broker gives coupons to builders for $1000 off the buyer's closing costs in return for the referral of home buyers for a loan. The coupon that defrays the buyer's cost, not the builder's costs. Ordinarily, the buyer cannot be a party to a kickback in his own loan, and the coupons are legal. However, if the builder uses the coupon to negotiate up his construction price, there is a kickback. Furthermore, if the mortgage lender gives the coupons only to builders who give him referrals, there may be a kickback.

Our third example demonstrates the effect that an intervening borrower will have on a referral fee. A lender pays $100 to a church for each member who closes a loan. The church advertises the loan program to its members and encourages them to borrow from the lender. If the lender writes the check to the church, it is a kickback. If the lender writes the check to the borrower, who then voluntarily signs the check over to the church, there is no kickback. The borrower cannot be a party to a kickback in his own loan transaction since the borrower is protected by RESPA. Hence, the borrower breaks the connection between the settlement service provider and the church making the referral for a fee.

Change the facts a little. The lender buys the church membership list and solicits the members. Loan officers attend the church picnic to pass out fliers advertising loan products. If the lender pays for access to the picnic (other than the cost of the meal and other activities for the loan officers), there may be a kickback. If the church endorses the lender, there may be a kickback. If the lender hires the pastor to take loan applications, there may be a kickback (depending on whether the pastor is a bona fide employee of the lender).

No Referral

Selling leads is not an illegal kickback because there is no a referral. A lead company finds consumers who are willing to apply for a loan, but the lead company does not take any action directed at the consumer to influence the consumer to use any particular lender. Only the lenders that buy leads solicit consumers to apply for a loan. Why don't lenders buy leads from the public at large? A lender that gives the borrower $50 for giving him the names of friends and relatives who are looking to refinance or to buy a home is purchasing a list. The borrower is not asked to do anything to influence friends and relatives to use the lender. However, the borrower cannot refrain from telling his friends about the lender, and the lender expects this to occur. Even if the lender ordered the borrower not to solicit for the lender, the lender cannot guaranty that the borrower will refrain from making referrals. If the borrower breaks his promise, and talks about the lender after receiving his $50, both the lender and the borrower are liable for a violation of Section 8.

No Thing of Value

The classic example is the lender that rents space in a title agency's building and refers borrowers to the title agency for title insurance. An illegal kickback could exist if the title agency were giving something of value to the lender. If the lender is paying market rates or above market rates for rent, it is not receiving anything of value for its referrals. If, however, the lender is paying below market rent, the difference is presumed to be a benefit for the referral of settlements service business.

The discounted value of title services was the basis of significant litigation in Michigan over the past several years.[19] Assume that title agencies charge $25 to a builder for the owner's title policy, and the buyer pays the remainder of the basic fee for the mortgage policy. Does the discount represent a benefit paid to the builder for referring business to the title agency? There are good arguments on each side of this issue. The title agency has less work to write title commitments for the lots because the title agency is able to perform one search for the whole project, and then just provide an update for each lot. On the flip side, the reduced cost of the owner's policy is an inducement for the builder to send all of his title business to the one title agency, and refer all borrowers there as well. If the title agent were truly lowering its fees due to decreased work, it would lower the basic insurance fee (to benefit the borrower and the builder). Furthermore, title insurance is priced according to the amount of coverage. The $25 premium is not related to the

level of risk assumed by the title underwriter. The implication is that the significantly discounted insurance premium is a kickback. Large settlements occurred in Michigan cases, resulting in title companies paying tens of millions of dollars in damages for overcharging borrowers for title insurance on new construction.

Section 8(b) of RESPA – The Other Shoe

The "little brother" of Section 8(a) of RESPA is Section 8(b):[20]

> "No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed."

Section 8(b) prohibits a mortgage broker or a title agent from taking a fee without providing substantial services. That much was established in two HUD Statements of Policy. HUD Statement of Policy 1999-1[21] defined the minimal services that a mortgage broker must perform to earn a fee. HUD Statement of Policy 1996-4[22] defined the core title services that a title agency must perform to earn the title insurance premium. The Statement of Policy covering mortgage broker fees was needed to stem a tide of litigation that threatened to swamp the mortgage broker industry.[23] The Statement of Policy regarding title insurance services was needed to stem business arrangements that allowed referral sources to earn a fee without providing much in the way of services.

The minimal services that a mortgage broker must perform were first espoused by HUD in an informal letter to the Independent Bankers Association of America, dated February 14, 1995. This letter identified fourteen services that a mortgage broker may perform to originate a mortgage loan. These include:

> (a) Taking information from the borrower and filling out the application;
> (b) Analyzing the prospective borrower's income and debt and pre-qualifying the prospective borrower to determine the maximum mortgage that the prospective borrower can afford;
> (c) Educating the prospective borrower in the home buying and financing process, advising the borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments could vary under each product;
> (d) Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process;
> (e) Initiating/ordering VOEs (verifications of employment) and VODs (verifications of deposit);
> (f) Initiating/ordering requests for mortgage and other loan verifications;
> (g) Initiating/ordering appraisals;
> (h) Initiating/ordering inspections or engineering reports;
> (i) Providing disclosures (truth in lending, good faith estimate, others) to the borrower;

(j) Assisting the borrower in understanding and clearing credit problems;
(k) Maintaining regular contact with the borrower, realtors, lender, between application and closing to apprise them of the status of the application and gather any additional information as needed;
(l) Ordering legal documents;
(m) Determining whether the property was located in a flood zone or ordering such service; and
(n) Participating in the loan closing.

These fourteen services were incorporated into HUD Statement of Policy 1999-1 published on March 1, 1999. HUD's Statement of Policy required a mortgage broker to provide five services from the list above in addition to taking the loan application. HUD also recognized that services (b), (c), (d), (j), and (k) on the list above were "counseling type" services that could provide more of a substantive benefit to the lender than to the borrower. Hence, a mortgage broker's services would be closely scrutinized if the mortgage broker provided only these five "counseling services."

HUD acknowledged that these are not the only services that a mortgage broker may provide, and that some of these services may be provided through technology rather than the efforts of a mortgage broker. Nevertheless, the important principle of this Statement of Policy is that it provided a safe harbor for mortgage brokers. Mortgage brokers could earn a fee by providing a limited number of identifiable services. Furthermore, the mortgage broker's total compensation should be measured against the totality of the services provided. Class action lawsuits that separately measured the services provided to the mortgage lender and services provided to the borrower against the amount that each party paid were no longer viable.

HUD's Statement of Policy 1996-4 established minimum title agency services:

"Section 8(c)(1)(B) specifically exempts payments of a fee 'by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance.' A more general provision, section 8(c)(2), exempts the 'payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed.' (See also 24 CFR 3500.14(g)(1).)….

"To qualify for a section 8(c)(1)(B) exemption, the attorney title insurance agent must 'provide his client with **core title agent services for which he assumes liability, and which includes, at a minimum, the evaluation of the title search to determine insurability of the title, and the issuance of a title commitment where customary, the clearance of underwriting objections, and the actual issuance of the policy or policies on behalf of the title company.**'"

More specifically, HUD defined five services that a title agency must perform to earn the entire its portion of title insurance premium (typically 70% to 85% of the premium) without scrutiny of the split between the agency and the underwriter:

"'Core title services' are those basic services that a title insurance agent must actually perform for the payments from or retention of the title insurance premium to qualify for RESPA's section 8(c)(1)(B) exemption for 'payments by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance.' In performing core title services, the title insurance agent must be liable to his/her title insurance company for any negligence in performing the services. In considering liability, HUD will examine the following type of indicia: the provisions of the agency contract, whether the agent has errors and omissions insurance or malpractice insurance, whether a contract provision regarding an agent's liability for a loss is ever enforced, whether an agent is financially viable to pay a claim, and other factors the Secretary may consider relevant.

"'Core title services' mean the following in Florida:
a. The examination and evaluation, based on relevant law and title insurance underwriting principles and guidelines, of the title evidence (as defined below) to determine the insurability of the title being examined, and what items to include and/or exclude in any title commitment and policy to be issued.
b. The preparation and issuance of the title commitment, or other document, that discloses the status of the title as it is proposed to be insured, identifies the conditions that must be met before the policy will be issued, and obligates the insurer to issue a policy of title insurance if such conditions are met.
c. The clearance of underwriting objections and the taking of those steps that are needed to satisfy any conditions to the issuance of the policies.
d. The preparation and issuance of the policy or policies of title insurance.
e. The handling of the closing or settlement, when it is customary for title insurance agents to provide such services and when the agent's compensation for such services is customarily part of the payment or retention from the insurer."

Controversy exists regarding core title services and retained risk, even after this guidance was published. For example, title plants provide an electronic document that mimics Schedule B of a title commitment. HUD's position is that "if the title insurance company provides its title insurance agent with a pro forma commitment, typing, or other document preparation services, the title insurance agent is not 'actually performing' these services. As such, the title insurance agent would not be providing 'core title services' for the payments to come within the section 8(c)(1)(B) exemption." What level of scrutiny of the title search is required before the commitment can be generated from the search document? Does the agency fulfill its obligation to provide all "core title services" if the title agent simply accepts the document provided by the search service and pushes a few keys to create the commitment?

Controversy also exists regarding the sharing of risks between insurance companies. State Insurance Commissioners recently fined several title insurance companies for entering into reinsurance agreements with title companies owned by builders. The reinsurance agreement paid the builders' reinsurance companies a fee that was disproportionate to the

risk that the reinsurer absorbed. The Commissioners found that splitting the insurance premium, without absorbing substantial risk, violated state insurance codes and RESPA.

HUD has not officially established minimum or core services that other settlement service providers must perform to earn a fee. Therein lays a problem. Section 8(b) implies that splitting a fee by agreement is illegal if no services are performed. However, is a modicum of service all that is necessary to earn a substantial fee? Furthermore, is it illegal to take a fee without providing a service when there is no second party that knowingly splits the fee? Without guidance from HUD, the issue of what other settlement service providers must do to earn a fee was left to the courts.

Back to Court

Once litigation subsided over mortgage broker fees, borrowers increasingly challenged miscellaneous lender compensation. Borrowers claimed that document preparation fees greatly exceeded the actual cost of preparing closing documents, underwriting fees exceeded the cost charged by automated underwriting systems, credit report fees exceeded the cost of the credit report, and that some lenders were making excessive profits from "junk fees." These claims took two forms. First, borrowers claimed that lenders cannot make a profit from third party services. These profits are termed "markups." Second, borrowers claimed that lenders cannot charge excessive fees, far above the cost or the value of services provided. These profits are termed "overcharges" or "overages." HUD supported claims in *amicus* briefs filed in various borrower lawsuits that markups and overcharges violate RESPA.

Markups

HUD and the Department of Justice enforce an informal policy that a settlement service provider cannot earn a fee without providing substantial services. HUD will take action against a lender or title agency that marks up third party settlement service fees passed on to the borrower. Markups typically occur when a service provider (typically a credit bureau) bills a lender monthly for services, or the actual cost (e.g. the recording fee) is determined after the closing. Charges for online credit reports vary (typically ranging from $8 to $15). The lender may have no idea what the credit report costs at the time of closing and, therefore, the lender charges the borrower a flat fee that is the average cost of the credit report. Title agents also charge flat fees for recording documents since they do not know until just before the closing how many pages are in the deed and mortgage.

