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Judicial Estoppel in Bankruptcy and the Quandary of the Undisclosed Cause of Action

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Collisions occur at the intersection of bankruptcy law and equity. Recently several courts have tried their hands at traffic control where bankruptcy law intersects with the equitable principle known as "judicial estoppel." The results have been mixed and evidence the tension between the goals of protecting the integrity of the courts and returning value to creditors.

Judicial estoppel has been described as follows:

> "[W]here a party assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his interests have changed, assume a contrary position, especially if it be to the prejudice of the party who has acquiesced in the position formerly taken by him." New Hampshire v. Maine, 532 U.S.742 (2001), quoting from Davis v. Wakelee, 156 U.S. 680, 689 (1895).

The collision occurs most often when a debtor (currently or formerly) in a bankruptcy case pursues a cause of action which he did not disclose as an asset in the bankruptcy case. The defendant typically will challenge the debtor's ability to pursue the action on two grounds: first, that the debtor lacks standing (because a trustee should control the asset); second, that the debtor and his trustee are barred by judicial estoppel from pursuing the case.

The Bankruptcy Code (11 U.S.C. §§ 101, et seq.) imposes several duties upon a debtor. Among these duties is the requirement that the debtor file "a schedule of assets and liabilities." 11 U.S.C. §521(a)(1) Official Form 6B, the required schedule for personal property, includes a line item (item 21) for "[o]ther contingent and unliquidated claims of every nature, including tax refunds, counterclaims of the debtor, and rights to setoff claims" together with a requirement that the debtor "[g]ive the estimated value of each." The debtor is under an affirmative duty to fully

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disclose all claims. Howe v. Richardson, 193 F.3d 60, 61 (1st Cir. 1991).

Irrespective of whether the debtor has fully disclosed his assets, section 541(a) of the Bankruptcy Code says that the filing of the case creates an estate composed of all of the debtor's property "wherever located and by whomever held…." In other words, the bankruptcy estate is not restricted to those assets which the debtor has scheduled but extends to all property, disclosed or undisclosed. The tension between judicial estoppel and bankruptcy arises when a debtor fails to disclose a "claim" on the schedules, but the claim is nonetheless property of the estate and should be available to pay creditors.

Courts generally cite three elements in barring the pursuit of a claim on the basis of judicial estoppel. First, the party against whom estoppel is asserted must have argued a contrary position in a prior case. Second, the court before whom the contrary position was argued must have accepted the position. Third, the assertion of the contrary position either conferred an "unfair advantage" on the party asserting the contrary position, or imposed an "unfair detriment" on the opposition. "ABI Consumer Bankruptcy Committee News", Volume 9, Number 3 (August 2011). These are the three elements traditionally cited, although the Supreme Court has cautioned that the circumstances under which the judicial estoppel may be applied "are probably not reducible to any general formulation." New Hampshire v. Maine, supra at ___, quoting Allen v. Zurich Ins. Co., 667 F.2d 1162, 1166 (4th Cir. 1982).

In the context of a bankruptcy case, the first traditional element ("argument of a contrary position") is satisfied when a debtor pursues a cause of action which he has failed to disclose on his bankruptcy schedules. The second element ("court adoption of the initial position") is typically satisfied when the debtor receives his discharge in bankruptcy, and the assumed fact that a Bankruptcy Court would not grant a discharge to a debtor if it were known that the debtor had filed inaccurate asset schedules. Guay v. Burack, 677 F3d 10, 18 (1st Cir. 2012) The third element ("unfair advantage or detriment") is satisfied by the fact that the debtor is presumed to seek to keep the recovery on the claim for his own benefit and to not share it with his creditors. Moses v. Howard University Hospital, 606 F.3d 789, 799 (D.C. Cir. 2010).

Among recent appellate decisions discussing judicial estoppel in the bankruptcy context are: Guay v. Burack, 677 F3d 10 (1st Cir. 2012); Reed v. City of Arlington, 620 F.3d 477 (5th Cir. 2010); and Love v. Tyson Foods, Inc., 677 F3d 258 (5th Cir. 2012).

The facts of the Guay case are quite intriguing. Kevin and Lorraine Guay filed a chapter 11 bankruptcy case. Several months after the chapter 11 filing, the debtors and their property were subjected to an improper warrantless search by state authorities during an investigation into environmental law violations. Subsequently, the debtors sued the State for damages arising from the warrantless search. About a month after the suit was filed, the debtors' chapter 11 bankruptcy case was converted to a case under chapter 7.

