

THOMAS W. RIECK
trieck@rieckcrotty.com
JEROME F. CROTTY
jcrotty@rieckcrotty.com
RONALD P. DUPLACK
rduplack@rieckcrotty.com
DOUGLAS C. CONOVER
dconover@rieckcrotty.com
KEVIN P. BROWN
kbrown@rieckcrotty.com
AMY E. COLLINS
acollins@rieckcrotty.com

RIECK AND CROTTY

ATTORNEYS AT LAW

A PROFESSIONAL CORPORATION

55 WEST MONROE STREET, SUITE 3390

CHICAGO, ILLINOIS 60603-5062

CHICAGO'S BUSINESS LAWYERS

TELEPHONE

(312) 726-4646

TELECOPIER

(312) 726-0647

FIRM WEB SITE:

<http://www.rieckcrotty.com>

MARCH/APRIL 2008

A POTPOURRI

IS EQUITY IN A BUSINESS CONSIDERED A MARITAL ASSET

SUBJECT TO DIVISION IN A DIVORCE?

Theresa Joynt, an Illinois resident, filed a petition for dissolution of marriage in 2004. Her husband, Michael, owned shares in Mississippi Value Stihl, Inc. ("MVS"). The shareholding ownership of MVS at that time was as follows:

Michael's father	48%
Michael	33
Michael's sister	<u>19</u>
	<u>100%</u>

MVS was a subchapter S corporation. Michael was president, and a member of the Board of Directors with his sister and father. As president of MVS, Michael received a salary plus biannual bonuses, as compensation for managing the daily operations. His annual compensation was approximately \$250,000. Expert testimony in the divorce proceeding indicated that Michael's compensation during the marriage was reasonable and fair for the services he provided to MVS.

MVS's retained earnings were approximately \$3,800,000 at the time Theresa filed the petition. The retained earnings had increased throughout the years, and dividends had periodically been declared and paid. Those retained earnings were held by MVS for future operating expenses. Michael was not able to receive a dividend unless a prorata dividend was paid to and agreed upon by a majority of the shareholders.

Michael also had a buyout contract with his father. The contract provided that, upon his father's death, Michael would become the majority shareholder of the company by purchasing his father's shares. At that time, as the majority shareholder, Michael would possess the authority to declare and pay dividends from retained earnings without approval from the remaining shareholder, his sister.

Theresa claimed Michael's 33% ownership in MVS entitled him to 33% of the retained earnings, or approximately \$1,275,000, and such earnings constituted marital property, subject to division in their divorce. Michael was only willing to admit that his cost basis in the MVS stock was \$94,000.

Surprisingly, the issue of whether retained earnings should be classified as marital property was one of first impression in Illinois when this case was decided in 2007 by the Illinois Appellate Court. Other states have generally held that retained earnings were non-marital property unless the shareholder-spouse owned a majority of the shares or otherwise had substantial influence over the decision to retain the net earnings or to disburse them in the form of cash dividends.

In this case, the Appellate Court found MVS's stock was owned in unequal percentages by three individuals. Michael possessed only a minority percentage of those shares and was not a controlling shareholder. As only one of three board members, he did not have the authority to unilaterally declare or withhold dividends. Accordingly, the Court held MVS's retained earnings were nonmarital property, and not subject to division in the divorce proceedings.

Please do not hesitate to contact us if you have any questions about how your economic assets would be divided in the event of a divorce based upon the current conduct of your business affairs.

* * * * *

TENANCY BY THE ENTIRETY PROTECTS A COOPERATIVE APARTMENT OCCUPIED AS A MARITAL RESIDENCE

Tenancy by the entirety is essentially a joint tenancy with right of survivorship with the added benefit of protection of the marital residence from the creditor of one spouse. Thus, for example, when the wife has no liability for a particular debt, a judgment creditor of the husband may not levy upon the marital residence if it is held by husband and his spouse as tenants by the entirety. By comparison, a typical joint tenancy with right of survivorship would not bar a creditor from levying upon the husband's interest and severing the joint tenancy, forcing the wife to either redeem the husband's interest to avoid foreclosure or find new accommodations with her portion of the sale proceeds.

