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### *A POTPOURRI*

#### **A SLIPSHOD CONTRACT IS NOT NECESSARILY AN AMBIGUOUS CONTRACT**

John M. Floyd & Associates (“Floyd”) is a consulting firm that provides services to banks. Floyd entered into an agreement with Star Financial Bank (“Star”). The agreement proposed four phases of the engagement. In the “analysis” phase, Floyd would analyze current operations at the bank and come up with recommendations and a plan to implement the changes. During the “presentation” phase, Floyd would meet with Star to determine which recommendations Star wanted to pursue. During the third phase, which Floyd's proposal referred to as the “installation” phase, Floyd would coordinate and assist in the installation of approved changes and install monitoring processes to track how the changes were working. In the final “follow-up” phase, Floyd consultants would meet with Star to review the results and fine-tune any implemented changes.

The parties disputed whether Star was obligated to pay for two changes that Floyd recommended. First, Floyd recommended that the bank initiate an overdraft privilege program. Under such a program, instead of returning overdrawn checks unpaid, the bank would honor many of those checks and would charge customers a fee for the privilege of overdrawing their account. Second, Floyd recommended that Star sell its portfolio of credit card accounts to a major national credit card issuer.

Star asked Floyd not to implement either of these ideas. Shortly after Floyd made the “presentation” phase on the overdraft protection, Star engaged another banking consultant which implemented substantially the same type of program that Floyd had offered to implement, but was willing to do it for roughly one fifth of the cost Floyd intended to charge Star. Star also implemented Floyd's recommendation to sell its consumer credit card portfolio, but used a different vendor for that sale.

Floyd's compensation on its proposal to Star was contingent on savings from Floyd's recommendations. The cost to Star was “one-third of the first-year's pre-tax earnings that are the results of [Floyd's] recommendations plus out-of-pocket expenses.” The contract also provided that “[t]he bank will have the final decision as to the installation of recommendations and only approved and installed recommendations will be used to quantify earnings.” The parties agreed that Floyd did not install or follow-up on either of these recommendations because Star engaged another banking consultant.

When Star implemented the types of programs that Floyd had recommended, Floyd sued Star for breach of contract for the contingent fees that Star would have owed if Star had used Floyd for those two changes.

Floyd argued that the contract required that Star pay if Star implemented any recommendation that Floyd made, even if Star hired another entity to implement it or made the changes internally, without the help of a consultant or other contractor. Star argued that the contract only obligated it to pay for changes if Floyd recommended and installed them (or coordinated the installation).

In finding that Star did not breach its contract, the court stated: “To interpret the contract in the way that Floyd asks us to would require that we add terms to the contract that are not contained within the four corners of the document. We are unwilling to do this. The contract does not envision that Star would pay for ideas, but rather for action. In the paragraph entitled ‘Payment,’ Floyd’s proposal states that the bank would ‘have the final decision’ on any recommendation and ‘only approved and installed recommendations’ would be used to quantify earnings. This is clear language that the obligation to pay did not arise after analysis or presentation of recommendations, but only after a change was installed. By the very terms of the contract, installation required that Floyd would ‘coordinate and assist in installation of approved changes [and] design and install monitoring and reporting mechanisms...’ The language here is unambiguous: the obligation to pay could not arise until a change was installed.”

The language of the contract set the measure of the payment at one-third of the benefit of the recommendations that are “accepted and installed.” But installed by whom? Floyd’s request for payment might have been valid if the contract provided that Star would pay for installed recommendations, even if Floyd was not involved in the installation. Consultants sometimes provide in their contracts for reimbursement for their ideas even if somebody else actually installs the recommendation, the theory being that the lion’s share of the work has been done at the point of recommendation.

Floyd argued that it conferred a substantial benefit on Star through its thorough analysis and its persuasive recommendation, and the obligation to pay arose when the recommendation was made. Floyd could have written into the contract that Star would be obligated to pay Floyd for any recommendation that was installed within twenty-four months of their engagement, even if somebody other than Floyd performed the installation. But Floyd did not write that term into the proposal it sent to Star, so it was not part of the contract between the parties.

