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IRS SCRUTINIZES PLAN ROLLOVERS AS BUSINESS STARTUPS

Under ordinary conditions, laid-off employees obtain replacement employment or create their own opportunities through start-up businesses. The sheer number of persons currently seeking employment, coupled with low employer demand and absence of traditional funding for start-ups or any other businesses, has caused many laid-off employees to consider use of qualified retirement plan account balances as a source to fund their own start-up businesses.

Various advisors and franchisors have developed structured programs that assist qualified retirement plan account balance rollovers into newly created plans that are then used to provide working capital for start-up companies. Such programs are commonly known as rollovers to business start-ups ("ROBS"). They have attracted the attention of laid-off employees strapped for cash as well as the IRS, which recently conducted a comprehensive study of ROBS marketing, structuring, and use, resulting in a detailed memorandum that should be reviewed carefully by everyone considering ROBS to fund a start-up venture.

The IRS notes that ROBS are intended to provide funding for the establishment of a business or franchise by applying tax-exempt retirement plan balances to the purchase of capital stock in a newly-formed company, while avoiding plan distributions that would otherwise be subject to income and excise taxes when balances are made available to the employee-plan participant.

The typical ROBS user is an individual seeking to start a personal business who has accumulated tax-deferred investment funds, usually in the form of a defined contribution account created under a prior employer's plan. The user is generally advised by a ROBS promoter or sponsor. Implementation of the ROBS generally proceeds with the following sequential steps:

- The individual establishes a new corporation sponsoring an associated and purportedly qualified retirement plan. At this point, the corporation has no employees, assets or business operations, and may not even have a contribution to capital to create shareholder equity.

- The plan document provides that all participants may invest the entirety of their account balances in employer stock.

- The individual becomes the only employee of the new corporation and the only participant in the plan.

- The individual then executes a rollover or direct trustee-to-trustee transfer of available funds from a prior qualified plan or personal IRA into the newly created plan. These funds might be any assets previously accumulated under the individual's prior employer's qualified plan, or under a conduit IRA which itself was created from such amounts. Because assets have been moved from one tax-exempt account to another, income or excise taxes otherwise applicable to the distribution are avoided.

- The sole plan participant then directs investment of his or her account balance into a purchase of new company stock. The stock is valued to reflect the amount of plan assets that the individual desires to access.

- The individual then uses the transferred funds to purchase a franchise or begin some other form of business enterprise, while income and excise taxes on the distribution from the prior tax-deferred accumulation account are avoided.

- Once the business is established, the plan may be amended to prohibit further investments in company stock, although amendment may be unnecessary since all stock is fully allocated. Consequently, only the original individual benefits from this investment option. Future employees and plan participants will not be entitled to invest in company stock.

- A portion of the proceeds from the stock transaction may be remitted back to the promoter, in the form of a professional fee. This may be either a direct payment from plan to promoter, or an indirect payment, where gross proceeds are transferred to the individual and some amount of his gross wealth is then returned to the promoter.

The IRS examined many commonly offered ROBS programs and found significant disqualifying operational defects in most. For example, required annual reports for some plans were not filed and the business entity created from the ROBS exchange often did not survive or applied the freed-up capital for personal, non-business purchases.

A primary concern related to potential violations of nondiscrimination requirements resulting from the fact that new company employees were not notified of the existence of the plan, did not enter the plan or receive contributions or allocable shares of employer stock. Another concern related to potential violations of prohibited transaction rules. All ROBS arrangements involve an exchange of start-up company stock for cash from the new company plan, and the exchange would be a prohibited transaction unless the stock has adequate value to substantiate the cash payment made by the plan. In many cases, there were no plan assets valuations or valuations that relied upon threadbare appraisals that often consisted of a single sheet of paper, signed by a purported valuation specialist, and were questionable because the valuation simply approximated available funds without a comprehensive valuation of the new venture, its assets, and prospective operations.

The IRS acknowledged that specific facts must be evaluated on a case by case basis to determine whether a particular ROBS transaction complies with established law and guidance. For this reason, individuals considering a ROBS transaction should confer with knowledgeable counsel.

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ONE-SIDED ARBITRATION AGREEMENT

IS "ILLUSORY" AND UNENFORCEABLE

Juan and Claudia Gonzalez ("Gonzalezes") bought a new vehicle from West Suburban Imports ("West Suburban"). The Gonzalezes subsequently filed suit because West Suburban overcharged the Gonzalezes for the new vehicle. In response, West Suburban sought to stay the proceeding pending the arbitration of the Gonzalezes' claim pursuant to an arbitration agreement (the "arbitration agreement") executed during the sale transaction. The Gonzalezes argued that the arbitration agreement was unenforceable because there was no mutual obligation to arbitrate claims and, thus, there was no consideration to support the arbitration agreement. West Suburban argued the arbitration agreement was supported by consideration because it was part of a series of agreements which together constituted the sale transaction.