HUD believes that each borrower should pay no more than the actual cost for third party services. Hence, anyone who paid $12 for an $8 credit report is entitled to a refund. HUD has fined several lenders for these infractions. While some fines have been substantial, many fines imposed by HUD were a few thousand dollars per lender – amounts too small to be economically worthwhile to contest.

Consumers have been less successful arguing to a court that they should receive compensation for fee markups. Three Circuit Courts of Appeals held that Section 8(b)

clearly and unambiguously does not prohibit mark-ups.[24] These courts held that:

- There is no violation of RESPA when there is no agreement or understanding between the credit bureau and the lender, or between the title agent and the Register of Deeds, that the lender would keep the difference between the charge to the borrower and the actual cost of the service.
- Section 8 requires a court to find two parties guilty. The only other party to the transaction is the borrower, but the borrower cannot be a party to a kickback in the borrower's own loan. Holding the borrower liable under a statute designed to protect the borrower leads to an absurd result.

Later court decisions by three different Courts of Appeals deferred to the arguments espoused by HUD to hold that a markup could be a kickback.[25] However, if the service provider can show that it rendered some service that can be compensated (and there is no overlap of other compensation or fee for the service), then there is no kickback. In theory, a lender or a title agent can earn a fee for almost anything. Enforcement of HUD's position has been limited in the past few years. Instead, state regulators have fined lenders for marking up credit reports on the basis that state laws expressly limit fees collected for third party services to the actual cost of these services.

There are several means of avoiding this issue:

- Raise the origination fee to bundle the origination of the loan with the credit report fee, and show the flat fee to the credit bureau or to the Register of Deeds as an estimated POC payment.
- Charge a credit review fee instead of a credit report fee, and show the flat credit report fee as an estimated POC payment.
- Increase the closing fee to include the cost of recording documents, and show an estimated POC payment to the Register of Deeds.
- Charge a recording service fee in addition to the fee charged by the Register of Deeds.

All of these methods are being used to level out the cost of services. However, a more prevalent practice creeping into the market is to increase "junk" fees rather than to bundle fees. HUD has, in effect, opened a Pandora's Box by making a mountain out of a molehill. Consumers are now paying more for incremental services than they did by paying an average amount for the cost of the third party service.

Overcharges and Overages

HUD and the Department of Justice have also argued, unsuccessfully to this point, that an excessive fee violates Section 8(b) of RESPA. HUD's argument, asserted in Statement of Policy 2001-1,[26] is that "A single service provider . . . may be liable under Section 8(b) when it charges a fee that exceeds the reasonable value of goods, facilities, or services provided." HUD's argument is based on a statement in Regulation X: "If the payment of a thing of value bears no relationship to the goods or services provided, then

the excess is not for services or goods actually performed or provided." In HUD's view, too many points, an oversized document preparation fee, or too high of a yield spread premium, is a fee split – the borrower is charged a reasonable fee for services, and the borrower is charged an additional amount for which the borrower receives no benefit. However, the 1973 legislative history of RESPA indicates that Congress rejected an explicit price control proposal when RESPA was enacted. Instead, it directed HUD to report to Congress on "whether Federal regulation of the charges for real estate settlement services in federally related mortgage transactions is necessary and desirable."[27] Congress took no further action regarding price controls. Thus the courts rejected HUD's argument since it was based on a HUD rule which was not supported by RESPA.

Exceptions to the Rule

Every rule has its exceptions, including Section 8 of RESPA. Five principal exceptions to the kickback rule (in addition to the "missing stool leg" concept discussed previously) are used to create affinity relationships between settlement service providers:

1. Payments for rendering services or providing goods.

Section 8(c) of RESPA allows payments for bona fide services and goods actually received, regardless of whether the party receiving the payment refers business to the party paying for the services and goods.[28] These services and goods typically take the form of subleases, desk licenses, joint advertising, marketing services, and other miscellaneous services. There are several caveats to this exception:

a. The services or goods must be bona fide. Simply stating that services and goods will be provided is not sufficient.

b. The services and goods must be provided on a commercially reasonable basis. A real estate broker that rents a conference room for loan closings, or subleases space as an executive office suite, must provide the same amenities and services that a conference center or an executive office suite would provide.[29]

c. The services or goods must be utilized. A lender or a title agency cannot rent space from a real estate broker that the lender or title agency does not intend to use.

d. The payment must be commensurate with the services rendered or the goods provided. If the marketplace rents conference rooms by the hour, a title agency may rent a conference room from a real estate agent by the hour – but not at a flat rate per closing.

e. No part of the compensation can be for the referral of business. A clause agreeing to refer business to each other is illegal since a "lead" is a thing of value.

HUD will presume that any markup of third party services and goods by a person in a position to refer settlement service business is a payment for the referral of business. If a

real estate broker sublets a bare office to a lender, the rent should be based on actual cost, and should not be marked up.[30] Services and charges for services provided by a referral source should be uniform. Real estate brokers should not charge a higher desk license fee to a lender simply because the lender may make a significant profit from referrals. Furthermore, office services provided to a lender under a desk license should be comparable to the office services provided by a real estate broker to its real estate salespersons with a desk license.

A real estate broker may charge more than its cost per square foot to sublet an office to a lender or title agent if the real estate broker provides extra services on a commercially reasonable basis. A real estate broker may provide postage, copying, fax, reception, conference rooms, etc., in addition to renting an office to a mortgage lender. If the real estate broker provides these services on a commercially reasonable basis, e.g. comparable to the service provided in an executive office suite, the real estate broker may price the subleased office comparable to the cost of space in a local executive office suite. If services provided to a lender are the same as are provided to a real estate salesperson with a desk license, the real estate broker should justify the license fee based on the market rate for the desk license. If the mortgage lender will use fewer services than a real estate salesperson, reduce the desk license fee accordingly. It is imperative that a lender or other settlement service provider should never pay a premium for introductions or referrals to business opportunities.

Similarly, a mortgage company or a title agency should not pay for "make work" that has little or no value. For example, marketing agreements that require the "service" of real estate salespersons to attend educational programs, or that require "access" to real estate professionals, are questionable at best. What is the utility of such a "service"? Marketing efforts should be justified under the education and marketing exception discussed below.

2. *Affiliated Business Arrangements*

The owners of a mortgage company, title agency, real estate brokerage, and/or other settlement service providers may earn a profit from a bona fide business investment,[31] even when some of the profit is generated through leads sent to the partially owned business, provided that:

a. The borrower must receive a copy of an Affiliated Business Arrangement Disclosure at the time a referral is made to an affiliated business. The model form of this disclosure[32] must be used to create a disclosure for each affiliate (do not delete Section B. of the model form, and settlement service fees should expressed in dollars, not percentages). An acknowledgement in the disclosure must be executed by the borrower no later than at closing, and the signed disclosure must be retained for five years.

b. A person cannot require the borrower to use the services of an affiliated business. An exception allows a lender to require a borrower to pay for the services of an affiliated appraisal company or credit bureau, or an attorney who represents the lender.

c. The profits of the affiliated business must be distributed according to percentage ownership, and percentage ownership should be determined by percentage of capital invested. Capital investment requirements cannot be reduced based on the expectation of leads generated for the affiliated business.

d. The affiliated business must be a living, breathing entity that performs services or provides goods, and earns income commensurate with these services and goods. Shell (or sham) affiliated business arrangements are prohibited by HUD Statement of Policy 1996-2.[33]

Remember also that HUD informal policies and HUD Statements of Policy 1996-4 and 1999-1 require any title agency, mortgage brokerage, or other settlement service business to provide substantive services. Any settlement service business must have at least one bona fide employee to perform substantive services. Fee splitting between affiliated businesses based on a split of substantive services is difficult and often runs afoul of secondary market or insurance underwriter requirements.

3. Secondary Market Sales

Prices paid by investors and borrowers to mortgage broker/lenders in table funded transactions must be commensurate with the level of work that the broker/lender provided toward originating the loan and completing the transaction. Mortgage brokers do not "own" an application or a loan, and the borrower is not anyone's "property." However, premium prices paid by an investor to buy a loan from a lender are beyond the oversight of HUD.[34] A lender's ownership of a loan is established by two factors, both of which must be present:

a. The lender must use its own money, either from its assets or from a warehouse line of credit, to fund or purchase the loan. However, a lender should not fund a loan with a warehouse line of credit that is provided by the loan purchaser, especially when the warehouse line can only be used to fund loans sold to the warehouse lender. These arrangements blur the line between a table funded loan and a true secondary market transaction. The potential penalties for a violation of Section 8 of RESPA are so harsh (triple damages, costs, attorneys fees, fines, and incarceration for a year) that it is not worth the risk to "test" a secondary market relationship in which the investor and its affiliates fund the closing and purchase the loan.

b. The lender must hold the loan long enough to establish title to the loan. Ownership of a loan for at least one day is necessary. Many lenders take a conservative approach, and hold the loan for at least two or three days after funding before selling the loan to an investor.

4. Educational and marketing expenditures.

Ordinary educational and marketing expenditures are exempt from scrutiny under RESPA, provided that the expenditure is referral neutral and it does not defray costs

ordinarily incurred by the recipient.[35] A weekend retreat and education program provided for real estate professionals, or tickets to a sporting event or a golf outing, are acceptable, provided that the invited target audience is based on bona fide business criteria (such as all of the real estate agents operating in a geographic area), and the invitation is not conditioned on the past, present, or future referral of business. Providing a free CLE course required for licensure would not be permitted because it is a cost that the recipient would ordinarily incur.

The hard part of marketing is being referral neutral. Rewarding builders with golf outings and sports tickets for referrals is prohibited. You can beg, but you cannot blackmail, bribe, compensate, extort, manipulate, reward, payoff, shakedown, or threaten referral sources to make referrals. Please also note that some state licensing laws prohibit gifts and other expenditures to obtain leads.[36]

5. Bona Fide Employment.

Section 14(g)(iv) and (vii) of HUD's Regulation X permit:

"(iv) A payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed;" and

"(vii) An employer's payment to its own employees for any referral activities." (emphasis added)

Settlement service providers should be able to hire pure "finders" and "rainmakers" that have no responsibilities other than to generate new clients for a settlement service business and its affiliates. However, HUD gave us a different message in a settlement agreement with Znet Financial. HUD fined Znet for paying $400 to real estate salespersons for each application for credit completed for Znet. Znet claimed that the real estate salespersons were employees being paid bona fide compensation, but HUD disagreed.