Floyd also could have written an exclusivity clause into the contract and required that Star refrain from using another banking consultant to implement any change that Floyd recommended for some time period after the engagement. But Floyd did not write that clause into the contract either.

The court concluded: “We have mentioned, in passing, some of the clauses that Floyd could have inserted to protect that compensation interest. But Floyd did not insert any of that language. Failing to bind Star to pay for Floyd’s work earlier in the engagement might have been slipshod contract drafting, but a slipshod contract is not necessarily an ambiguous contract. We are left to enforce the contract as we find it – a contract that left Star free to pick and choose which recommendations to adopt and free to shop for a more competitive quote from other consultants and service providers.”

All contracts must be carefully drafted or carefully reviewed before signing. Please do not hesitate to contact us if you need assistance in either endeavor.

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## HOW TO ASSET-PROTECT AN INHERITED IRA

An inherited IRA, unlike a regular IRA, may not be exempt from creditor attack under the laws of some states. The reason is in the difference between an inherited IRA and a regular IRA: in a regular IRA funds were contributed by the owner; and in an inherited IRA a beneficiary may make no contributions into the account, nor may he or she roll over the inherited individual retirement account into another retirement plan. Illinois law makes no distinction between the protection afforded to a regular IRA and an inherited IRA.

A surviving spouse is almost always advised to roll over an IRA inherited from his or her spouse into his or her own IRA, which is always asset-protected. Further, the spouse follows the normal withdrawal requirements for his or her own IRA. A surviving spouse could retitle an IRA as an inherited IRA as such, but then he or she would be required to take distributions each year just as any other IRA beneficiary would be required to do, and, depending upon the applicable state's law, may also not be able to asset-protect the IRA.

When we speak of an "inherited IRA" we are referring to an IRA inherited by a non-spouse beneficiary. Because it may not be asset-protected, when a non-spouse beneficiary inherits an IRA outright it is subject to the claims of the beneficiary's creditors, or to the claims of a beneficiary's spouse in a divorce, or dissipation as a result of reckless spending by a beneficiary, thereby negating opportunity for tax-free appreciation over the life of the non-spouse beneficiary.

Anyone who owns an IRA and is contemplating leaving the IRA to a non-spouse beneficiary, with the expectation that the non-spouse beneficiary will stretch out required minimum annual distributions over his or her life without depletion as a result of creditor's claims or an award in a divorce proceeding or reckless spending by a beneficiary, should consider leaving the IRA to a IRA stand-alone trust for the benefit of the beneficiary and designated successor beneficiaries in future generations.

In a recent private letter ruling, the IRS sanctioned a specially structured form of trust that is designed to spread out the required minimum distributions over the life of the beneficiary and still retain the benefits of spendthrift protection.

The strategy requires the creation by the owner of the IRA of a revocable trust dedicated solely to be the beneficiary of the IRA. This trust is, at the discretion of the owner of the IRA, either a conduit trust, meaning the trustee will distribute the minimum required distribution annually to the beneficiary, or it is an accumulation trust, meaning income is distributed in the sole discretion of the trustee.

This revocable trust becomes irrevocable upon the death of the grantor. As an irrevocable trust, the principal of the IRA is not subject to the claims of the non-spouse beneficiary's creditors or spouse in the event of a divorce. As such, this inherited IRA is now asset-protected.

IRAs are becoming a more significant asset in most wealth plans. Please do not hesitate to contact us if you have any questions about providing asset protection for non-spouse beneficiaries who may inherit your IRA.

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**THE “COMPETITION PRIVILEGE” IS NOT A DEFENSE TO  
A CLAIM FOR TORTIOUS INTERFERENCE WITH CONTRACT**

Paradama Productions, doing business as AMA Pro Racing (“AMA”), sponsored various professional Supercross racing events. Supercross racing is championship dirt track stadium motorcycle racing. AMA promoted its races through promotional contracts with promoters such as Clear Channel Communications (“Clear Channel”).