The Seventh Circuit Court of Appeals recently upheld a district court decision which interpreted the Illinois tenancy by the entirety law as encompassing shares of a cooperative apartment building. In that case, a married couple owned shares of a cooperative apartment building and occupied that apartment. A creditor of the husband sought to have the shares turned over to the creditor in order to satisfy a judgment against the husband. The creditor argued that the tenancy by the entirety law applies only to real estate and not to shares of a cooperative apartment building which, under Illinois law, are deemed to be personal property. The court held that the Illinois tenancy by the entirety statute did not distinguish between personal property and real property. Thus, because the married couple occupied the apartment as their marital residence, their shares of the cooperative – which were owned by the couple as tenants by the entirety – were protected. Accordingly, the court thus refused to order the husband to turn over the shares of the cooperative to the creditor to satisfy its judgment against the husband.

Please do not hesitate to telephone us if you desire more information about tenancies by the entirety or how to hold title to your marital residence.

* * * * *

AN ORAL PARTNERSHIP AGREEMENT IS ENFORCEABLE

Upon graduating from dental school, Davinder Laroia (“Laroia”) was hired by Paul Reuben (“Reuben”) to work in his dental practice. Laroia was paid \$125 per day upon commencement of his employment. After being employed by Reuben for a few months, Laroia’s salary was increased because Reuben was satisfied with his performance. Further, Reuben also said he planned to make Laroia a partner in the practice.

Several months later, when Reuben failed to take the necessary steps to make Laroia a partner, Laroia advised Reuben that he would be leaving the practice if he was not made a partner. In response, Reuben confirmed he would enter into a partnership agreement with Laroia and stated that Laroia would not be required to make a capital contribution to the partnership that Laroia’s capital contribution would be in the form of services rendered.

Thereafter, the parties opened a joint checking account, over which both parties had signatory power. All receivables were deposited into the joint checking account and the practice obtained malpractice insurance in the names of “Drs. Reuben and Laroia Prtsp.” Laroia was given increased responsibility at the practice, was paid one half of all profits, received with additional benefits, and was referred to by Reuben as “his partner.”

A few years later, Reuben asked Laroia to leave the practice. Laroia brought suit, alleging a partnership existed and that he was entitled to one half of the partnership’s assets. Reuben argued that there was no written agreement and, therefore, a partnership could not exist. Laroia conceded that there was no formal written agreement, but argued an oral partnership existed based upon Reuben’s representations and actions.

Under the Uniform Partnership Act (which is applicable in Illinois), a partnership is defined as an association of two or more persons to carry on as co-owners in a business for profit. In the absence of a written agreement, the existence of a partnership is a question of intent to be inferred from the acts and conduct of the parties. Thus, Illinois courts have held that a written agreement is not necessary for the formation of a partnership.

In determining whether a partnership exists, the courts look at the following facts: (i) the manner in which the parties have dealt with each other; (ii) the mode in which each has, with the knowledge of the other, dealt with persons in a partnership capacity; (iii) whether the alleged partnership has advertised using the firm name; and (iv) whether the alleged partners shared the profits. The burden of proving the existence of a partnership rests on the party asserting a partnership exists.

After reviewing the relevant facts in this case, the court determined that there was substantial evidence the parties intended to form a partnership. Specifically, the court noted the parties’ agreement to split fees and the use of a joint checking account, as well as Reuben’s continued reference to Laroia as his partner.

Of course, a written agreement is always preferable to an oral one. Please do not hesitate to call us if you have any questions regarding preparation of a partnership agreement or any partnership issue.