This settlement sends a clear message that certain employees must perform substantive services (similar to a mortgage broker's services) to earn bona fide compensation. That is not what the rule says, but that is how HUD enforces its rule. HUD will only allow an employer to compensate bona fide employees. Furthermore, compensation may only be paid for settlement services benefiting the employer. For example, HUD will allow a company to compensate employees for referring new business to their employer, but HUD will fine a company for paying compensation to employees for referring business to the employer's affiliate.[37]

HUD evaluates twenty factors outlined in IRS Revenue Ruling 87-41 to determine whether a person is a "bona fide" employee or an independent contractor. Unfortunately, we do not know how may of these factors must be satisfied under HUD scrutiny, or which factors weight more heavily than others. The twenty factors are:

i. **INSTRUCTIONS**. A person who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. HUD will ask whether the employer has the right to require compliance with instructions.

ii. **TRAINING.** HUD will ask whether the employer trains employees by requiring an experienced employee to work with a new employee, by corresponding with employees, by requiring employees to attend staff meetings, or by using other methods, and whether the employer wants work performed in a particular manner.

iii. **INTEGRATION**. An employee must necessarily be subject to a certain amount of control by the owner of the business. Integration of the employee's services into the employer's operations generally shows that the employee is subject to direction and control of the employer.

iv. **SERVICES RENDERED PERSONALLY**. HUD will ask what services must be rendered personally by the employee to accomplish the required work and to achieve the expected results.

v. **HIRING, SUPERVISING, AND PAYING ASSISTANTS**. Management responsibility for hiring, supervising, and paying assistants shows control over employees on the job. Independent contractor status is indicated if the employee hires, supervises, and pays assistants to do work for the employee. HUD will examine a written employment contract to determine whether the person is an employee who follows management direction, or whether the person is an independent contractor who provides materials and labor and under which the contractor is only responsible only for the attainment of a result. HUD will also ask whether "employees" hire their own assistants, and how the assistants are compensated.

vi. **CONTINUING RELATIONSHIP**. HUD will ask whether there is a continuing relationship between the employee and employer. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.

vii. **SET HOURS OF WORK**. Set hours of work indicate employer control of the employee. Part time employees should have regular work hours, and all employees subject to minimum wage or overtime requirements should complete time sheets to document regular hours and a continuing employment relationship.

viii. **FULL TIME REQUIRED**. True employment is indicated if (a) the employee must devote substantially full time to the employer's business, (b) the employer controls the amount of time the employee spends on the job, or (c) the employer restricts the employee from doing other gainful work. An independent contractor is free to work when and for whom he or she chooses.

ix. **DOING WORK ON EMPLOYER'S PREMISES**. The employer presumably controls the employee's activities if work is performed in the employer's offices, especially if the work could be done elsewhere. Work done off the premises of the employer, such as originating loans from home, indicates some freedom from control. However, this fact by itself does not mean that the person is not an employee. Control over the place of work is also indicated when the employer has the right to compel the employee to travel a designated route (e.g. who makes out of town travel arrangements for business trips?), to canvass a territory within a certain time, or to work at specific places as required.

x. **ORDER OR SEQUENCE SET**. The fact that an employee must perform

services in the order or sequence set by the employer shows that the employee is not an independent contractor. Often, the employer does not set the order of the services or sets the order infrequently. It is sufficient to show control, however, if the employer retains the right to establish a sequence of job functions. In mortgage lending, the sequence of events in the origination of a loan is determined largely by state and federal disclosure requirements.

xi. **ORAL OR WRITTEN REPORTS**. A requirement that the employee submit regular or written reports to a manager or main office indicates a degree of employer control.

xii. **PAYMENT BY HOUR, WEEK, MONTH**. Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.

xiii. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES**. An employer ordinarily pays employee business and/or traveling expenses. An employer, to be able to control expenses, generally retains the right to regulate and direct employee business activities.

xiv. **FURNISHING OF TOOLS AND MATERIALS**. Employers ordinarily furnish significant tools, materials, and other equipment (e.g. laptop and loan origination software) to allow employees to complete their work.

xv. **SIGNIFICANT INVESTMENT**. Persons that invest in employer facilities that are not typically maintained by employees (e.g. computer system leases) tend to be independent contractors. On the other hand, lack of investment in the employer's business indicates dependence on the employer for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to home offices.

xvi. **REALIZATION OF PROFIT OR LOSS**. A person who can realize a profit or suffer a loss as a result of the person's services (in addition to the profit or loss ordinarily realized by employees) could be an independent contractor (or a partner), but the person who cannot is an employee. For example, if a person is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the person is an independent contractor. The risk that an employee will not receive payment for his or her services, however, is common to both independent contractors and employees, and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

xvii. **WORKING FOR MORE THAN ONE FIRM AT A TIME**. If an employee performs services for several unrelated firms at the same time, that factor generally indicates that the person is an independent contractor. However, a person who performs services for related employers may be an employee of each business. As a general rule, state licensing laws dictate that an employee of a financial services company may only work for one licensee.

xviii. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC**. The fact that a person makes his or her services available to several firms on a regular and consistent basis indicates an independent contractor relationship.

xix. **RIGHT TO DISCHARGE**. The right to discharge an employee is a factor

indicating an employee-employer relationship. An employer exercises control through the threat of dismissal, which causes the employee to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.

xx. **RIGHT TO TERMINATE**. If the employee has the right to end his or her relationship with an employer at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

Other exceptions

Several other exceptions are listed in the statute and regulation; however, these exceptions have not been used to establish affinity relationships between different types of settlement service providers. These include:

a. Cooperative brokerage arrangements. HUD will not examine the split of bona fide real estate broker commissions. Real estate professionals are subject to RESPA in all other respects.

b. The split of title premiums between the title agent and the title underwriter. HUD will not question whether a typical 80%-20% split is reasonable if the title agency performs all core title services.

c. Bona fide attorney fees.

HUD has authority to create other exemptions, but that is unlikely.

Special Title Agent Rules Lead to Special Litigation

Some of the usual avenues of developing business are not available to title agencies. Section 9 of RESPA[38] states:

> ***"No seller of property that will be purchased with the assistance of a federally related mortgage loan shall require directly or indirectly, as a condition to selling the property, that title insurance covering the property be purchased by the buyer from any particular title company."***

This means that one of the title agent's best source of referral business - the form purchase agreement given to the seller - cannot specify that the buyer will use a particular title agent to purchase the mortgagee title insurance policy.

Furthermore, some state laws and rules prohibit or restrict affinity relationships by (a) limiting the amounts that title agencies and underwriters can spend on marketing, (b) prohibiting rebates to insured parties or reductions in filed rates, or (c) prohibiting payments for leads. Hence, title agencies and companies engage in joint ventures to generate referral business more than other settlement service providers.

Joint ventures between title agencies and real estate brokers work well, provided that there is a sufficient volume of referrals to make the joint venture profitable. The real estate broker partner refers sellers to the affiliated title agency to purchase the owner's policy. The title agency charges the seller the basic title insurance premium (less any reissue credits), and charges the buyer a "split premium" or "simultaneous issue" premium for the lender's policy. For example, if the basic premium for a $100,000 policy is $500, and both the owner's policy and the lender's policy were purchased from the same agency, the seller pays $300 for the owner's policy and the buyer pays 40% of the basic premium for the lender's policy ($200, or less if the mortgage loan is less than the purchase price). If the seller and the buyer purchase title insurance from different title agencies, each party would pay $500 for their policy.

The buyer, faced with the choice of paying $200 or $500 for the same policy, would choose the seller's agency to simultaneously issue the lender's policy. The title agency that issues the lender's policy must close the loan so that the lender receives a first lien letter, closing protection letter, and final policy without standard exceptions. Hence, the buyer was usually locked into the real estate agent's affiliated title agency without any contractual requirement to use that agency.

This scenario changed as lenders established their own joint ventures with title companies. Most title underwriters now offer simultaneous issue premiums for the lender's policy that allow lender affiliated title agencies to effectively compete with real estate broker affiliated title agencies. The lender will steer borrowers to an affiliated title agency to issue the lender's policy and close the loan. The borrower pays the same premium to the lender's affiliated title agency that would be charged by the agency issuing the owner's policy. Sometimes the lender's affiliated title agency will charge a below market closing fee to entice the borrower to use its services.

Competition lead to modest range wars in certain markets. Some real estate brokers and their favored title agencies began charging a documentation fee to the buyer if the buyer permitted the lender's title agency to close the transaction. Section 9 of RESPA prohibits sellers from directly *or indirectly* requiring borrowers to use a specific title agent. Litigation ensued, alleging that the documentation fee is a condition of selling the property that indirectly requires the buyer to use the seller's preferred title agency.

Recently, a Minnesota real estate broker was attacked for violating fiduciary duties to its customers. Revising the title commitment order form and real estate broker advertisements to specify that real estate brokers and title agencies are independent contractors (comparable to the Mortgage Origination Agreement used by mortgage brokers) may address some state law issues, but it will not resolve RESPA claims. The result of this litigation may not be known for several years.

Flying Too Close to the Sun

Profit sharing programs and insurance premium splits in three affinity programs were attacked on the basis that the split favors a referral source, or the payment violates

state law. These are worth noting, simply to point out how these programs failed despite the best intentions of the parties. Please note that these matters were settled without any admission of wrongdoing.

First, private mortgage insurance companies offered to sell "Performance Notes" to lenders that purchased PMI policies. The performance Notes paid interest at a rate based on the payment performance of the lender's loan portfolio. OCC Interpretive Letters 833 and 834, and an informal HUD opinion under RESPA, authorized national banks to purchase these notes. Lenders steered borrowers to purchase mortgage insurance from companies that offered "Performance Notes." The more policies the insurer issued to the lender's borrowers, the more notes a lender could purchase. Performance Notes were phased out because (a) the New York Insurance Commissioner stated in Insurance Department Circular Letter No. 2 that Performance Notes violated state insurance laws by sharing insured risk with unlicensed entities, and (b) Performance Notes faced increasing litigation under RESPA.

Second, private mortgage insurance companies offered secondary mortgage pool insurance to lenders to replace the fees paid to investors for "special" servicing rights. In "ordinary" servicing, the lender makes principal and interest payments when the borrower defaults. The lender is repaid if and when the secured property is foreclosed and sold. Investors offered "special" servicing contracts to lenders (for a fee) that required the investor to take the risk that a foreclosure sale of the property would not recoup all principal and accrued interest. Investors accepted pool insurance policies in lieu of special servicing fees. Litigation against the mortgage insurers alleged that unreasonably low pool insurance premiums were illegal kickbacks for the referral of individual mortgage insurance policies.[39]

Third, title companies encouraged builders to establish reinsurance companies. The concept was simple – split the risk of loss and the title insurance premium with the builder's reinsurance company. However, the builders' reinsurance companies assumed little risk and were paid a significant portion of the premium. State regulators, and later HUD, entered into settlements with these title companies and builders.[40]

All of these affinity programs failed because they skirted one of the "golden rules" of affinity relationships. Payments to someone in a position to refer settlement services must be commensurate with the substantive services or goods provided, or the risk absorbed. The difference between the payment (or discount) and the market value of the service or goods is presumed to be a kickback for the referral of settlement service business.

Next: Part 2: Making it Work

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[1] This article discusses portions of Sections 8 and 9 of RESPA, 12 U.S.C. 2607 and 12 U.S.C. 2608, in relation to marketing and other affinity relationships between mortgage brokers, mortgage lenders, title agencies, real estate brokers, other settlement service providers, and other parties involved in residential transactions. This article by no means provides a complete discussion of these statutes, or the various inventions that settlement service providers create to attract business.

This article is presented in two parts. Part 1 discusses the practical implications of Sections 8 and 9 of RESPA, and portions of HUD's Regulation X (24 CFR Part 3500) for settlement service providers. Part 1 will discuss the definition of a kickback, and its exceptions in an academic exercise. You must understand what is prohibited to understand what is allowed. Part 2 will discuss practical considerations for implementation of various marketing and affinity arrangements with regarding to the restrictions and exceptions imposed by these statutes and regulations. In plain English, Part 2 will discuss various methods of establishing affinity relationships that do not violate RESPA. Please note that this article is adapted from a weekly column previously published in RESPANews.com (http://www.respanews.com).