Several years before its promotional contract with Clear Channel was set to expire, AMA began negotiating a new contract. While negotiating with Clear Channel, AMA also began discussions with three other promoters, including JamSports and Entertainment, LLC. (“JamSports”). AMA’s negotiations with JamSports progressed to the point that AMA and JamSports signed a letter of intent regarding a contract to promote the AMA-sanctioned supercross race series for a period covering seven seasons. Among other things, the letter of intent provided that AMA would negotiate exclusively with JamSports regarding the promotional contract for a 90 day period.

Thereafter, Clear Channel, which had knowledge of exclusivity provision of the letter of intent, continued to pursue a promotional contract with AMA. During the exclusivity period, Clear Channel proposed the terms of a deal to AMA, sent letters and e-mails to AMA regarding such deal, and initiated meetings and telephone communications with AMA, in an all-out effort to obtain the promotional contract. When Clear Channel was successful in obtaining the contract after the exclusivity period expired, JamSports filed suit alleging tortious interference with prospective economic advantage and tortious interference with contract.

As a defense to both claims, Clear Channel argued that an entity that is competing for prospective business, and is doing so lawfully, cannot be held liable for tortious interference with prospective economic advantage or contract. The so-called “competition privilege” entitles a firm “to divert business from [its] competitors generally as well as from one’s particular competitors provided one’s intent is, at least in part, to further one’s business and is not solely motivated by spite or ill will.”

While the court found that the competition privilege precluded JamSports from pursuing its claim for tortious interference with prospective economic advantage, the court held the competition privilege was not a defense to a claim for tortious interference with contract. In so finding, the court noted that while generally there is nothing wrong with one entity trying to take a client from another, a party can engage in such competitive action only so long as it does not precipitate a breach of contract between the client and the party’s competitor. Thus, since Clear Channel’s activities resulted in AMA breaching the letter of intent with JamSports, Clear Channel had tortiously interfered with JamSports’ contract.

If you have questions about whether a competitor improperly interfered with one of your company’s contracts, please telephone a member of the firm.

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## **TIERED ASSET STRUCTURE GENERATES LARGE ESTATE TAX DISCOUNTS**

A recent Tax Court decision demonstrated – once again – that taxpayers can derive significant benefits by structuring their business assets to compound discounts and reduce estate or gift taxes.

Jane Astleford (“Astleford”) and her husband were successful real estate investors. After her husband died in 1995, Astleford restructured some of her real estate investments and made gifts to her children in 1996 and 1997 of interests in the entity she created. First, in 1996 she created the Astleford Family Limited Partnership (“AFLP”) and contributed real estate to the partnership, then gave each of her children a 30% limited partnership interest in the AFLP, retaining a 10% general partnership interest. In 1997, she transferred substantial real estate holdings to the AFLP, including her 50% interest in an entity called Pine Bend General Partnership (“PBGP”). The effect of the 1997 transfers would have been to increase Astleford’s general partnership interest, but she also gave additional limited partnership interests to her children. The IRS audited the 1996 and 1997 gift tax returns Astleford filed with respect to these gifts, and determined the total value of her gifts was approximately \$11.56 million, whereas Astleford claimed the total gifts were \$4.23 million.

Astleford and the IRS litigated the dispute in the U.S. Tax Court. The Tax Court judge addressed a number of disputed issues. First, Astleford argued that her transfer to the AFLP of the PBGP general partnership interests should be treated as a transfer of an assignee interest (with limited rights) rather than a general partnership interest (with substantial rights), and, as a result, the transfer should have been allowed a 45% discount. The judge held that the form of the transaction should not control the substance, and that Astleford should not receive a discount for that transfer.