The existence of the suit was no secret. The State knew about the bankruptcy case. The chapter 7 trustee knew about the suit because the State raised it at the creditors' meeting. However, the Guays did not schedule the lawsuit as an asset, even after the court instructed them to amend their schedules. To the contrary, they actually filed an affidavit with the court affirming that their schedules were complete.

Ultimately, the bankruptcy court granted the Guays a discharge. After the entry of the discharge, the State requested that the damages suit be dismissed on two grounds: a) that the debtors lacked standing because the cause of action belonged to the bankruptcy estate and was controlled by the trustee; and, b) that the Guays were judicially estopped from recovery because they had never reflected the claim as an asset in the bankruptcy case. The chapter 7 trustee subsequently abandoned the suit indicating that he had determined that the suit was either burdensome to the estate or of inconsequential value. Nevertheless, the State succeeded in having the case dismissed on the basis of judicial estoppel. The State prevailed and the First Circuit affirmed, finding that: a) the Guays had adopted a contrary position when they failed to schedule the lawsuit in their bankruptcy case; and b) the bankruptcy court accepted the contrary position in when it granted the bankruptcy discharge.

The First Circuit did not require proof that the Guays had gained an unfair advantage over the State. In fact, the State had stipulated that the Guays had not gained an unfair advantage. Rather the First Circuit focused on the need to protect the "integrity of the bankruptcy process…..even where it creates windfall for an undeserving defendant." 677 F.3d at 19. The First Circuit's decision emphasizes the need to preserve the integrity of the bankruptcy process. The opinion says little about the effect of the chapter 7 trustee's abandonment of the claim, and that the abandonment essentially meant that the claim was of no value to the debtors' creditors. The panel dismissed the debtors' argument that the "oral" disclosure of the suit at the creditors' meeting militated against the application of judicial estoppel. It was the State and not the debtors that had initiated the discussion of the suit, noted the panel. Further, "oral" disclosure did not excuse the debtors' failure to be complete when preparing their bankruptcy schedules.

No one doubts that a debtor should be barred from pursing for his own benefit (and not for the benefit of his creditors) a cause of action which the debtor knowingly has failed to disclose on his bankruptcy schedules. The problem cases are those in which creditors stand to benefit from a recovery. Should innocent creditors bear the consequences of the debtor's bad acts?

In Reed v. City of Arlington the Fifth Circuit, in an en banc opinion, appeared to have answered that question:

The question before the en banc court is whether judicial estoppel bars a blameless trustee from pursuing a judgment that the debtor – having concealed the judgment during bankruptcy-is himself estopped from pursuing. We hold that it does not. This result upholds the purpose of judicial estoppel, which in this context is to protect the integrity of the bankruptcy process, by adhering to the tenets of bankruptcy laws and by preserving the assets of the bankruptcy estate for equitable distribution to the estate's innocent creditors.

650 F3d 571, 572. The debtor, a firefighter, won a substantial judgment against the City of Arlington pursuant to the Federal Medical Leave Act. The City appealed the decision to the Fifth Circuit. During the appeal, the firefighter and his wife filed a chapter 7 bankruptcy case. They did not disclose the judgment on their bankruptcy schedules. The debtors received their discharge and the case was closed.

The Fifth Circuit affirmed the judgment but remanded for a recalculation of damages. While the case was on remand, the City became aware of the bankruptcy case and notified the bankruptcy trustee. The trustee moved to reopen the bankruptcy case and to substitute herself as the real party in interest. The City moved to dismiss the case on the grounds that both the debtor and the trustee were judicially estopped from pursuing the claim. The district court fashioned a remedy whereby the debtor was judicially estopped, but the bankruptcy trustee was not and could pursue the claim for the benefit of creditors.

The City appealed to the Fifth Circuit. The panel first hearing the appeal reversed the district court and held that both the debtor and the trustee were estopped. Re-hearing the matter en banc, the Fifth Circuit changed course and affirmed the lower court.

We now affirm the judgment of the district court and state a general rule that, absent unusual circumstances, an innocent trustee can pursue for the benefit of creditors a judgment or cause of action that the debtor fails to disclose in bankruptcy.