In finding the arbitration agreement unenforceable, the court noted the pertinent section of the arbitration agreement stated as follows:

> A "dispute" is any controversy or claim (other than: a claim relating to the buyer's failure to pay an agreed upon down payment or failure to pay any amount due pursuant to a promissory note executed in lieu of a cash down payment; as to the issuance, by buyer, of a check which is not honored by the buyer's bank; a buyer's failure to provide good title to a trade-in vehicle; a misrepresentation, by buyer, concerning the amount remaining due on any loan concerning a trade-in vehicle; any claim relating to the possession, repossession or replevin of the vehicle; or relating to actions to enforce any Retail Installment Contract executed by you in connection with the purchase of the vehicle) arising from or relating to the vehicle you have purchased from us on the date shown above.

Thus, "(t)he express language of the arbitration agreement makes clear that it is intended to require (the Gonzalezes) to arbitrate any claims that they could assert against (West Suburban), but it imposes no such reciprocal obligation upon (West Suburban). Illusory promises of this sort are plainly unenforceable because a party has not obligated itself to do anything."

The court also rejected West Suburban's argument that the arbitration agreement was supported by consideration because it was part of the sale transaction because of the arbitration agreement's survival language stated: "(t)his Arbitration agreement shall, with respect to such dispute, survive the termination or expiration of any purchase order and/or bill of sale or any retail installment contract executed at the time the vehicle is purchased." Thus, the arbitration agreement was intended to be a separate agreement which survived the sales transaction. As such, it must be supported by separate consideration in order to be enforceable. Accordingly, since the arbitration agreement failed to impose mutual obligations to submit claims to arbitration, the arbitration agreement lacked consideration and was unenforceable.

All contracts must be supported by consideration. If you have a question about whether a contract, including an arbitration agreement, is enforceable, please telephone a member of the firm.

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WHAT IS THE SCOPE OF A CONTRACT'S INTEGRATION CLAUSE?

Most written contracts include an integration clause, which is a clause that provides that all prior or contemporaneous negotiations merge into the executed contract. An integration clause prevents the imposition of provisions which were previously discussed but not included in the final contract. This clause, however, may not preclude the consideration of all prior or contemporaneous negotiations between the parties, as a recent Illinois case, *Midwest Builder Distributing, Inc. v. Lord and Essex, Inc.*, demonstrates.

Midwest Builder Distributing, Inc. ("Midwest") sought to collect amounts due for building materials supplied to Lord and Essex, Inc. ("Lord"). Midwest obtained a judgment against Lord for the amounts due for the materials, plus attorneys' fees and costs, pursuant to a credit information sheet executed by Lord. Lord appealed, arguing Midwest could not recover its attorneys' fees and costs because subsequent subcontract agreements executed by the parties did not allow for the recovery of the same and contained an integration clause stating all prior and contemporaneous negotiations between the parties merged into the subcontracts.

In finding the subcontract's integration clause did not prevent Midwest from collecting its attorneys' fees and costs, the court stated that a contract is integrated when the parties intend it to be a final and complete expression of the agreements between them. "The effect of integration is to preclude evidence of understandings, not reflected in writing, reached before or at the time of its execution which would vary or modify its terms." Thus, the integration clause in the subcontractor agreements was intended to override any other prior or contemporaneous understandings, including the terms in the credit information sheet.

The court noted, however, that "even if a contract is integrated, the scope of integration does not extend infinitely to any and all dealings that might have occurred between the parties. Evidence of an extrinsic agreement may be admissible if it is . . . a separate and distinct matter . . . capable of existence as an independent legal act." Accordingly, evidence of a prior agreement may be considered if it is not inconsistent with the primary agreement.

The court thus held that Midwest could collect its attorneys' fees and costs, concluding as follows:

> There is no text in the subcontractor agreements that deals with omission of remedies or purports to clash or overlap with the remedies provided under the credit information sheet. Nor is there relevant testimony that would tend to show that the documents were drafted deliberately to avoid mention of them. Hence we find that the subcontractor agreements do not extend to the issue of remedies. The provisions in the credit information sheet for interest, court costs, and attorney fees in the event that Midwest pursues collection by suit are not subsumed by the subcontractor agreements, but are enforceable as consistent terms of an independent agreement . . .