* * * * *

E-MAILS GENERALLY SATISFY WRITTEN NOTICE REQUIREMENTS

It is not unusual for a contract, such as a lease, real estate purchase agreement, or a distributorship agreement, to contain a provision which provides that any notice required to be given under the agreement must be in writing. There are also numerous statutes which require notice in writing be given in order to comply with the statute. As individuals rely more and more on e-mail communications, the question may arise whether a notice sent by e-mail complies with the written notice requirement of a contract or statute.

The answer to such a question depends on the contract or statute which imposes the written notice requirement. If the contract or statute specifically states that a notice sent electronically will satisfy the written notice requirement, then e-mail notice is satisfactory. The answer is less certain, however, when the contract or statute is silent on the issue of electronic notice. In some circumstances, an individual can rely on the Federal Electronic Signature in Global and National Commerce Act (“Electronic Signature Act”) and/or the Illinois Electronic Commerce Security Act (“Electronic Commerce Act”) to assert a notice sent electronically satisfies the written notice requirement.

The Federal Electronic Signature Act states as follows:

Notwithstanding any statute, regulation, or other rule of law . . ., with respect to any transaction in or affecting interstate or foreign commerce,

- (1) a signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form; and
- (2) a contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.

Excluded from the provisions of the Electronic Signature Act are wills, family law statutes, the Uniform Commercial Code, cancellation notices for utilities and insurance policies, product recall notices and hazardous material warnings.

The Illinois Electronic Commerce Act states “(w)here a rule of law requires information to be ‘written’ or ‘in writing,’ or provide for certain consequences if it is not, an electronic record satisfies that rule of law.” Excluded from the Electronic Commerce Act are wills and certain documents which transfer title.

While the aforementioned statutes authorize the use of electronic communications to satisfy a written notice requirement, any doubt whether a written notice was properly given can be avoided by also providing the notice in writing.

* * * * *

AN IRREVOCABLE TRUST CAN SOMETIMES BE AMENDED

In the last issue of *A Potpourri*, we reviewed several drafting alternatives which would allow an irrevocable trust to be amended. Sometimes, however, it becomes necessary to effect a change in a trust where the authority to modify the trust is not contained in its original terms. In this issue of *A Potpourri*, we will discuss the issue of amendment of existing irrevocable trusts which do not provide for amendment of the trust.

The amendment of an existing irrevocable trust is an extraordinary measure and should be undertaken only where the grantor's original intent cannot be achieved without modification or if the grantor's intent will be thwarted without the modification. In such circumstances, the trust agreement's terms relating to the administration of the trust could be disadvantageous or present problems in dealing with the changed or unanticipated circumstances. However, if all the beneficiaries are competent and agree with the trustee as to a modification of the stated terms of the trust, the beneficiaries cannot later complain about the trust being administered in accordance with the agreed modification.

In the alternative, the trustee, or the beneficiaries, or both, can seek an order from a court of equity that would permit the trustee to deviate from the administrative provisions of the trust. The court will not, however, authorize the trustee to take actions that are merely for the convenience of the trustee, or permit the trustee to alter distributions of income or principal to the beneficiaries or deal with the trust principal in a manner which would favor one beneficiary or class of beneficiaries over another.

Where all the beneficiaries of a trust are competent and request that the dispositive terms of an irrevocable trust be altered, or if the beneficiaries have been engaged in litigation over the terms of the irrevocable trust, the parties can request that the court authorize an agreed compromise with respect to the parties' interests in the terms of the irrevocable trust. A court may also authorize a modification if there was a mistake such that the trust does not include terms that the grantor intended to be included therein.

It may also be possible to effect an amendment of an irrevocable trust by creating a new irrevocable trust with terms that are more consistent with the grantor's original intent or more suitable to the grantor's family's changed circumstances. This strategy could be structured as a sale or a distribution of the assets (such as a life insurance policy) from the existing irrevocable trust to a new irrevocable trust, the terms of which are more consistent with the grantor's intent. Proper planning and research prior to the implementation of such a new irrevocable trust are essential to make certain there are no adverse income or gift tax effects.