[2] 12 U.S.C. 2607

[3] All of the published settlement agreements between HUD and various settlement service providers are available at HUD's web site. Some settlement agreements are not published at all, and some settlements are simply announced through a press release.

[4] 12 U.S.C. 2607(a)

[5] 12 U.S.C. 2607(b)

[6] 12 U.S.C. 2607(c)

[7] 12 U.S.C. 2607(c)(2) states, "Nothing in this section shall be construed as prohibiting…the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed…"

[8] Providing a true discount to the borrower for a bundle of settlement services has the added advantage of eliminating the restrictions on the "required use" use of an affiliated settlement provider. Section 15(b)(2) of HUD's Regulation X, 24 C.F.R. 3500.15(b)(2) prohibits anyone from requiring the use of an affiliated settlement service provider if the borrower will be required to pay for the service. However, Section 2(b) of HUD's Regulation X, 24 C.F.R. 3500.2(b) states:

> "Required use means a situation in which a person must use a particular provider of a settlement service in order to have access to some distinct service or property, and the person will pay for the settlement service of the particular provider or will pay a charge attributable, in whole or in part, to the settlement service. However, the offering of a package (or combination of settlement services) or the offering of discounts or rebates to consumers for the purchase of multiple settlement services does not constitute a required use. Any package or discount must be optional to the purchaser. The discount must be a true discount below the prices that are otherwise generally available, and must not be made up by higher costs elsewhere in the settlement process."

Hence, a lender can require its borrowers to use an affiliated title agency to obtain the lender's title policy and for the closing of a loan if the title agency offers a package of closing costs that bundles the title insurance premium, closing fee, and recording fees at a significant discount to the cost of these services if priced separately.

[9] 12 CFR 226.2(a)(17) states:

> *Creditor* means: (i) A person (A) who regularly extends consumer credit[3] that is subject to a finance charge or is payable by written agreement in more than 4 installments (not including a downpayment), and (B) to whom the obligation is initially payable, either on the face of the note or contract, or by agreement when there is no note or contract.
> [3] A person regularly extends consumer credit only if it extended credit (other than credit subject to the requirements of §226.32) more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year. If a person did not meet these numerical standards in the preceding calendar year, the numerical standards shall be applied to the current calendar year. A person regularly extends consumer credit if, in any 12-month period, the person originates more than one credit extension that is subject to the requirements of §226.32 or one or more such credit extensions through a mortgage broker.

[10] See 12 C.F.R. 226.3(a) and the Official Staff Commentary to that section of Federal Reserve Board Regulation Z in Supplement I to 12 CFR Part 226 for the definition of business purpose credit.

[11] Section 5 of HUD's Regulation X, 24 C.F.R. 3500.5

[12] 24 C.F.R. 3500.14

[13] 24 C.F.R. 3500.14(d)
[14] 24 C.F.R. 3500.14(e)
[15] Courts of Appeals for Fourth, Seventh, and Eighth Circuits held that a markup of a third party fee without an agreement with the third party is not illegal. See Boulware v. Crossland Mortgage Corp., 291 F.3d 261 (4th Cir. 2002); Echevarria v. Chicago Title & Trust Company, 256 F.3d 623 (7th Cir. 2001); and Haug v. Bank of America, N.A., 317 F.3d 832 (8th Cir. 2003). The Second, Third, and Eleventh Circuits held that identifying a third party in agreement with the markup is not needed to find a violation of Section 8(b) of RESPA. See Kruse v. Wells Fargo Home Mortgage, Inc., 383 F.3d 49 (2d Cir. 2004); Santiago v. GMAC Mortgage Group, Inc., 417 F.3d 384 (3d Cir. 2005); and Sosa v. Chase Manhattan Mortgage Corp., 348 F.3d 979 (11th Cir. 2003). None of these courts has held that an overcharge or an excessive fee for services rendered is prohibited by RESPA.
[16] 24 C.F.R. 3500.14(f)
[17] See endnote 7.
[18] See FTC financial privacy disclosure rules at 16 C.F.R. Part 313, and FTC information security rules at 16 C.F.R. Part 314. Similar rules were promulgated by federal banking regulators for depository institutions, and by states for insurance entities, pursuant to Article V of the Gramm Leach Bliley Act.
[19] See the settlement agreement in Jergess v. TransNation Title Insurance Company, E.D. Mich., S.D. Consolidated Case No.: 00-72124 (February 8, 2006).
[20] 12 U.S.C. 2607(b)
[21] 64 F.R. 10080 (3/1/1999). The 1999-1 Statement of Policy was supplemented by HUD Statement of Policy 2001-1, 66 F.R. 53052 (10/18/2001).
[22] 61 F.R. 49397 (9/19/1996)
[23] Over 100 class action lawsuits were filed against lenders claiming that the yield spread premium paid to brokers violated RESPA. HUD Statement of Policy 1999-1 did not stop the lawsuits since the first Court of Appeals to examine this issue after HUD issued its Statement, Culpepper v. Irwin Mortgage Corp. (Culpepper III), 253 F.3d 1324 (11th Cir. 2001), cert. denied, 122 S. Ct. 930 (2002), interpreted HUD's policy very narrowly. HUD's Statement of Policy 2001-1 (66 F.R. 53052 (10/18/2001))expressly rejected the narrow interpretation in Culpepper III. Courts of Appeals issuing opinions following the 2001 Statement supported HUD's interpretation of Section 8 of RESPA regarding lender paid broker fees and rejected the opinion in Culpepper III. See, e.g., Glover v. Standard Federal Bank, 283 F.3d 953, 963-965 (8th Cir. 2002); Schuetz v. Banc One Mortgage Corp., 292 F.3d 1004, 1007. (9th Cir. 2002); O'Sullivan v. Countrywide Home Loans, Inc., 319 F.3d 732, 738 (5th Cir. 2003).
[24] See Endnote 11.
[25] See Endnote 11.
[26] 66 F.R. 53052 (10/18/2001)
[27] See Kruse v. Wells Fargo Home Mortgage, Inc., 383 F.3d 49 (2d Cir. 2004). See also the discussion in Martinez v. Wells Fargo Bank, N.A., Case No . C-06-03327 RMW (N.D. CA, San Jose Div. 3/30/2007)

[28] 24 C.F.R. 3500.14(g) states, in part:

> (g) Fees, salaries, compensation, or other payments. (1) Section 8 of RESPA permits…
>
> (iii) A payment by a lender to its duly appointed agent or contractor for services actually performed in the origination, processing, or funding of a loan;
> (iv) A payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed;…

[29] See the HUD settlement with Metropolitan Title Company.
[30] A real estate broker that owns a building may rent space to a title agency at market rates since it is not just subletting the space that it rents.
[31] 24 C.F.R. 3500.15
[32] Appendix D to 24 C.F.R. Part 3500
[33] 61 F.R. 29258 (6/7/1996)
[34] 24 C.F.R. 3500.5(b)(7) states:

"(7) Secondary market transactions. A bona fide transfer of a loan obligation in the secondary market is not covered by RESPA and this part, except as set forth in section 6 of RESPA (12 U.S.C. 2605) and Sec. 3500.21. In determining what constitutes a bona fide transfer, HUD will consider the real source of funding and the real interest of the funding lender. Mortgage broker transactions that are table-funded are not secondary market transactions. Neither the creation of a dealer loan or dealer consumer credit contract, nor the first assignment of such loan or contract to a lender, is a secondary market transaction (see Sec. 3500.2.)"

[35] 24 C.F.R. 3500.14(g)(vi)
[36] See, for example, Michigan Office of Financial and Insurance Services Bulletin No. 2001-07-INS. But see Chicago Title Ins. Co. v. Butler, 770 So. 2d 1210, 1214 (Fla. 2000), in which the Court held that statutes prohibiting rebates of commissions paid to insurance agents were an unconstitutional infringement on the public's right to effective bargaining power with those from whom they seek to purchase services.
[37] See the HUD settlements with Coldwell Banker Residential Real Estate, Inc., and with Prudential Locations, LLC.
[38] 12 U.S.C. 2608. See also 24 C.F.R. 3500.16.
[39] Several lawsuits were filed on December 17, 1999 in U.S. District Court for the Southern District of Georgia against Mortgage Guaranty Insurance Company, PMI Mortgage Insurance Company, Republic Mortgage Insurance Company, and United Guaranty Corporation. One of these lawsuits was dismissed on the basis that state laws, not federal laws, regulate insurance activities. Marie Pedraza, et al. v. United Guaranty Corp., et al., No. 99-239, slip op. (S.D. Ga. Aug. 14, 2000). One lawsuit was filed in the Eastern District of Texas, Moore v. Radian Group, Inc. et al., and another in North Carolina. See also the order in Barnes v. Republic Mortgage Insurance Company, Case No. CV199-240 (S.D. GA 2/5/2003) denying class certification. One of these cases lead to litigation between the mortgage insurance company and its professional liability insurance carrier over who would foot the $1.4 million bill for defense of these various lawsuits (the mortgage insurer won). See PMI Mortgage Insurance Company v. American International Specialty Lines Insurance Company, 394 F.3d 761, (9th Cir. 2005).
[40] See, e.g., the settlement between HUD and AHT Reinsurance, Inc.

This article is for general information only and should not be used as a basis for specific action without obtaining further legal advice.

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OPTIONS: FIRST REFUSAL RIGHTS COULD BE THORNY

By Harris Ominsky *

A right of first refusal means that a recipient has the right to meet an outsider's offer when the seller puts the property up for sale. These rights sound simple and on the surface do not seem to be much of a sacrifice by the optionor, but frequently they are the subjects of litigation.

A recent Maryland appellate court decision held that the optionor may be guilty of bad faith when it contracts to sell property to a third party subject to a condition that has the primary purpose of frustrating the optionee's rights. That is particularly true when the added condition to the third-party sale would be of little benefit to the optionor. *Bramble v. Thomas,* 2007 WL 49255 (Md., Jan. 8, 2007).

In that case Bramble, a company mining sand and gravel, had acquired the parcel it was working on for its business. It had also obtained an assignment of a right of first refusal on an adjacent property owned by "Lanes." The right of first refusal gave Bramble the right to acquire the property by matching any offer that Lanes intended to accept. Lanes were required to tender such an offer to Bramble within thirty days, and Bramble was required in the agreement to match both the price and the terms of the intended sale.

A Bramble of Offers

The dispute revolves around an attempted sale by Lanes of the optioned parcel to a local real estate broker named Thomas for $105,000, and a condition in the proposed sale prohibiting mining on the optioned parcel. When Bramble received the proposed agreement, it accepted the price with one major deviation. It excluded the mining restriction.

After that, without responding to Bramble's acceptance, Lanes renegotiated with Thomas to sell the property to Thomas for $120,000. Lanes then tendered this contract to Bramble. Bramble indicated that its earlier acceptance

of a $105,000 offer constituted a binding contract, and that therefore the renegotiated contract was a nullity that did not affect Bramble's rights. Bramble then retendered its acceptance of the first offer for a price of $105,000, this time including the mining restriction. This acceptance was more than thirty days after the original tender of the first Thomas offer, and so was technically not in compliance with the right of refusal.

Lanes then asserted that they could not sell to anyone because of the confusion, and attempted to return a deposit that Thomas had paid them. Thomas countered by suing to nullify the first Bramble acceptance because it did not comply with the use right, and also sought to enforce its other rights against Lanes.