If you have a question about the scope of an integration clause, please telephone a member of the firm.

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SURVIVORSHIP CLAUSE MERITS THOROUGH CONSIDERATION

Some well thought-out estate plans can go awry for failure to pay attention to the consequences of simultaneous deaths of the spouses. Granted, the occurrence of the simultaneous deaths of spouses – where it is impossible to determine which spouse died first – is a remote possibility, but if it happens, the effect on the decedents' intentions with respect to the ultimate distribution of their assets and on estate taxes can be disastrous.

Most states have enacted the Uniform Simultaneous Death Act (the "Act"). The Act provides that if it is not possible to determine which spouse died first, then each spouse will be presumed to have survived the other. Applying this presumption, and assuming a husband with a $8 million estate and wife with a $2 million estate, the estate tax on the husband's taxable estate (ignoring any state death taxes) would be as follows:

Adjusted Gross Estate	$ 8,000,000
Tentative Estate Tax	3,500,800
Less: Estate Tax Credit	(1,455,800)
Estate Tax	$ 2,045,000

If, however, the husband's trust agreement provided that his wife would be presumed to have survived him in the event of their simultaneous deaths, then the husband's estate would be entitled to the marital deduction, illustrated as follows:

	Husband	Wife
Adjusted Gross Estate	$ 8,000,000	$ 2,000,000
Marital Deduction	(4,500,000)	
Taxable Estate	3,500,000	5,500,000
Tentative Estate Tax	1,455,800	2,375,800
Less: Estate Tax Credit	(1,455,800)	(1,455,800)
Estate Tax	$ 0	$ 920,000

Thus, by including a simultaneous death clause that overrides the Act, the estate tax paid by husband and wife would be reduced to $920,000, a substantial savings.

The failure to incorporate the appropriate simultaneous death provision can also have unintended consequences with respect to distribution of assets. In the example, assume husband and wife had presumed that the much younger wife would survive and their primary goal (as set forth in the husband's trust) was to provide income to their children after husband's death and to distribute the bulk of their estate to charities (as set forth in the wife's trust). In the event of their simultaneous deaths, by application of the Act, the children would receive the bulk of their assets directly from the husband. The charities would receive the $2,000,000 from the wife's trust. Thus, their ultimate goal for distribution of their assets would have been thwarted.

Please do not hesitate to contact us if you have any questions regarding the application of the Act, planning around it, or your estate plan in general.

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RECENT COURT OPINION EXPOSES EMPLOYERS OF NOTARIES TO FINANCIAL LIABILITY FOR NEGLIGENT PERFORMANCE OF NOTARY RESPONSIBILITIES

Until December 2008, employers of notaries public believed that under the Illinois Notary Act, an employer of a notary could only be liable for damages if:

(a) the notary public was acting within the scope of the notary's employment at the time the notary engaged in the official misconduct; and
(b) the employer consented to the notary public's official misconduct.

A recent development in the case of *Vancura v. Katris, et al.* illustrated that the generally held belief was untrue. Vancura successfully presented an alternative theory alleging that the employer of a notary should be held liable for damages caused by an improperly notarized document under a theory of negligent supervision. Vancura alleged that Kinko's breached its duty to the public to train, supervise, and control its notary-employees to assure they were authenticating only signatures executed by properly identified persons.

Vancura sued Kinko's, among other defendants, to recover damages he suffered as a result of a forged mortgage assignment which was notarized by Gustavo Albear ("Albear"), a Kinko's employee. On December 20, 1995, two men entered into a Kinko's store with a mortgage assignment which assigned Vancura's $100,000 interest in the subject mortgage to themselves. It was undisputed that the mortgage assignment bore the notary stamp of Albear. Albear testified that the signature on the notary line of the mortgage assignment was not his, but he also testified that he did not store his notary seal in a secure location.

The court ruled there was sufficient evidence to find Kinko's liable for negligence in its training and supervision of Albear as a notary. According to the court, the evidence showed that Kinko's was willfully and consistently ignorant of whether Albear understood what he was supposed to do. The court concluded that a reasonably careful employer would have confirmed that notary training conveyed what a notary needed to know before allowing an employee to begin validating legal documents such as the mortgage assignment at issue in that case. In an interesting twist, however, the court refused to find Kinko's liable under the Illinois Notary Act because there was insufficient evidence that Kinko's consented to Albear's misconduct. This result, no doubt, was little consolation to Kinko's because it remained liable to Vancura due to the court's finding of negligent supervision and training.