While it is preferable that flexibility be incorporated into the original terms of an otherwise irrevocable trust, under certain circumstances, the terms of an irrevocable, non-modifiable trust may be altered. Please do not hesitate to contact us if you have any questions regarding reformation or modification of a irrevocable trust.

* * * * *

SECURITIES SELLERS AND BUYERS SUBJECT TO FIVE YEAR BAR

Nothing lasts forever. This adage applies to claims made under statutory or common law. In the recent case of *Klein v. George G. Kerasotes Corp.*, the Seventh Circuit Court of Appeals described how claims limitations affect sellers and buyers of securities.

The case involved an action by Michael P. Kerasotes, a former shareholder in George P. Kerasotes Corporation (“Corporation”), a closely-held family business. Kerasotes alleged he was forced to sell his shares, the value of his shares was misrepresented, and the price the Corporation paid for his shares was improperly discounted. He argued that, as a seller, his claim was not recognized under the Illinois Securities Law of 1953 (the “Act”) and, consequently, was not subject to the Act’s claims limitations.

Legal claims generally are subject to limitation periods which bar recovery if claims are not asserted within a given time. This encourages prompt assertion and resolution of claims while evidence and parties are still available, and enables parties to conduct business and other activities without the need to forever look over their shoulders. Limitations periods vary depending upon the type of claim and are often subject to extension for “repose” periods intended to cover situations where discovery of a potential claim may be difficult due to concealment of facts or other circumstances.

In April, 1995, Kerasotes received a letter from the Corporation stating that he owned 1,900 shares which the Corporation wanted to buy at \$140 per share for a total of \$266,000. The Corporation as a whole valued itself at \$7,850,000 or approximately \$310 per share for each of the 25,350 outstanding shares. It applied certain discounts to Kerasotes's shares because they were nonvoting and otherwise non-marketable.

On May 23, 1995, Kerasotes signed a Stock Redemption Agreement, believing he had no choice but to accept the Corporation’s offer.

On February 9, 1999, Kerasotes sought to renegotiate the share’s purchase price, believing that he had not received fair value. The Corporation refused, again pointing to an enterprise value of \$7,850,000. However, the actual value of the Corporation in 1998 was \$49 million, more than six times higher than the valuation for the purchase of Kerasotes’ shares.

On August 24, 2003, Kerasotes became aware of the Corporation’s greater fair value.

On August 3, 2005, Kerasotes filed his lawsuit against the Corporation and certain officers and directors.

The defendants argued that because a sale of a security was involved, the Act applied, including its three year limitations period and its repose period, which extended the applicable claims bar to a date five years following the date Kerasotes knew or should have known that he had not received fair value. Kerasotes claimed that the Act did not provide a remedy for sellers and that its limitations and repose periods did not apply, apparently believing that his common law fraud claims were subject to a longer limitations and repose period.

The trial and appellate courts rejected Kersaotes' arguments, concluding that the express language of the Act addressed claims by sellers, as well as buyers, of securities. Consequently, the limitations and repose periods under the Act served to bar Kersaotes' claims. He believed something was amiss by February 9, 1999. Arguably, he should have investigated further at that time and filed a claim within five years thereafter. By waiting until August 3, 2005 to file, he forfeited any possible claim for recovery.

The *Kerasotes* case serves as a reminder that potential claims should be promptly evaluated and asserted, including review of applicable claims limitations and repose periods. A dead-bang winner will become a loser if asserted after the limitation period has expired. Please be sure to consult counsel immediately upon receipt of information that you may have a claim. To quote another adage: there is no profit in delay.

* * * * *

**PREFERENCE PAYMENTS UNDER THE BANKRUPTCY ABUSE
PREVENTION AND CONSUMER PROTECTION ACT OF 2005**

Anyone who has been involved in a bankruptcy is probably familiar with the term "preference payment." A preference payment is a payment made to a creditor within 90 days prior to the filing of a bankruptcy petition by a debtor or within 1 year prior to the filing of the bankruptcy petition if the creditor is deemed to be an "insider" of the debtor, such as an officer or key shareholder of a corporate debtor. A claim of "preference" means the bankruptcy trustee may seek to recover the payment. Such payments are called a preference payment because the creditor would receive more than it would normally be entitled to receive under the United States Bankruptcy Code (the "Code"). The Code however provides certain defenses to the bankruptcy trustee's power to recapture preference payments. One such defense is known as "the ordinary course of business."