While the judge denied the taxpayer’s discount for the claimed difference between the assignee interest and a general partnership interest for PBGP, the judge agreed that two levels of discounts were appropriate under the facts presented. Astleford claimed separate discounts for lack of control and lack of marketability should be applied to the value of the PBGP interest contributed to the AFLP and that the same type of discounts should apply to the limited partnership interests which Astleford gave to her children.

The IRS had a very different view. Its expert took the position that discounts should be applied only to the AFLP interests given to the children, and that the discount should be slightly higher given that the PBGP interest owned by AFLP was not a controlling interest.

The judge agreed with the taxpayer, and concluded that discounts were indeed appropriate for both the PBGP interest as an asset of AFLP and for the gifts of the AFLP interests. The court applied a 30% lack of control discount to the PBGP interest, and combined discounts for lack of control and marketability of approximately 17% and 21%, respectively, for Astleford’s 1996 and 1997 gifts of AFLP interests. The result was that judge determined that the aggregate value of the gifts was approximately \$7.1 million, which was significantly less than the IRS’ claim of \$11.56 million. This result was a huge victory for the taxpayer.

This case, and similar cases over the past few years, provides valuable guidance to taxpayers with respect to structuring business interests to obtain significant gift and estate tax discounts. If you have any questions regarding your estate planning involving business interests, please do not hesitate to contact us.

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## **INDEMNIFICATION PROVISIONS MUST BE CAREFULLY REVIEWED**

### **TO DETERMINE IF THERE IS PROTECTION FOR SIMPLE MISTAKES**

An indemnification provision is a common clause in most contracts. Generally, an indemnification provision provides that the indemnifying party will assume the liability of the second party's actions. Such a provision may resemble the following:

Party A will not be liable to Party B by reason of the actions of Party A in the conduct of the business of Party B except for Party A's gross negligence, fraud or willful misconduct.

In such circumstances, A is only liable to B for gross negligence, fraud or willful misconduct but not for ordinary negligence. Fraud and willful misconduct are intentional acts. A simple mistake, whether intentional or not, could be considered to be ordinary negligence, but gross negligence results only from an unintentional act. The difference between ordinary negligence and gross negligence, therefore, has real consequences in many business relationships. Unfortunately, the distinction between the two is not often clear.

Liability for both ordinary negligence and gross negligence requires a plaintiff to prove the same elements: that the defendant owed the plaintiff a duty; the duty was breached; the breach was the cause of the plaintiff's loss; and plaintiff suffered actual damages. The difference lies in the degree of care taken by the defendant to prevent the loss from occurring. In a case of ordinary negligence, the plaintiff must prove that the defendant did not exercise reasonable care to prevent the injury. Gross negligence, in Illinois, requires the plaintiff to prove that the defendant acted recklessly. Thus, similar acts with identical consequences can have drastically different outcomes with regard to liability.

For example, and with reference to the above indemnification provision, if B contracts with A to install equipment in B's facility and during the installation A severs a power cable causing a significant loss of production and monetary damage to B, the deciding question to determine liability will rest on the reasonableness of A's actions. If severing the cable was a mistake, but one which a person exercising reasonable care would make, there would be no negligence. If severing the cable could have been prevented by A's exercise of the care of a reasonable person, A would be guilty of ordinary negligence, but not liable by operation of the indemnification provision. Finally, if A's action in severing the cable was reckless, i.e., A realized there was a high probability of harm but did not take any precaution to prevent it, he may be liable for gross negligence and, therefore, liable to B under the terms of the indemnification provision.

Liability varies greatly depending upon the circumstances. If you are the indemnifying party in a contract, you will want to be insulated from the consequences of your simple mistakes, your ordinary negligence, so you will want to be certain that your indemnification obligation extends only to "gross" negligence.