650 F.3d at 573.

The law in the Fifth Circuit appeared stable until the Circuit's recent ruling in Love v. Tyson Foods, Inc. The operative facts of the case follow the standard pattern to a great extent. Love was a debtor in a bankruptcy case when he filed a discrimination/retaliation case. He did not disclose the claim in his bankruptcy case. Tyson Foods found out about the bankruptcy case and moved to dismiss the claims against it on the grounds that the debtor was judicially estopped. The district court dismissed the case. The Fifth Circuit panel affirmed.

The feature which distinguishes Love from Reed is that Love was a debtor in a case under chapter 13 of the Bankruptcy Code rather than a debtor in a case under chapter 7. Although there is a "chapter 13 trustee," the trustee does not typically take control of the debtor's assets or the debtor's business. The central function of the chapter 13 trustee is to collect a portion of the debtor's future earnings and distribute it to creditors in accordance with the terms of the debtor's pan. The chapter 13 debtor remains in control of the bankruptcy estate.

Love not only failed to disclose his discrimination/retaliation claim on his schedules, but also did not account for it in his chapter 13 plan. Love was not the "blameless trustee" of the sort protected by the Fifth Circuit's decision in Reed v. City of Arlington. The panel affirmed the lower court's determination that he was judicially estopped from pursuing his claim.

Circuit Judge Haynes issued a spirited dissent. He argues, quite persuasively, that regardless of Love's personal failings, he still has the role of a trustee (in the same sense as the trustee in the Reed case), and that the rationale of Reed should prevail here. Haynes argued that a remedy should be fashioned by which creditors, but not Love, benefit. To do otherwise, argues Haynes, is to do "inequity in the name of equity." 677 F.3d at275, quoting 27A Am.Jur.2d Equity § 84 (2012).

Judicial estoppel is an equitable principle which should, as Judge Haynes notes, be used to effect equitable results. However, it is also accepted that the most important function of judicial estoppel is to preserve the integrity of the judicial process. An appellate court reviews a lower court's application of an equitable principle by determining whether the lower court "abused its discretion." The majority opinion in the Love case states that it does not intend to change existing precedent, but merely to affirm that the lower court did not abuse its discretion in applying the principle. Yet, the opinion can be interpreted differently. One cannot help but be confused when it seems that the traffic signal operated by the appellate court appears to be simultaneously red, yellow and green.

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New York's Expedited Procedure for Collecting on a Note or Default Judgment

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It is common commercial practice to draft a separate promissory note evidencing the debt created in a transaction. New York State offers an attractive expedited procedure for collecting on such a note, and also for domesticating and collecting on a foreign default judgment, that could be of interest to attorneys from other jurisdictions.

In many jurisdictions, collecting on an instrument for money owed, such as a promissory note, can be a lengthy process. In addition to the delays and inefficiencies inherent in all litigation, when a defendant indisputably owes money on an unambiguous note, his only "defense" may be to delay collection in hopes that the creditor will grow frustrated and agree to compromise on the amount owed or, worse, so that he can secrete assets.

Typically, the first step in collecting on a note is to prepare a summons and complaint and attempt to effect service on the defendant, which can be difficult if the defendant chooses to be evasive. After service is effected, the defendant typically has anywhere from 20 to 60 days to respond initially to the complaint. The initial response may be a dilatory tactic, such as a request for more time to respond, or a meritless motion to dismiss that nevertheless delays matters while the court sorts out the issues raised in the motion. And although many jurisdictions, in theory, permit the plaintiff to move for summary judgment at any time, the reality is that many judges are loath to entertain summary judgment motions before the defendant has had an opportunity to conduct discovery, even if his defenses are highly dubious.

New York provides an attractive alternative to this morass. Briefly stated, pursuant to Section 3213 of New York's Civil Practice Law and Rules ("CPLR 3213"), if an action is based upon an "instrument for the payment of money only" or upon a judgment, the plaintiff may commence the action by immediately moving for summary judgment on the instrument or judgment. Thus,

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instead of preparing a formal complaint, the plaintiff files and serves a summons and motion for summary judgment. The defendant then is required to submit opposition to the motion as his initial response. The judges who sit in New York's commercial parts are familiar with this procedure, and generally will not permit a defendant to delay judgment by raising spurious defenses in opposition. Furthermore, even if the court does deny the motion, the moving and answering papers generally are treated as the complaint and answer, so the case can proceed as an ordinary action even if the motion fails.