Prior to the amendment of the Code by The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Amendment"), to establish an ordinary course of business defense, a creditor was required to prove the payment was received within the ordinary course of its business or the financial affairs of the creditor and debtor (*e.g.*, payments were regularly made between 60-90 days after the date of the billing) *and* that such practice was according to ordinary business terms. Ordinary business terms were established by proof that the payment practice was customary within either the creditor's or debtor's industry.

As a result of the Amendment, a creditor can establish an ordinary course of business defense if the creditor can prove that payment was received *either* within the ordinary course of business or financial affairs of the creditor and debtor, *or* the payment was based upon ordinary business terms. In interpreting the Amendment's ordinary business terms provision, the bankruptcy courts require the creditor to prove the payment was consistent with the customary payment practices of both the debtor's and creditor's industries.

If you have any questions about preference payments, please telephone a member of the firm.

* * * * *

PLANNING FOR THE ILLINOIS DEATH TAX IN 2009

In an effort to reduce or eliminate federal estate taxes, most potentially taxable estate plans provide that the credit shelter trust – frequently referred to as the “family trust” – is funded up to the federal applicable exclusion amount, which is \$2,000,000 in 2008 and increasing to \$3,500,000 in 2009, and provide the balance of the estate is to pass to the surviving spouse outright or in a marital trust. That strategy usually results in no federal estate tax at the time of the first spouse’s death.

For Illinois estate tax purposes, the applicable exclusion amount is frozen at \$2,000,000 for persons dying in 2008 and 2009. Therefore, for Illinois residents who do not own out-of-state property and who die in 2009, the typical estate plan that fully funds the credit shelter trust at \$3,500,000 that reduces federal taxes to zero will incur an Illinois death tax of \$229,200. That is a tax rate of 15.28% on \$ 1,500,000 of assets in the credit shelter trust that are subject to the Illinois death tax.

A strategy to avoid the Illinois death tax would be to limit the size of the family trust to \$2,000,000, but doing so forgoes the use of the deceased spouse’s full federal exclusion amount, thus exposing an additional \$1,500,000 to potential federal estate tax at the surviving spouse’s death. The cost of saving \$229,200 could be as much as \$675,000 ($\$1,500,000 \times 45\%$ federal estate tax rate), if the surviving spouse has a federally taxable estate at the time of his or her death. Hence, it appears to be fiscally prudent to incur the Illinois death tax at the death of the first spouse and preserve the \$1,500,000 balance of the federal exclusion amount for a probably higher federal estate tax rate at the time of the surviving spouse’s death. If this strategy is adopted, most married clients with a federally taxable estate should plan for an additional cash outlay to pay the Illinois death tax at the time of the death of the first spouse to die.

All this may change, as you may be aware, on or before 2010, when amendments in the federal estate tax law are anticipated. In addition, there is legislation currently proposed in Illinois that is intended, like the federal practice, to defer the Illinois death tax until the death of the surviving spouse. If enacted, such legislation could provide additional estate planning opportunities. As estate and business planning is a substantial portion of our firm’s practice, we will continue to monitor changes in the law and new opportunities for tax savings.

The Illinois death tax must be considered in all taxable estates that exceed \$2,000,000. Please do not hesitate to call us if your estate plan should be updated or if you want to discuss the implications of the Illinois death tax. Even if your estate does not exceed \$2,000,000, you should periodically review your wills and trust to be certain they are consistent with your intentions.

* * * * *

From *The Lawyer Joke Book*:

The young attorney finished his summation: “And if it please the court, if I am wrong in this, I have another argument that is equally conclusive.”

* * * * *