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## **REPRESENTATIONS AND WARRANTIES IN BUSINESS AGREEMENTS**

## ARE NOT SYNONYMOUS

Legal documents, such as purchase agreements or plans of reorganization or merger, almost always contain representations and warranties. Lawyers often use the phrase “representations and warranties” interchangeably, almost as a word of art. However, representations and warranties are different words that address different concepts and can produce different legal results.

Representations are statements of present or past fact. For example, “The financial statements fairly present the financial condition of the seller.” Future “facts” cannot generally form the basis of representations because no one can know the future. At best, someone can have an opinion. A warranty is a promise that a statement of fact is true.

If a representation is intentionally false, one may claim deceit (a tort) and allege fraudulent misrepresentation. Elements of such a claim include: (a) knowledge or conscious ignorance of the statement’s falsity; (b) an intent to induce reliance; and (c) justifiable reliance. If one cannot prove another’s knowledge, or if the claimant knew that the statement was false so that reliance on its truthfulness is not justifiable, the claim for fraudulent misrepresentation will fail.

Generally, one injured by a fraudulent misrepresentation has a choice of remedies: (a) rescind the contract and obtain restitutionary recovery; or (b) affirm the contract and sue for damages. The ability to rescind — to unwind a closed transaction — is a remedy not available to one suing for a breach of warranty. In addition, one may be able to obtain punitive damages under special circumstances involving fraudulent misrepresentation.

In the past 15 years, courts have been struggling anew with the meaning and implications of a common law *warranty* — a promise that a statement of fact is true. The seminal case was *CBS Inc. v. Ziff-Davis Publishing Co.*, where Ziff-Davis “represented and warranted” the financial condition of the division it was selling to CBS. CBS, however, as part of its due diligence, sent in its own accountants to review the division’s financial statements. They reported that the financial condition was not as represented and warranted. The parties closed anyway, and then CBS sued.

In New York’s highest court, the issue was whether CBS had a cause of action for breach of warranty. Ziff-Davis argued that CBS did not because it had known about the problems with the financial statements and had not justifiably relied on the warranties. Stated differently, Ziff-Davis argued that the standards for a cause of action for a fraudulent misrepresentation and a breach of warranty both required justifiable reliance on the truthfulness of the statement. Ziff-Davis lost.

According to the New York court, a warranty is a promise of indemnity if a statement of fact is false. A promisee does *not* have to believe that the statement is true. Indeed, the warranty’s purpose is to relieve a promisee from the obligation of determining a fact’s truthfulness. Since the *CBS* case was decided, the majority of states have followed it.

The meaning of *warranty* is critical where a party has made both representations and warranties. A fraudulent misrepresentation claim will fail if a claimant knew that a statement was false; however, in a jurisdiction that follows the *CBS* rule, a claimant may sue for breach of warranty on the same statement and recover, despite knowledge of the falsity of the statement, subject to some limitations. This is a substantial business and legal reason for a party to receive both representations and warranties.

If you have a question about the implications of representations and warranties when reviewing a legal document, please call us.

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### **TOP TEN WAYS TO GET SUED – GUARANTEED**

William Bronchick, CEO of Legalwiz Publications, in recent publication of the Mid-America Association of Real Estate Investors, states as follows:

Over 80 million lawsuits are filed every year in the United States. If you are in business, you should be thinking about the risks involved. The following are some of the most common pitfalls that lead to liability and lawsuits for small business owners . . .

- Pitfall #1      Doing Business as a Sole Proprietor
- Pitfall #2      Doing Business as a General Partnership
- Pitfall #3      Using a Corporation Improperly
- Pitfall #4      Personal Guarantees
- Pitfall #5      Failure to Maintain Adequate Insurance
- Pitfall #6      Sexual Harassment in the Workplace
- Pitfall #7      Using “Independent” Contractors
- Pitfall #8      Failure to “Get it in Writing”
- Pitfall #9      Opening Your Mouth too Wide
- Pitfall #10     Owning All of Your Assets in One Business Entity

Please do not hesitate to contact us if you want to know how to avoid these pitfalls.

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