This procedure can be particularly useful if you wish to domesticate a default judgment against a debtor that has a bank account or other attachable assets in New York, as many commercial firms do. Saving time in those circumstances can be the difference between collecting on a judgment, and having a defendant who has rendered himself judgment proof.

If you will be suing on an instrument, the question of whether the action is based upon an instrument for the payment of money only is crucial. The plaintiff must be able to establish the elements of its case by proving only, first, the existence of the instrument and, second, the amount of money owed. If anything needs to be proved beyond the existence of the instrument and a failure to make the payments called for by its terms, the procedure might lead into objections and detours about the propriety of invoking CPLR 3213, and end up creating delay instead of expediting recovery. The rule thus should be used only in clear cut cases. There is much case law debating what qualifies as an instrument for the payment of money only, but courts generally agree that the two quintessential examples are promissory notes and dishonored checks.

Happily, it is possible to structure transactions to maximize the availability of this procedure. In an acquisition, for example, an instrument for deferred purchase price can be drafted to be uncluttered with reference to extraneous documents or other factors. Indeed, an express statement might be added to the effect that the instrument is one for the payment of money only within the meaning of CPLR 3213. And New York is very liberal in enforcing a forum selection clause in commercial contracts, so a provision can be inserted into the instrument, and the other transactional documents, choosing New York law and submitting to jurisdiction in appropriate New York courts, to ensure that the expedited procedure is available.

If you would like an assessment about whether the facts of your case might be amenable to invoking CPLR 3213, contact Jack A. Gordon of this firm's litigation department. If you would like advice in structuring a transaction to maximize the potential availability of CPLR 3213, contact Harry C. Beatty of our corporate department.

For more information about Kent, Beatty & Gordon, LLP, please visit kbg-law.com.

The Contractors' Friend (The Federal Miller Act)

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While you can't lien a federal construction job, you may still be able to recover your claim by pursuing a payment bond claim. If you furnish labor or materials for a construction project owned by the federal government, federal law prevents you from filing a mechanics' lien against the jobsite property. However, generally speaking, most federal construction projects must be covered by a payment bond furnished by the prime contractor, and you may instead be able to assert a claim against that payment bond.

The Federal Miller Act governs claims against payment bonds issued in connection with federal construction projects. A payment bond is issued by a surety company, which undertakes to pay the claims of qualifying parties who furnish labor or materials to the federal construction job, subject to the provisions of the Miller Act, and the terms and conditions of the payment bond itself.
Under the Miller Act, there are two classes of claimants who are eligible to assert a claim against the payment bond: (1) those who furnish labor or materials to the prime contractor for the project, and (2) those who furnish labor or materials to a first-tier subcontractor for the project (that is, to a subcontractor who has a contract with the prime contractor). A party who furnishes labor or materials to a second-tier or lower subcontractor is *not* eligible to assert a claim against the payment bond. Neither is a party who furnishes materials to another material supplier.

If your contract is directly with the prime contractor, you are not required to furnish any written notices that you are asserting a claim against the payment bond. **You need only file suit to enforce your payment bond claim within one year of the last date that you furnished labor or materials** for the job for which a balance remains due. In practice, however, it is generally advisable to obtain a copy of the payment bond and give written notice of nonpayment and written notice of your payment bond claim to the owner, the prime contractor, and the surety company well before the one-year suit deadline. This may get you paid without the need to file suit to enforce your bond claim.

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The Contractors' Friend (The Federal Miller Act)

However, if your contract is with a first-tier subcontractor, then there are further requirements, *in addition* to filing suit within one year. In this circumstance you must also furnish (1) a written notice of nonpayment and (2) a written notice of your payment bond claim to the prime contractor <u>within 90 days of the last date that you furnished labor or materials to the job</u> for which a balance remains due. This notice must be actually received by the prime contractor by this deadline, not just mailed by the deadline. The notices must be sent by registered mail with a return receipt requested. Although not required by the Federal Miller Act, the notice should also be furnished within the same time frame to the owner, the surety company, and the claimant's customer on the job (the first-tier subcontractor).

In some cases, it is difficult to determine the last date a claimant furnished labor or materials for the federal construction job. The court cases decided under the Federal Miller Act, however, do provide some guidance on the issue. For example, the courts have made it clear that the 90-day notice deadline and the one-year suit filing deadline begin to run when the last of the services were furnished or the last of the materials were provided as part of the original contract, and these deadlines do not restart if you subsequently furnish labor or materials to correct defects or make repairs on items previously furnished for the federal job. These deadlines also do not restart if you furnish punch list or warranty work or materials for the job.