The trial court granted summary judgment for Thomas, holding that Bramble's original acceptance did not comply with the terms of the refusal right, and Bramble then appealed.

In light of the litigation, the right of first refusal, which seems simple on the surface, had become a costly and thorny issue for Bramble. It may not escape the reader that there is a certain Dickensian quality to the name of "Bramble", one of the major characters in the somewhat complex plot that has unfolded here.

Appellate Wisdom

On appeal, the Maryland Appellate Court reversed the lower court and found that the summary judgment was inappropriate because a genuine issue of fact existed. The issue was whether the first Thomas contract was tendered to Bramble in bad faith because of the insertion of a condition that was of no consequence to the parties except to frustrate Bramble's rights under the option. Thomas argued that the restriction against mining was material because the property was worth less with the restriction than without it. Therefore, Bramble would be getting a windfall if it would be able to acquire the property for the $105,000 price without the restriction.

The appellate court, in a well-researched opinion, cited conflicting precedents in various jurisdictions about whether this type of option may be exercised if accepted with variations from the triggering offer where the variations "constitute no substantial departure" from the offer. The court held, however, that whether the omission was material was not necessary to its decision in this case. It stated that there was a genuine issue here of whether the Lanes and Thomas inserted "in bad faith," the no-mining clause as a "poison pill" to discourage Bramble from exercising its right of first refusal. The court characterized the original contract that created the refusal right as a contract, which Lanes had a duty to carry out in "good faith." It held that the optionor "should not be permitted to engage in a subterfuge or devious means to prevent the other party from performing, and then use that as an excuse for failing to keep its own commitment."

The court said that when the case goes to trial, Bramble would have the burden to show that the no-mining condition was inserted in bad faith, and then that burden would shift to Thomas and Lanes to counter that. Bramble had argued that the mining restriction was inserted at the request of Thomas, in order to impede the exercise of the refusal right. Thomas was a real estate broker, knew of Bramble's use of the property, and would have no apparent reason to desire such a restriction on its own rights. Since it seems that the Lanes were selling out all of their property at that location, it is not apparent why they would have any reason to include a restriction on mining. Of course, that restriction might have value, and the Lanes may have been looking to sell that right in the future to Bramble or some other party, which would give them additional income to the $105,000 price for the property.

Frustrating Rights of First Refusal

While options of first refusal seem simple, the *Bramble* case is just one factual situation indicating how thorny they can be. For example, the court cited an earlier case where the option or included the option parcel in a proposed sale of a larger parcel, and then requested that the optionee match the price for the larger parcel.

It also cited a case where the optionors received an offer from a third party to buy their property for $200,000.00, which consisted of a combination of the offerors' home stated to be worth $48,000, with the balance to be paid in cash. When the optionee attempted to exercise its right of first refusal, it matched the $200,000 price but

conditioned the acceptance with an offer to pay $50,000 of that price with any piece of real estate of the seller's choice with a value of up to $50,000. In that case the court held that the optionee had not exercised effectively its right of first refusal because the optionors were acting "in good faith" even though the inclusion of "unique consideration" made it impossible for the optionee to match exactly the terms of the triggering offer.

The casebooks are populated with many versions of offers to sell by optionors, which tend to frustrate or defeat options of first refusal. For example, in a Wyoming case, a court barred the optionor from selling the optioned property as part of a larger sale; and in *Halyak v. A. Frost, Inc.,* the Pennsylvania Superior Court held that a landlord could not defeat the right of a tenant which had been given the right of first refusal to lease other space in the building. In that case, the landlord had offered another tenant a lease for new space, conditioned on the other tenant's obligation to surrender its occupied space. The landlord claimed that the designated space it had demanded in return was a key component to the transaction, because the landlord could lease that surrendered space at a much higher rental. Since the optionee could not possibly surrender the other space he did not occupy, he could not meet that part of the offer. See OMINSKY, REAL ESTATE LORE, PP. 329-331 (AMERICAN BAR ASSOCIATION, 2005).

Some of these issues may be headed off by proper drafting of rights of first refusal. However, for cases where that has not worked, the *Bramble* decision is trying to strike a balance between two clashing concepts. One requires an optionee to "match exactly the terms of a triggering offer (i.e., a lack of materiality of the omitted terms is no defense)." On the other hand, the bad-faith rule prohibits adding "bad faith terms to the triggering offer which are intended to nullify the right of first refusal."

This should prove to be a difficult balance for future courts to implement in dealing with rights of first refusal, particularly because a proper ruling seems to depend on getting into the head of the optionor.

- The American Bar Association has recently published Mr. Ominsky's new book, *Real Estate Lore, Modern Techniques and Everyday Tips for the Practitioner.*

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FRACTIONAL INTEREST DISCOUNT IN ARTWORK

by

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Dallas, Texas

Just in time for Thanksgiving, in the fall of 1993, Judge Whalen handed down the Tax Court Memo decision in *LeFrak* 1(cite) and cemented in the minds of many the idea of discounts in fractional interests in real property. In that case, he determined that the discounts were 20% for a minority interest and 10% for lack of marketability. To be sure, *LeFrak* was not the first case to recognize discounts. Earlier cases included *Propstra* 2(cite) (a 15% discount), *Youle* 3(cite) (a 12.5% discount) and *Pillsbury* 4(cite) (a 15% discount). But LeFrak got 30% - double the previous amounts. More cases would to follow 5(cite) . But could the concept work in personal property? If the reasoning of a recent case is followed, the answer is, in essence, "no."

The *Pillsbury* case cited above discussed the concept. No discount was given, and the Court in that case said that it could not give a discount based on a "bare assertion" where there was no evidence to support the claim. But in the recent case of *Stone v. United States*, No. 3:06-cv-00259, United States District Court for the Northern District of California (May 25, 2007), there was plenty of evidence.

In *Stone*, the decedent, Lois Stone, died on September 1, 1999. On her estate tax return, the executor valued the estate's 50% undivided interest in 19 works of art at $1,420,000, using a 44% fractional interest discount. The IRS took the position that the value should be simply the total value of the artwork, multiplied by the 50% undivided interest, or $2,766,250. The estate paid the tax and sued for a refund.

After going through the usual discussion of the definition of "fair market value," the Court tackled the argument by the IRS that no discount at all was warranted. The Court pointed out that the government's own expert said a 2% discount was warranted, so "no discount" was out of the question.

But the Court likewise found the estate's argument for a 51% discount (7% higher than the position taken on the return) unpersuasive. The Court found very credible the testimony of two experts for the government who laid out a history or art sales, and clearly testified that they were aware of fractional interests in artwork being traded, but that none of these had ever occurred at a discount. Even the estate's appraiser admitted he could find no data on discounts.

The Court reasoned that artwork in not fungible. From that, and the testimony of the experts (and commenting that unlike this case, sales of fractional interests in real estate sales had comparable sales evidence of discounts) the Court concluded, in general, that a hypothetical willing seller of an undivided interest in art would rather sell the whole piece and split the proceeds, then sell a fractional interest at a discount. Such a sale might be by agreement or might be by partition. But, because a partition could be sought, no hypothetical willing seller would accept anything less than full value.

Turning to specifics, after dissecting the testimony of estate's expert asserting a 51% discount, the Court said that "a small discount is appropriate to account for legal fees" (here, legal fees would have been about 1%) and a further discount of 2% for costs of sale should be added. No appraisals would be necessary. "Some discount" would be appropriate for the uncertainties involved in waiting to sell the art. The Court would give no discount for lack of control, lack of marketability, lack of liquidity, the time value of money or other discounts commonly discussed in such cases.

The Court stopped short of making a final determination of the appropriate discount. Instead, it ordered the parties to seek to reach an agreement on valuation. But the tone of the Court's opinion suggests that, if pushed to decide, the Court would "just say no" to big discounts.

1. *Samuel J. LeFrak and Ethel LeFrak v. Commissioner, T.C.* Memo 1993-526 (November 16, 1993)

2. *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982)

3. *Estate of Youle v. Commissioner, T.C.* Memo 1989- 138 (March 30, 1989)

4. *Estate of Eleanor O. Pillsbury, deceased v. Commissioner*, T.C. Memo 1992-425 (July 27, 1992).

5. *Estate of Ellie Williams, deceased v. Commissioner, T.C.* 1998-59 (February 12, 1998)(20% for lack of marketability and 30% for lack of control for a total discount of 44%)*;* *Estate of Alto B. Cervin v. Commissioner, T.C.* Memo 1994-550 (October 31, 1994)(20% discount), *rev'd on other issues*, 111 F.3d 1252 (5 th Cir. 1997); *Estate of Bonnie I. Barge, deceased v. Commissioner, T.C.* Memo 1997-188 (April 23, 1997)(25% discount)

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INHERITED IRA NOT PROTECTED FROM CREDITORS

By

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Federal law provides protection for most qualified plans, including 401(k), pension and profit sharing plans.But protections for Individual Retirement Accounts ("IRAs") are a matter of state law. Most, if not all, states provide that IRAs are exempt. But there is a growing body of case law questioning the exemption of inherited IRAs.

A recent case highlights this growing trend. *In Re: Russell Jarboe d/b/a RJ's Brokerage & Plants* 1(cite) was a case out of the United States Bankruptcy Court for the Southern District of Texas, Houston Division. It interpreted Texas law and, in particular, § 42.0021 of the *Texas Property Code*. In general, subsection (a) of that provision exempted from seizure by creditors those assets, whether vested or not, in "any stock bonus, pension, profit sharing, or similar plan, including a retirement plan for self-employed individuals, and under any annuity or similar contract purchased with assets distributed from that type of plan, and under any retirement annuity or account described in Section 403(b) or Section 408A of the Internal Revenue Code of 1986, and under any Individual Retirement Account or any Individual Retirement Annuity, including a simplified employee pension plan, and under any health savings account described in Section 223 of the Internal Revenue Code of 1986, is exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract or account does not qualify under the applicable provisions of the Internal Revenue Code of 1986."

While Texas law was at issue, many states have similar types of provisions. For example, New York law, in Article 52, § 5205(c)(2), exempts "all trusts, custodial accounts, annuities, insurance contracts, monies, assets or interests established as part of, and any payment from, either any trust or plan, which is qualified as an Individual Retirement Account under Section 408 or Section 408A of the United States Internal Code of 1986, as amended …". Florida law, in Title XV, Chapter 222, Section 222.21(2)(a)(2) exempts any money "maintained in accordance with a plan or governing instrument that has been determined by the Internal Revenue Service to be exempt from taxation under s.401(a), s.403(a), s.403(b), s.408, s.408A, s.409, s.414, s. 457(b), or s.501(a) of the Internal Revenue Code of 1986, as amended …".