An Illinois employer has a duty to its employees and third parties to hire, retain, supervise, train and entrust employees such that the employees do not cause harm to others. An employer of notaries public is thus advised to closely monitor the training and supervision of its notary-employees. If you have any questions about the Illinois Notary Public Act or the obligation of Illinois employees for supervision, please contact a member of the firm.

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GUARANTOR'S SNITCH ABOUT PRINCIPAL

MAY RESULT IN DISCHARGE OF GUARANTOR'S OBLIGATION

When a guarantor becomes aware that the borrower is at risk of defaulting under the loan, the guarantor's natural inclination might be to keep his mouth shut and hope the problem works itself out. However, a recent Illinois case demonstrates just the opposite: it may be better to inform the lender as to the facts and demand that it take immediate action.

Leonard DeFranco ("DeFranco") was one of three guarantors of a line of credit provided in 2001 by JP Morgan Chase Bank ("Lender") to Earth Foods, Inc. ("Borrower"), of which DeFranco was an owner. Prior to Borrower's default under the line of credit, DeFranco sent the Lender a letter in which he warned that Borrower was dissipating its inventory, which was pledged as collateral to Lender. In his letter, DeFranco demanded that the Lender take action.

Borrower defaulted on its obligation to the Lender in February 2004. Lender sent a notice of default to Borrower and to the guarantors, including DeFranco, in April 2004. Soon after, Borrower transferred its assets to a third party, and Lender filed suit against the guarantors in June 2004.

DeFranco took the position that he was entitled to the benefit of Section 1 of the Illinois Sureties Act (the "Act"), which provides in pertinent part:

> When any person is bound, in writing, as surety for another for the payment of money . . . apprehends that his principal is likely to become insolvent . . . if a right of action has accrued on the contract, he may, in writing, require the creditor to sue forthwith upon the same; and unless such creditor, within a reasonable time and with due diligence, commences an action thereon, and prosecutes the same to final judgment and proceeds with the enforcement thereof, the surety shall be discharged . . . .

DeFranco claimed that his guaranty should be discharged based on the Lender's failure to take prompt action to prevent the Borrower from selling off its inventory without using the proceeds to pay down the line of credit due to the Lender. The trial court disagreed, pointing out that DeFranco was a guarantor, not a surety, and therefore not entitled to invoke the Act to discharge his guaranty obligation.

On appeal, DeFranco argued that the distinction between a surety and a guaranty was purely technical. The Lender took the position that the Legislature should have included guarantors in the Act if it intended a guarantor to avail itself of the remedy. The Appellate Court acknowledged there is an academic distinction: a surety is primarily liable for the debt on the same basis as the original obligor, whereas a guarantor becomes liable secondarily, *i.e.*, only after the original obligor does not pay. But, after reviewing the practical implications, the legislative history of the Act, the fact that the distinction is blurred even within the legal community, and the fact that guarantors are a subset of sureties, the Appellate Court held that DeFranco could claim the protection of the Act. In November 2008, the Appellate Court remanded the case to the trial court where the judge will ultimately determine whether the facts of the case will result in a discharge of DeFranco's guaranty.

Representation of borrowers and lenders is a routine part of our practice. If you need advice as to the actions to be taken in anticipation of a default or with respect to a guaranty, please do not hesitate to contact us.

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From Lawyers Jokes, Quotes, and Anecdotes – 2004 – Andrew McMeel Publishing:

When the attorney learned that his colleague of thirty years was dying, he hurried to the hospital. He found his friend struggling through page after page of the Holy Scripture. "Looking for solace, my friend?" he asked compassionately. "Nope," said the dying man replied, "loopholes."

* * *

When you go to court, you are putting your fate into the hands of twelve people who weren't smart enough to get out of jury duty.

- Norm Crosby

* * *

A doctor told his patient that she only had six months to live. The distraught patient asked the doctor what she could possibly do to have more time. The doctor advised, "Marry a lawyer. It will be the longest six months of your life."

* * *

Of course, you can't take it with you, but with taxes, funeral expenses, and lawyers' fees, you can't leave it behind either.

* * *

WIFE: You just don't care anymore!
HUSBAND: You're upset. Let's buy you something to make you feel better.
WIFE: Like what?
HUSBAND: How about a trip to the Orient?
WIFE: No.
HUSBAND: A BMW?
WIFE: No.
HUSBAND: Well, what do you want?
WIFE: A Divorce.
HUSBAND: I wasn't planning on spending that much.

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