The Miller Act requires that a lawsuit to enforce a payment bond claim must be brought in the federal district court for the district in which the job is located.

Not all federal jobs are bonded. The general requirement is that federal jobs in excess of $150,000.00 are to be bonded. However, the Miller Act specifically exempts certain jobs, including, for example, certain Army, Navy, Air Force and transportation jobs. Thus, it is crucial for potential bond claimants to find out whether any federal job that they are subcontracting for is (a) covered by a payment bond, and (b) that they would qualify as a party able to claim against the bond

There are many complex and technical issues that can arise under the Federal Miller Act. **Anyone contemplating reliance on such a bond, or estimating the risk posed by entering into a contract as a subcontractor on a federal job is strongly advised to consult with an attorney with a record of enforcing such claims before committing**. The key is to find out at the inception of the job if the prime contractor furnished a payment bond for the job and whether you are eligible to assert a claim against it.

If you want to enhance your protection and ability to recover against a distressed contractor, a Miller Act claim is an excellent remedy that gives eligible bond claimants a statutory right to a copy of the bond. Then, the key is to ensure that you are positioned such that you have available the information and documentation necessary to timely satisfy applicable notice and suit filing deadlines, which trip up many who would otherwise have been able to pursue a bond claim. **Taking these steps from the outset will *significantly* enhance your prospects for getting paid on a federal job.**

About David M. Henry

David M. Henry, an AV-Rated attorney with Kohner, Mann & Kailas, S.C., has more than 20 years of experience resolving construction and commercial bankruptcy issues for commercial creditors, primarily in the construction industry. He files construction liens and enforces construction lien and payment bond claims throughout the United States. David has collected millions of dollars for clients by perfecting and enforcing construction lien and payment bond claims on hundreds of construction projects throughout the United States. David is a panelist for the upcoming 2012 Association of Corporate Counsel Annual Meeting program entitled "*Optimize Lien and Bond Process and Case Management to Boost Company Revenue*." He can be reached at dhenry@kmksc.com, or at (414) 962-5110.

About Kohner, Mann & Kailas, S.C.

Founded in 1937, Kohner, Mann & Kailas, S.C. (KMKSC) is a business and commercial law firm listed in Martindale-Hubbell's Bar Register of Preeminent Lawyers and recognized as a 2012 "Go-To Law Firm for Litigation" by ALM, the publisher of *The American Lawyer, The National Law Journal and Corporate Counsel* magazine. KMKSC provides quality legal expertise across the areas of law encountered by businesses in the course of their operations and growth. Our services range from high-profile appellate representation and international business issues to ensuring that critical everyday needs, such as debt recovery, are fulfilled efficiently and expertly. Our purpose is to deliver excellent results for our clients, whether the issue is advice on the avoidance of legal disputes, closing a transaction, protecting assets or winning in court. KMKSC is continually advancing the interests of our clients in negotiations, transactions, litigation and alternative dispute forums across North American and beyond.

What The Bankruptcy Court Taketh Away, The Bankruptcy Court Giveth Back: *Four Recent Rulings That Dramatically Impacted Mechanic's Lien Laws In North Carolina*

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Population Boom Leads To Construction Boom

North Carolina has experienced unprecedented population growth in the last twenty years as a result of multiple converging economic and social factors. This once sleepy agrarian state has become a powerhouse of finance, a global center for high-tech research and development, and a retirement mecca. That population explosion has taxed the state's infrastructure systems, local governments, public school systems and housing supply. Despite the ongoing effects of the Great Recession, North Carolina's construction boom continues, albeit at a slower pace. Many out of state contractors, suppliers and subcontractors lined up to tap into the construction backlog that North Carolina based contractors and suppliers could not handle quickly enough to satisfy the state's growing needs. Some of these early out of state companies got a quick and expensive lesson in what North Carolina based contractors and suppliers already knew: North Carolina has some of the strongest and most complicated lien laws in the country.