In this Texas case, the Court noted that the statutes of the different states, while all having an apparently similar purpose, are different in their wording. And thus, while citing other cases from other jurisdictions, the Court concluded that none of those cases provided anything more than food for thought. In this case, the statute contained trailing language behind the primary operative provision, and referred to plans that are "qualified" under the Internal Revenue Code. The Court asked the question, "What does this mean?" The Court cited cases from other Bankruptcy courts, all of which have opened the door for creditors to seize inherited IRAs. One case was *In re Kirchen.* *2(cite)* The *Kirchen* court listed what it perceived to be the attributes of an IRA, concluding that if an IRA does not satisfy those requirements, it "will not qualify or comply with the Internal Revenue Code."3(cite) Using *Kirchen* as a guide, the Court in the Texas case focused on the following: (a) the IRA could not be rolled over into another IRA (as the original participant or a beneficiary-spouse might be able to do); (b) contributions could not be made to the inherited IRA; (c) most importantly, the owner of an inherited IRA could remove funds from the IRA at any time, for any reason, and without penalty; and (d) the person inheriting the IRA was required either to start taking lifespan-measured withdrawals from the IRA within one year or to take the entire amount within five years, regardless of the beneficiary's age. The one thing the Court conceded that inherited IRAs have in common with other IRAs is tax deferral.

As a result of these key differences, the Court concluded "… that an IRA inherited from someone other than a spouse may not be claimed as exempt …". And, as a result "… an inherited IRA does not 'qualify' under Texas Property Code § 42.0021. The mere fact of temporary tax deferral is insufficient." And, thus, the creditors were allowed to reach the assets inside the inherited IRA.

One of the trends advocated by some recently is that all people should have "inheritance trusts," and that such trusts should be the designated beneficiaries of their parents' and others' wills, life insurance and retirement accounts. Perhaps such a trust, with an IRA-sensitive tax provision, interposed between the decedent-participant and the beneficiary-debtor, could be a possible means to alleviate this growing problem. But, then, whether that will work when what otherwise appeared to be the plain language of a statute did not, is something that should be carefully considered and questioned.

1. 2007 Bankr. LEXIS 1147

2. 344 B.R. 908 (Bankr. E.D. Wisc. 2006)

3. 344 B.R. at 913.

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Proposed Regulations Limiting Estate Tax Deductions for Uncertain Claims Against Decedents and Other Administration Expenses Under §2053

May 2007

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Introduction

The IRS has issued proposed regulations dealing primarily with the deductibility of claims against a decedent's estate that are uncertain in amount at the date of death. The general approach for such contingent or uncertain claims is that a deduction is allowed only as payments are actually made by the estate, but there is an exception for estimated amounts that are ascertainable with reasonable certainty. Unless stated otherwise, all references to regulations in this summary refer to the newly issued proposed regulations.

I. Background.

There have been various cases in the last several years dealing with the deductibility of claims against the estate when the precise amount of the estate's liability is uncertain at the date of death. For example, there may be threatened or pending litigation against the decedent at the date of death. The trend of the recent cases has been to value the claim based on facts known at the date of death and not considering post-death facts including

settlement agreements. There is a split among the circuit courts of appeal on this issue. Aghdami, *Effect of Post-Mortem Facts On Claims Against the Estate,* TR. & EST. 18 (May 2004); Loeb, *Crossed Circuits on Estate Tax Deductibility of Disputed or Contingent Claims*, 12 CALIF. TR. & ESTS. Q. 6 (Summer 2006). The Preamble to the proposed regulations points out that there are two lines of cases dealing with this issue, going back to the 1920s.

The "date of death" line of cases follows Ithaca *Trust v. Commissione*r, 279 U.S. 151 (1929), which held that the estate tax charitable deduction for a charitable remainder interest was determined as of the date of death. These cases generally do not allow courts to consider post-death events (such as settlement agreements) in valuing a claim. However, even the courts that follow this line have recognized some exceptions, such as when a claim is not presented for payment or when a claim is contested, contingent, unenforceable, or becomes unenforceable after the decedent's death. *E.g., Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982) ("The law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims."); *Estate of Van Horne v. Comm'r*, 78 T.C. 728, 734 (1982), *aff'd,* 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984) (dicta that post-death events are relevant in cases where the claims are potential, unmatured, contingent, or contested at the date of death). Several of the recent cases following the *Ithaca Trust* line have even held that the amount actually paid pursuant to a settlement agreement (sometimes for pennies on the dollar) is not even admissible into evidence in the tax proceeding to determine the date of death value of the claim. *Estate of Smith v. Comm'r,* 198 F.3d 515 (5th Cir. 1999), *nonacq*. 2000-19 IRB; *Estate of McMorris v. Comm'r*, 243 F.3d 1254 (10th Cir. 2001); *Estate of O'Neal v. U.S.*, 258 F.3d 1265 (11th Cir. 2001).

The "actual payment" line of cases follows *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929), *cert. denied*, 280 U.S. 603 (1929). Jacobs distinguished the valuation of claims from the determination of the amount of charitable deductions (that were addressed by the Supreme Court in *Ithaca Trust*), stating that "... the claims which Congress intended to be deducted were actual claims, not theoretical ones." Older cases in the First, Second, Fifth, and Eighth Circuits have considered post-death events in valuing uncertain claims. *Estate of Sachs v. Comm'r*, 856 F.2d 1158 (8th Cir. 1988); Comm'r v. Shively's Estate, 276 F.2d 372 (2d Cir. 1960); *Comm'r v. State Street Trust Co*., 128 F.2d 618 (1st Cir. 1942). The Fifth Circuit had held similarly in a per curiam opinion in *Estate of Hagmann v. Comm'r*, 492 F.2d 796 (5th Cir. 1974), but the Fifth Circuit later distinguished the holding in that case based on its specific unusual facts.

The lack of consistency in the lines of cases results in disparate treatment of similarly situated estates, and the IRS determined that a consistent rule is needed. The IRS states that the date of death approach often requires a "re-trial" of the valuation of the claim on the date of death in a tax proceeding even though the underlying claim has been resolved by a settlement or court proceeding. The IRS concludes that the date of death approach is inefficient, expensive (appraisal and litigation costs), often results in a deduction different than the amount actually paid, and forces the taxpayer to take contradictory positions in the tax proceeding and the court proceeding on the underlying claim.

The Preamble states that it reaches this decision in light of (1) its review of court cases, (b) legislative history to §2053, and (c) furtherance of the "effective and fair administration of the tax laws." (The Preamble does not discuss the legislative history that supports its "actual payment" approach.)

The Preamble justifies taking a different position for valuing §2053 deductions (using amounts actually paid) versus the valuation of assets in the gross estate (which is based on the date of death values) based on statutory differences. It observes that §2031(a)

specifically refers to "the value at the time of his death" whereas §2053 does not refer to value at the date of death.

II. General Rules Applicable to All of §2053, §20.2053-1.

A. Applies to All of §2053. Proposed Regulation §20.2053-1 applies to all deductions under §2053, not just claims against the estate.

B. Limit to Amounts Actually Paid (and Not Reimbursed), §20.2053-1(b)(1). A sentence is added to this regulation limiting all deductions under §2053 (including funeral expenses, executor commissions, attorney fees, administration expenses, and mortgages) to "the total amount actually paid." A corollary of this requirement is that no deduction is allowed if the amount "is or could be compensated for by insurance or otherwise." §20.2053-1(b)(5).

C. Court Decree, §20.2053-1(b)(2). The proposed regulations restate the discussion in the current regulations regarding the effects of court decrees. The mere payment of funeral expenses, administration expenses, claims or mortgages is not, by itself, sufficient to assure the deductibility of the amount paid. While a court decree is not required to support a deduction, the proposed regulation adds that a court decree may be relied on if four requirements are met: (a) the expenditures are otherwise deductible under §2053 and its regulations; (b) the expenditures have been paid by the estate or meet the requirements for estimated expenses; (c) the court reviewed the facts relating to the expenditures; and (d) the court's decision is consistent with local law. For example, a decree allowing an executor's commission "in excess of the amount or limit prescribed by statute" may not be relied on.

If the court decree is based on consent of the parties, the consent must be "a bona fide [deleting the following parenthetical in the current regulations—"(and not a mere cloak for a gift)"] recognition of the validity of the claim and [must be] accepted by the court as satisfactory evidence upon the merits." The proposed regulation restates the provision in the existing regulation that "[c]onsent given by all parties having interests adverse to that of the claimant will be presumed to be recognition of the claim's validity."

D. Settlements, §20.2053-1(b)(3). A settlement may be relied on to support the deduction of an amount paid (or meeting the requirements for estimated expenses described below) if five requirements are met: (a) the settlement resolves a bona fide issue in an active and genuine contest; (b) the settlement is the product of arm's length negotiations by parties having adverse interests with respect to the claim; (c) the settlement is within the range of reasonable outcomes under applicable state law governing the issues resolved by the settlement; (d) the settlement is consistent with local law; and (e) the underlying claim is not unenforceable. The "reasonable outcomes" condition is met if the settlement "results in a compromise between the positions of such adverse parties and reflects the parties' assessments of the relative strengths of their respective positions."

Observe, if all family members agree with the validity of a claim by another family member, they may have difficulty establishing the arm's length requirement for settlements. That requirement does not exist for the court decree provision (even a court decree based on consent), so the parties may wish to go through a court proceeding rather than just relying on a settlement agreement.

E. Estimated Amounts, §20.2053-1(b)(4). The current regulation allows the deduction of estimated amounts that are ascertainable with reasonable certainty (as opposed to vague and uncertain estimates) and will be paid, even if the exact amount is unknown. The

proposed regulation adds that the executor has the duty to notify the IRS if the payment is waived or left unpaid, and must pay the resulting additional estate tax (with interest). (Observe: that requirement is in the current regulation dealing with executor commissions, §20.2053-3(b)(1).)

If an amount cannot be ascertained with reasonable certainty, no deduction is allowed until the amount is paid (or presumably when it later becomes ascertainable with reasonable certainty, thus satisfying the "estimated amounts" exception; this is stated explicitly in proposed regulation §20.2053-4(b)(1) regarding potential and unmatured claims.) However, the estate can file a protective claim for refund before the statute of limitations runs on refund claims. The proposed regulation states two requirements for the protective claim for refund: (a) it must identify the outstanding liability or claim that it would have been deductible under §2053(a) had it already been paid; and (b) it must describe the reasons and contingencies delaying the determination of the liability or the actual payment of the claim.

III. Executor Commissions and Attorney Fees, §20.2053-3(b-d).

A. Protective Claims for Refund, §20.2053-3(b)(2-3) & §20.2053-3(c)(1). The proposed regulation adds that a protective claim for refund may be filed if the requirements for deductibility in the current regulation are not satisfied before the statute of limitations for refunds has expired.

B. Omission of Paragraph Regarding Attorney Fees of Beneficiaries; Expenses in Defending Against Claims, §20.2053-3(d)(3). The proposed regulation omits a paragraph in the current regulation that allowed attorneys fees incurred by beneficiaries regarding their respective interests in the estate. A paragraph is substituted regarding expenses incurred in defending the estate against claims. These expenses are deductible even if the estate is not ultimately victorious. Deductible expenses include costs relating to arbitration, mediation, costs and depending claims (even if the claim is unenforceable), and costs in reaching a settlement. However, expenses incurred merely to extend the time of payment or not in good faith are not deductible.

IV. Claims Against the Estate, §20.2053-4. The one short paragraph in the current regulations has been expanded to 5 pages of detailed provisions regarding the deductibility of claims against the estate.

A. General Requirements. Deductible claims are limited to "legitimate and bona fide claims that—

(i) Represent personal obligations of the decedent existing at the time of the decedent's death;

(ii) Are enforceable against the decedent's estate at the time of payment; and

(iii) Are actually paid by the estate in settlement of the claim."

B. Potential and Unmatured Claims; Contested Claims, §20.2053-4(b)(1-2). Unmatured claims that later mature and are paid are deductible. No deduction may be taken on an estate tax return for a potential or unmatured claim or for a contested claim, but the estate can file a protective claim for refund. (For potential and unmatured claims, the regulation restates the protective claim for refund provisions in the "Estimated Amounts" clause of §20.2053-1(b)(4). For "contested claims," the proposed regulation just references §20.2053-1(b)(4) relating to estimated amounts.)

C. Multiple Parties; Reimbursement, §20.2053-4(b)(3). If the claim is asserted against the estate and one or more other parties, only the portion "due from and paid by the estate" may be deducted. The deductible portion must be reduced by any reimbursement received from any other party or the amount the estate could collect from another party or insurer even if the estate declines or fails to attempt to collect (unless the cost of collecting from others "would have outweighed the benefit from those efforts").

D. Claims by Family Members, Related Entities, or Beneficiaries, §20.2053-4(b)(4). There is “a rebuttable presumption that claims by a family member of the decedent, a related entity, or a beneficiary of the decedent's estate or revocable trust are not legitimate and bona fide and therefore are not deductible. Evidence sufficient to rebut the presumption may include evidence that the claim arises from circumstances that would reasonably support a similar claim by unrelated persons or non-beneficiaries." A settlement of such a claim similarly is presumed "not to be deductible absent evidence of the legitimacy and bona fide nature of the client." There is a definition of family members, including the decedent's spouse, grandparents, parents, siblings, and spouses and lineal descendents of grandparents, parents and siblings. [Observe: Spouses of such lineal descendents are not included.] A related entity is an entity in which the decedent, either directly or indirectly, had a beneficial interest at the date of death or in the preceding three years, other than a publicly-traded entity or a closely held entity in which the interests of the decedent and family members is less than 30% (whether voting or nonvoting).

E. Unenforceable Claims, §20.2053-4(b)(5). Claims that are unenforceable prior to death or before they are actually paid are not deductible, even though the estate pays the claim.

F. Claims Founded on a Promise, §20.2053-4(b)(6). The current regulation says that claims founded on a promise or agreement or deductible only if the promise or agreement was "bona fide and in exchange for adequate and full consideration." The proposed regulation also requires that “the promise or agreement must have been made in good faith, and that the price must have been an adequate and full equivalent reducible to money value."

G. Recurring Payments, §20.2053-4(b)(7). If recurring payments on an enforceable non-contingent obligation will likely extend beyond the final determination of the estate tax liability, the estate may deduct the present value of the payments on the date of the decedent's death as an estimated amount (under the exception described in §20.2053-1(b)(4).) §20.2053-4(b)(7)(i). However, if the recurring payments are for a contingent obligation (including one for which there is a reasonable likelihood that full satisfaction of the liability will not be made) or for any other situation not described by the preceding sentence, the deduction is limited to amounts actually paid. §20.2053-4(b)(7)(ii). If a commercial annuity is purchased to satisfy a recurring obligation on an enforceable and certain claim (whether or not contingent), the estate can deduct the sum of (a) the amount paid for the commercial annuity, and (b) any amount actually paid prior to the purchase of the commercial annuity.

Observation: The substantive regulation states the present value limitation only for recurring payments on non-contingent obligations that will likely continue beyond the final determination of the estate tax liability, §20.2053-4(b)(7)(i). All other situations involving recurring payments are governed by §20.2053-4(b)(7)(ii), which allows a deductions for amounts actually paid, and does *not* have the present value limitation. For this purpose, the estate may be able to take a larger deduction if the limiting conditions in subparagraph (i) do not apply. An example in the proposed regulations raises an interesting interpretation issue on this point. Under the example, the estate owes 7 non-contingent annual payments under a divorce decree after the date of death, and one of the annual payments is made before the estate tax return is filed. The example concludes that “[t]he estate may take a deduction for the present value of these payments.” Apparently, that

means that only the present value of the payment made before the filing date is allowed, not the full amount of such payment. (If a contingency applied [such as a provision to cease the payments on the spouse's remarriage or death], apparently the full amount of the payments would be deductible as made, not just the present value of the payments.)

H. Interest on Claims, §20.2053-4(c). The interest accrued up to the date of death and actually paid on a claim is deductible as a claim. (The date of death amount applies even if the estate elects the alternate valuation date for purposes of valuing assets.)

"Post-death accrued interest may be deductible in appropriate circumstances either as an estate tax administration expense under section 2053 or as an income tax deduction."

V. Taxes, §20.2053-6, 20.2053-9, 20.2053-10. The regulations are updated to refer to the deductibility of state estate taxes for decedents dying after 2004 under §2058. The regulations also add a provision clarifying that a deduction is allowed for any post-death adjustments increasing a tax [such as gift or income tax] (and allowing a protective claim for refund to keep the statue of limitations open to make such a claim.) §20.2053-6(g). Similarly, any refund subsequently determined and paid after the date of death must be reported to the IRS and the resulting additional estate tax must be paid (with interest). See §20.2053-6(g)Ex. 2.

VI. Effective Date. The new provisions will apply to decedents dying on or after the adoption of final regulations

VII. Observations.

A. Approach Favors IRS But Seems a Reasonable Approach Except For Different Treatment of Claims and Counterclaims. The IRS has argued for the actual payment approach in the recent litigated cases and in its informal notices. See Field Service Advice 200217022. The actual payment approach generally favors the IRS, preventing estates from arguing for a high date of death value of a claim against the estate despite an actual settlement and payment of a much lower amount. In this respect, the position of the proposed regulation is self-serving in reversing the trend of recent cases that favors the date of death approach. (Of course, the opposite can also occur. For example, much more serious environmental liability facts may become known after the date of death, resulting in a higher deduction under the actual payment approach.) Despite the self-serving result, using an actual payment approach seems to be a reasonable approach for efficient administration of the tax system—except that the system would seem more complicated than ever if there are claims and counterclaims involved. (See paragraph C below.) In light of those complications, perhaps the approach is not sound.

B. Contrast With Valuation of Claim Owned By Estate Against Another Party. The flip side is the valuation of claims owned by the estate (rather than claims against the estate.) Claims owned by the estate are assets of the estate and are governed under the general valuation principles based on date of death values. These two different types of claims will be treated differently in the future.

The issue is even more acute with a claim owned by the estate—because it is not possible to just wait until after the claim has been resolved. The IRS will want to make a determination of the amount of the claim as an asset of the gross estate to determine the amount of the estate tax. This exacerbates the problem of the contradictory positions dilemma, discussed in Paragraph J below, because the executor will have to take a position on the estate tax return as to the value of the claim owned by the estate.

C. Effect of Counterclaims. What if there is a claim against the estate, but the estate makes a counterclaim, or the reverse situation in which the estate has a claim against another party but that party makes a counterclaim against the estate? (This is a very real problem because it is very typical in many, if not most, lawsuits to have counterclaims.) The claim against the estate would be governed by one set of rules (possibly deferring any deduction until the claim is paid, allowing a deduction only for the amount actually paid) and the claim by the estate against the other party would be governed by a different set of rules (deferring the value of the estate's claim presumably would not be delayed until the time of actual payment, and the value of the claim would be based on the date of death value rather than the actual amount of the payment). The goal of the IRS's position in the proposed regulations is largely based on administrative convenience and efficiency, but this very common situation will result in even more complexity in light of the different approaches that will apply to the claim and counterclaim.

D. Attorneys Fees of Beneficiaries. The Preamble did not discuss the reason for deleting the paragraph dealing with attorneys fees paid by beneficiaries of the estate regarding their respective interests in the estate. §20.2053(c)(3). It is not clear whether this signals a change of position by the IRS regarding the deductibility of such attorney fees incurred by estate beneficiaries.

E. Claims of Family Members and Related Parties. Claims by family members or related parties may be deducted only if the estate overcomes the presumption that such claims are not legitimate and bona fide. §20.2053-4(b)(4). This documents the IRS's long term hesitancy to allow a deduction for "trumped up" intra-family claims.

F. Unenforceable Claims. The executor will have to be careful not to pay claims after they have become unenforceable, because such amounts will not be deductible even though actually paid. §20.2053-4(b)(5). (Of course, the payment of unenforceable claims raises fiduciary liability concerns as well.) This may be particularly important with claims by family members, where the executor and family members agree that a valid claim of a family member should be paid by the estate. The parties will need to be careful to pay the claim within the applicable statute of limitations period.

G. Settlements. One of the requirements for relying on settlements to recognize the deductibility of expenses under all of §2053 is that the settlement is based on arm's length negotiations of parties who are adverse to each other. §20.2053-1(b)(3). That may be difficult to establish in a harmonious family situation. The parties may wish to obtain a court decree regarding the claim, because that requirement does not exist in the provision dealing with court decrees. (Even court decrees based on consent do not have a stated arm's length negotiations requirement, but the parties must establish the bona fides of the claims). §20.2053-1(b)(2).

H. Recurring Payments. As discussed in Item IV.G above, the estate may be entitled to a larger deduction if the underlying claim has some contingency or if payments will not likely extend beyond the final determination of the estate tax. In that case, a deduction is allowed only as payments are made, but the full amount of the payments would be deductible, not just the present value of the payments discounted back to the date of death.

I. Protective Claim for Refund; Later Actual Claim for Refund. If there is any uncertainty at all regarding the ultimate amount of a claim against the estate or if a claim is not paid, the executor must be careful to file a protective claim for refund before the statute of limitations runs on refund actions. Once the amount of the uncertainty is resolved, the executor should then file an actual claim for refund to get a refund attributable to the additional administration expense.

J. Contradictory Positions; Practical Dilemma. The Preamble observes that the estate may take contradictory positions in the tax proceeding and the underlying proceeding to determine the amount of the claim against the estate. A practical problem is how to balance estate tax reporting with the defense of the actual litigation. The plaintiff suing the estate may depose the executor the day after the estate tax return is due and subpoena a copy of the return. If the claim against the estate is reported at a high value on the estate tax return (to support a large deduction), the plaintiff will use that as "Plaintiff's Exhibit 1" to argue that even the estate thinks the claim is valid and large. The best approach seems to report the claim against the estate on the Form 706 and list its value as "Undetermined."

The problem is even worse if the estate owns a claim against another party. The executor will have to take a position on the estate tax return as to the value of the asset. Even if the executor lists the value as "uncertain" on the estate tax return, the issue will be addressed in the audit, and it is more likely that the attorney defending the claim will be able to discover the negotiated value than in the case of a claim against the estate, for which a deduction can just be delayed until after the underlying claim is resolved.

K. *Graegin* Loans. The proposed regulations do not seem to impact *Graegin* loans at all. While §20.2053-1(b)(1) limits §2053 deductions to amounts actually paid, §20.2053-1(b)(4) allows the deduction of estimated amounts that are ascertainable with reasonable certainty, with a requirement to contact the IRS if the actual amount that is later paid differs from the estimate. The current and proposed regulations both allow a deduction of estimated amounts of administration expenses that may be ascertained with reasonable certainty and will be paid. Current Reg. §20.2053-1(b)(3); Proposed Reg. §20.2053-1(b)(4).