Constitutional Mandate

The teeth of North Carolina lien laws are found in the mandate contained in Article X Section 3 of the North Carolina Constitution, which specifically requires the General Assembly to make adequate provisions for a lien to protect the rights of those that provide labor and materials for the improvement of the lands of another. North Carolina's early founders recognized that this state would be built on the backs of the everyday laborers who would be subjected to hardship if not protected from unscrupulous land owners, who wielded the power to withhold monies owed. Under Chapter 44A of the North Carolina General Statutes, many of these original protections are still in place. Among them is the ability of a contractor or materialman to claim a lien on the improved real property that relates back in time to their first date of furnishing of labor or materials to the project. *N.C. Gen. Stat. § 44A-10*. Subcontractors and suppliers can also subrogate to the rights of the contractor having a direct contractual relationship with the owner of the real property they are improving with their provision of materials and/or labor through the notice of claim of lien on funds provisions contained within N.C.G.S. § 44A-19-23 ("the Relation-Back Doctrine"). The Relation Back Doctrine is a very powerful right because North Carolina is a "pure race" jurisdiction. That means the first to record an interest at the courthouse is the first in priority. A liening contractor, subcontractor or supplier may, under certain circumstances claim a lien superior to the owner of the real property and/or those of any financing institutions with a deed of trust recorded against the real property for the purposes of securing a loan, if the lien claimant's first date of furnishing predates the filing date of the deed of trust. Therefore, the Relation Back Doctrine can be problematic for title insurance companies, owners and lenders.

Doctrine Translates To Power In Nc's Bankruptcy Courts

Most North Carolina construction lawyers, contractors, subcontractors and suppliers operated under the belief that providing labor and/or materials for the improvement of the real property within the definition of Chapter 44A of the North Carolina General Statutes provided them with inchoate lien rights that arose upon the first date of furnishing of labor or materials. *N.C. Gen. Stat. § 44A-10*. These inchoate lien rights may be perfected post-petition as an exception to the automatic stay under 11 U.S.C. § 362(b)(3). See *Equitable Life Assurance Soc. v. Basnight*, 234 N.C. 347 (1951). These liens would be given "super priority" to all other interests in the funds *N.C. Gen. Stat. § 44A-22*. It was commonly accepted in the Bankruptcy Courts of North Carolina that a claimant's lien rights could be exercised prior to or after the filing of bankruptcy, providing the lien right was exercised within the statutorily prescribed time limits of N.C. Gen. Stat. § 44A-12.

Rulings In The Eastern District Of North Carolina Send Tremors Through The Nc Construction Community

The troubles for North Carolina's lien claimants began with the filing of the two now infamous cases, *In re Harrelson Utilities, Inc.* No. 09-028158 (E.D.N.C. Bankr. July 30, 2009), and *In re Mammoth Grading, Inc.*, No. 09-01286-8 (E.D.N.C. Bankr. Aug. 24, 2009). Both companies were seeking voluntary Chapter 11 bankruptcy protection.

Ferguson Enterprises Inc. of Virginia ("Ferguson") was an unpaid subcontractor on numerous real estate development projects throughout North Carolina for which Mammoth Grading, Inc. ("Mammoth") and Harrelson Utilities, Inc. ("Harrelson"), were acting as general contractors or first tier subcontractors. After the filing of Mammoth's and Harrelson's bankruptcy petitions, Ferguson filed multiple notices of claims of lien on funds due Harrelson and Mammoth and multiple claims of lien by way of subrogation to Mammoth and Harrelson's lien rights on the various construction projects.

The Adverse Ruling

In each case, the Bankruptcy Court for the Eastern District of North Carolina held that the post-petition filing and service of claims of liens and notices of claims of liens filed by Ferguson and various other subcontractors and suppliers to Mammoth and Harrelson violated the automatic stay imposed by *11 U.S.C. § 362*. The Bankruptcy Court's rulings in *Mammoth* and *Harrelson* held that a subcontractor's lien rights do not constitute "an interest in property" within the meaning of Bankruptcy Code section 362(b) (3) which excepts from the automatic stay imposed by § 362 (a) (4) acts to perfect a "preexisting interest in property" and that post-petition claims of liens and notices of claims of liens are invalid and unenforceable. As you can imagine, these rulings were simultaneously celebrated and reviled by the various factions impacted by them. Ferguson, along with four other subcontractors, appealed the Bankruptcy Court's orders in both cases to the United States District Court. On August 26, 2010, the United States District Court consolidated the *Harrelson* and *Mammoth* appeals.