In *Estate of Graegin v. Comm'r*, T.C. Memo, 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation. The estate borrowed $204,218 from a corporation, 97% of whose stock was owned by the decedent or the decedent's son. The $204,218 unsecured note provided a fixed 15% interest rate for the entire 15 year term and the note provided for a substantial prepayment penalty. Even though the estate could have made some annual payments on the note (because it anticipated receiving dividends on its preferred stock in the corporation of $70,000 per year), the note was structured to require payment of all principal and interest in a single balloon payment at the end of the 15 year term. The 15 year term and the balloon payment were utilized because the decedent's wife had a 15 year life expectancy, and a trust for the wife that would terminate when she died contained liquid funds which could be used to pay off part of the note. The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note. The court observed that it was "disturbed by the fact that the note requires only a single payment of principal and interest", but determined that such a repayment term was not unreasonable given the decedent's post-mortem asset arrangement. The court observed that it was "mindful of the potential for abuse presented by the facts in this case", but found the executor's testimony regarding his intention with respect to repayment of the note credible. ¶88,477 PH Memo TC at 2446-88. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid.

L. Post-Death Interest Expenses. Similarly, the proposed regulations do not appear to impact the deductibility of post-death interest expenses. If the interest expense cannot be estimated with reasonably certainty it would only be deducted as actually paid, particularly in light of the additional sentence added to Reg. §20.2053-1 limiting deductions under §2053 to amounts actually paid unless the estimated amounts provision applies. (The cases have been pretty lenient in allowing an estate tax deduction for post-death interest.)

Various cases have permitted the deduction of post-death interest with respect to loans obtained by an executor for general estate purposes, where the loans were necessary for the administration of the estate. E.g., *Estate of Huntington v. Comm'r.*, 36 B.T.A. 698 (1937); *Estate of Todd v. Comm'r,* 57 T.C. 288 (1971); *Hipp v. U.S.*, 72-1 U.S.T.C. ¶ 12,824 (D. S.C. 1971). However, an interest deduction will not be permitted where the estate administration is unduly prolonged or where the estate could have sold assets other than at distress prices instead of borrowing funds. *See Hibernia Bank v. U.S.*, 75-2 U.S.T.C. ¶13,102 (N.D. Calif. 1975), *aff'd*, 581 F.2d 741 (9th Cir. 1978).

The IRS position is to allow a deduction for post death interest on amounts borrowed to pay estate taxes in order to avoid a "forced sale of assets." Rev. Rul. 84-75, 1984-1 C.B. 193. Some of the cases cited above also involved borrowings to pay estate taxes. The cases have even allowed post-death interest deductions for amount borrowed from family entities to pay estate taxes. *Estate of Thompson v. Comm'r*, T.C. Memo 1998-325; *McKee v. Comm'r*, T.C. Memo. 1996-362; *Estate of Graegin*, T.C. Memo. 1988-477.

ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

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NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Probate and Trust Article

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Erickson Extends §2036 to Using Partnership Funds to Pay Decedent's Estate Taxes

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Estate of Erickson v. Commissioner , T.C. Memo 2007-107 is another §2036 victory for the IRS in a "terrible facts" case. The case is particularly interesting in that the retained enjoyment of the partnership was the use of partnership funds to pay estate taxes (albeit through the purchase of an estate asset and a redemption of part of the estate's interest). However, the case was surrounded with other facts that made readily apparent that the only purpose of the partnership was to try to secure an estate tax discount.

Key Facts

1. The decedent was an Alzheimer's patient in poor health in her 80s when the partnership was created.

2. There was a delay in funding, including scurrying to fund interests in several condos on the decedent's deathbed.

3. The decedent had two daughters, one of whom managed the decedent's affairs under a power of attorney and acted under the power of attorney to create and fund the partnership and (on the decedent's deathbed) to make gifts of partnership interests.

4. The other daughter (who was also a partner) testified that she did not understand anything about the particulars of the partnership except that it saved taxes.

5. The partnership was funded with almost all of the decedent's liquid assets (including $2,000,000 of marketable securities) and interests in several condominiums; the decedent initially acquired an 86% limited partnership interest.

6. There was also a $1.0 million credit shelter trust for the decedent that had been created at her husband's prior death.

7. Two days before the decedent died, the daughter (acting under the power of attorney) scrambled to convey the various interests in condominiums to the partnership and to make gifts to the decedent's grandchildren, reducing the decedent's percentage of the partnership from 86% to 24%.

8. The partnership assets had the same managers of the investment portfolio and the same management company managing the condominiums as before the partnership was created.

9. Post-death, partnership funds were used to pay part of the decedent's estate and gift taxes. The estate sold the decedent’s home to the partnership for $123,500 and the partnership redeemed some of her partnership interests for $104,000. This is the money from the partnership that the estate used to pay part of the estate and gift taxes.

Bona Fide Sale for Full Consideration Exception to §2036

(The court analyzed the section 2036(a)(1) application before addressing whether the bona fide sale exception applied. Instead, I will first summarize the bona fide sale exception discussion.)

The court first gave the obligatory regurgitation of general factors bearing on whether a legitimate and significant nontax reason existed for the partnership. The court listed the following factors: (1) “Standing on both sides of the transaction” (one daughter did everything regarding creation and funding of the partnership); (2) Financial dependence on distributions from the partnership; (3) Commingling of partnership and personal funds; (4) Failure to transfer assets to the partnership; and (5) Just serving as a vehicle to change the form of the investments, a "mere asset container." [That last factor is a throwback to the Tax Court’s “recycling of value” theory of the full consideration requirement before Bongard, but now called the “mere asset container” theory and now applying to the bona fide requirement rather than to the full consideration requirement.]

The court next rejected the estate’s purported non-tax reasons for the partnership. (1) Centralized management – the management of the investment portfolio and condominiums did not change after the assets were contributed to the partnership. (2) Creditor protection – the court’s one sentence response reflects that the court does not at all understand (or refuses to understand) the potential asset protection advantages of a limited partnership: “A creditor who sought funds from the partnership, however, would have a significant asset base from which to recover from the partnership, over $2 million.” [That’s beside the point. The point is that a limited partner’s creditors generally cannot reach inside the partnership and get access to partnership assets.] However, the facts of the case do not reflect any particular creditor concerns. (3) Facilitating gift giving – which the court says is not a significant nontax purpose.

The court emphasized that all facts and circumstances must be reviewed to determine whether the transaction is bona fide. The Court pointed to the following factors, among others, to conclude that the bona fide test is not satisfied:

- **Partnership consisted mainly of passive assets (including marketable securities and rental properties)**
- **Same managers as before the partnership was created.**
- **Making loans to family members of the partnership on favorable terms.**
- **Partnership was planned unilaterally by one daughter.**
- **Same law firm represented all partners in the creation and funding of the partnership.**
- **Delay in funding – the key seemed to be scurrying around on the decedent's death bed to complete the funding (suggesting testamentary motivations).**
- **Financial dependence – $227,000 of partnership assets were used to pay estate taxes; the disposition of cash from the partnership was characterized partly as a purchase of the decedent's residence and partly as a redemption, but the form is not controlling.**

Section 2036(a)(1) Application

The court mentioned many of the same factors as in the bona fide test analysis. It gave the following list of general factors that courts have previously considered in determining whether a decedent impliedly retained the right to possession and enjoyment of transferred assets: "co-mingling of funds, a history of disproportionate distributions, testamentary characteristics of the arrangement, the extent to which the decedent transferred nearly all of his or her assets, the unilateral formation of the partnership, the type of assets transferred, and the personal situation of the decedent."

The court noted the delay in funding the partnership (suggesting a failure to respect formalities of the partnership) and then the scurry to complete the funding of the decedent's and other family members' contributions on the decedent's deathbed: There was "no hurry to alter their relationship to their assets until decedent's death was imminent."

The court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Ericsson (or the estate) could use the assets if needed."

The partnership had little practical effect during the decedent's life and was mainly an alternative method to provide for the decedent's heirs.

The court concluded that no one factor is determinative, but the court must consider all facts and circumstances. The court's summary seems to emphasize its "smell test" problem with the partnership: "The transaction represents decedent's daughters' last-minute efforts to reduce their mother's estate's tax liability while retaining for decedent the ability to use the assets if she needed them."

Key Planning Points from *Erickson*

1. The partnership involves a transfer of all liquid assets from an Alzheimer's patient in her 80s and in poor health by her daughter acting under a power of attorney, with some transfers and gifts being made on her deathbed. Expect the IRS to try to grab the low hanging fruit.

2. This is the first case to focus on the post-mortem use of partnership assets to pay estate tax liabilities. (The Fifth Circuit *Strangi* case addressed post-mortem use of partnership assets to pay estate liabilities, but did not focus on the payment of estate and gift tax liabilities.) Apparently, there were no distributions from the partnership to the decedent during her lifetime, and indeed there was $1 million in a credit shelter trust for her support. This suggests keeping assets outside the partnership to pay for living expenses *and* anticipated post-death expenses, including estate taxes (or at least a substantial part of them). Query whether future cases will similarly focus on the use of partnership assets to pay estate taxes, even when the payment occurs in a sale and redemption transaction.

3. This raises an interesting question—what if the estate had retained enough assets to pay the gift and estate taxes? Would the transfer of substantial assets to the partnership, even on the decedent's deathbed, have avoided the application of §2036 when there was no other evidence of an implied agreement for retained enjoyment of the assets (i.e., because the $1.0 million in the bypass trust was enough to provide all of her living expenses for her life)? The estate could not have satisfied the bona fide sale exception (for the same reasons described above), but arguably there is no retained enjoyment of the partnership assets (express or implied) that would trigger the application of §2036(a)(1).

4. The IRS in prior cases has tried to argue that the partnership's payment of estate taxes could constitute §2036(a)(1) retained enjoyment. For example, the *Estate of Bassler* case (U.S. Tax Court, Docket 003532-02 (filed February 14, 2002)) was tried before Judge Thornton. The decedent contributed about $35 million to the FLP and kept about $6 million for living expenses. The IRS argued that she needed to retain assets to live on AND to pay estate taxes in order to avoid §2036(a)(1). The IRS wanted to introduce into evidence a cash flow summary including estate taxes (which the court did not allow to be introduced into evidence). (The case was settled after trial.) While the IRS has tried to make this argument previously, *Erickson* is the first case that explicitly focused on the payment of estate and gift taxes as the §2036(a)(1) trigger.

5. The question often arises as to how best to pay estate taxes if the estate does not have sufficient liquidity without using partnership assets. In this case, structuring the transaction as a purchase of an estate asset and as the redemption of the estate's interest in the partnership did not avoid the §2036(a)(1) taint. Using a loan, purchase, or redemption would still seem far preferable to merely having the partnership make a large distribution to the decedent's estate to get cash to the estate for paying estate taxes. If possible, it would be preferable for the estate to borrow the needed funds from a third party or from the beneficiaries. Another alternative would be to have third parties (perhaps family members or related entities) purchase limited partnership interests in the FLP from the estate to generate estate liquidity.

6. Management activities for some assets contributed to the partnership should change if centralized management is a nontax purpose of the partnership.

7. This is yet another case mentioning a lack of negotiations, the fact that one partner planned the entire transaction, and that the same law firm represented all parties.

8. This is also another case mentioning disproportionate distributions, but the court particularly focused on the fact that distributions were made only to the decedent (really the decedent's estate).

9. Finally, this is yet another case (reminiscent of *Rosen*) in which the court failed (or refused) to understand the potential asset protection advantages of owning limited partnership interests rather than owning assets directly.

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