The Mammoth And Harrelson Appeals

On July 29, 2011, Mammoth filed with the Bankruptcy Court a motion to abandon to Ferguson the bankruptcy estate's claim to funds on deposit with the Clerk of Superior Court of Wake County, North Carolina for one particular project. As it turned out, this would serve to resolve the one remaining lien claim in both cases. On September 12, 2011, the United States District Court stayed Ferguson's appeal pending the Bankruptcy Court's decision on Mammoth's abandonment motion. The Bankruptcy Court allowed Mammoth's motion to abandon and ordered that the funds held by the Wake County Clerk be abandoned to Ferguson and be credited against Ferguson's claim in the bankruptcy estate. Mammoth then moved to dismiss Ferguson's appeal. In its Motion to Dismiss, the Trustee for Mammoth argued that the abandonment of these funds on deposit with the Wake County Clerk, which represented the remaining amount in controversy on appeal, rendered Ferguson's appeal moot.

Cracks In The Armor

On February 23, 2012, United States District Judge for the Eastern District of North Carolina Malcolm J. Howard issued an order granting Mammoth's Motion to Dismiss Ferguson's appeal. In the words of Judge Howard, the Bankruptcy Court's rulings "have turned the construction industry's standard operating procedure on its head." Judge Howard's order went on to analyze the *Mammoth* rulings and questioned if the Bankruptcy Court's rulings prohibiting the filing of notices of claim of lien and claims of lien post-petition were in accordance with North Carolina statutory lien law and the further constitutional protections afforded laborers and materialmen by the North Carolina Constitution. Judge Howard went on to express particular concern that the Bankruptcy Court may have erred in determining that a lien under Chapter 44A, Article 2 Part 2 of the North Carolina General Statutes does not arise until the filing of a notice of claim of lien by the subcontractor. However, Judge Howard was bound by law to dismiss Ferguson's appeal as being moot. Before doing so, he cited several examples where the District Court could issue a ruling on the appealed issue, if the dismissal of the appeal would prevent an adverse ruling from being heard on the merits by a set of circumstances such as an appeal being rendered moot.

For the reasons cited above and to resolve the inadequacies of the Bankruptcy Court's ruling in *Mammoth*, Judge Howard vacated the *Mammoth* rulings and remanded the case to the Bankruptcy Court for further proceedings. By vacating the *Mammoth* decision, Judge Howard essentially overturned it, which meant *Mammoth* was no longer binding precedent.

A Small Victory Paves The Way

Even with the rulings from Judge Howard in the *Mammoth* appeal, the rulings from *Harrelson*, holding that the filing of post-petition claim of lien or notice of claims of lien constituted a violation of the automatic stay, remained the law of the land, at least for the Eastern District of North Carolina. The bright side of this small victory was that the *Harrelson* rulings had never been adopted by the Middle or Western Districts of North Carolina and there was now a substantial crack in the reasoning behind the rulings in *Harrelson* and later *Mammoth*.

The Latest Ruling: Construction Supervision Services, Inc.

The most recent Bankruptcy Court ruling to impact the rights of lien claimants came from the Honorable Randy D. Doub presiding over *In Re Construction Supervision Services, Inc.*, (E.D.N.C. Bankr. March 14, 2012) ("CSSI"). CSSI, like the facts of *Mammoth* and *Harrelson*, involved a general contractor/subcontractor seeking Chapter 11 bankruptcy protection from its creditors. Many of CSSI's creditors were material suppliers and subcontractors that prior to *Mammoth* and

Harrelson would have been able to protect their rights to payment with the filing of post-petition claims of lien and claims of lien on funds under Chapter 44A of the North Carolina General Statutes. Several of these creditor suppliers filed emergency motions for relief from stay seeking the Bankruptcy Court's permission to file and serve liens on funds in the hands of CSSI. The movants believed that CSSI was attempting to use money that would have normally been used to pay secured subcontractor/supplier priority lien claims to fund a portion of its reorganization plan.

Judge Doub ruled that based on the instructive guidance from the United States District Court in its order resolving the *Mammoth* appeal and based on his own detailed analysis of North Carolina lien law and the Bankruptcy Code:

- subcontractors and suppliers have the right to file post-petition liens, and that doing so is not a violation of the automatic stay imposed by *11 U.S.C. § 362.*; and
- suppliers and subcontractors are not required to make a motion seeking relief from the automatic stay before filing such liens.

Conclusion

Many states have similar Relation Back Doctrines in their lien laws. Therefore, the decisions of *Mammoth*, *Harrelson* and *CSSI* are instructive on the interplay between the Bankruptcy Code and state law. Most states have quick deadlines within which to file a lien. A bankruptcy filing can cause lien claimants to sit on their rights and not file a lien for fear of violating the automatic stay. Doing so may cause them to lose their right to file a lien against the construction project, which may in turn cause the client to lose any chance at recovering the amounts that it is owed by a bankrupt debtor. The decisions discussed in this article set forth the various arguments as to why the automatic stay of the Bankruptcy Code would or would not apply to filing or perfecting a lien claim post-petition.

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Charleston Grocery Store Prevails in CGL Dispute

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A Charleston grocery store prevailed in a recent ruling involving a coverage dispute after a shooting in the store. In Pennsylvania National Mutual Casualty Insurance Company v. DOSCHER'S SUPER MARKETS, Dist. Court, D. South Carolina 2012, Anita Thorne, as Guardian ad Litem for Burton Thorne, brought suit in the Court of Common Pleas for Charleston County with respect to injuries her son sustained when he was shot by a coworker at Doscher's Super Market. As a result, Penn National Insurance Company, Doscher's insurer, subsequently filed suit against Doscher's in United States District Court regarding Penn National's duty to defend and indemnify Doscher's in the underlying state court action.

The facts of the underlying tort action alleged that Doscher's employed Burton Thorne as a grocery store bagger, and that Thorne was shot by a fellow employee in the break-room during one of Thorne's work shifts. The underlying complaint alleges that the employer failed to take adequate steps to make the workplace safe and to protect the defendant-employee, Burton Thorne, after learning of threats by the co-worker. Thorne and others testified that he was shot because of the shooter's jealousy over Thorne's friendship with a fellow female employee, not because of a work-related dispute, and that the shooting coincidentally happened to take place on the premises of Doscher's.

The CGL policy at issue excluded coverage for bodily injury to an "'employee' of the insured arising out of and in the course of … employment by the insured." The only dispute here was whether Thorne's injuries arose out of his employment. In considering the cross motions for summary judgment, the judge noted that South Carolina courts have interpreted the term "arising out of" when used in an insurance policy exclusion, to be narrowly construed to mean "caused by."

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Viewing the evidence in the light most favorable to the insurer, Judge David Norton could not find that the alleged assault was "caused by" and "arose out of" the employment of Thorne. Rather, the evidence showed that the incident was caused by a personal dispute. Therefore, the employer's liability exclusion does not apply, and therefore Penn National was not relieved of its duty to defend and indemnify the employer.

Only time will tell how this case will affect other CGL policies as this is a fact-specific inquiry. To defend or not to defend in this matter? It appears we have an answer, unless the Fourth Circuit says otherwise.

About Bennett Crites

Bennett Crites is a shareholder in the Collins & Lacy Charleston Office practicing in products liability, premises liability, automobile negligence, defamation, insurance bad faith and commercial trucking law. Bennett has experience in litigating cases from minor injury to wrongful death and catastrophic injury. Super Lawyers® has identified Bennett as a Rising Star®. Prior to joining Collins & Lacy, Bennett was an attorney with a law firm in Charleston, South Carolina. He also served as a judicial law clerk to the Honorable R. Markley Dennis, Jr. and has corporate experience in the financial sector. Bennett earned his law degree from the University of South Carolina School of Law and his undergraduate degree in Business Administration from the Citadel.

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Directors and Officers Insurers Win Summary Judgment on Specific Litigation Exclusion

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Directors and Officers policies are typically claims-made policies which attempt to exclude coverage for wrongful acts which occur after the inception of the policy but arise from a nucleus of facts which preceded the inception of the policy. As a result, questions as to whether later acts are "interrelated" with prior acts can be tremendously important. A recent decision by the United States District Court for the Central District of California, *XL Specialty Insurance Co. v. Michael Perry*, June 27, 2012, granted summary judgment to insurers on interrelatedness grounds and provides an interesting discussion of the issue.

The case arose out of the 2008 collapse of IndyMac Bank and bankruptcy of its holding company, Bancorp. The former directors and officers of IndyMac and Bancorp were subsequently sued in several venues for breach of fiduciary duties, security laws and other claims. The opinion grouped these suits as eleven Underlying Actions, the first being known as the Tripp Litigation, a class action securities suit alleging IndyMac violated its own underwriting standards when originating loans.

Two coverage years were implicated: 2007-2008 (Tower 1) and 2008-2009 (Tower 2). Each tower consisted of eight layers of coverage with 10 million dollars per layer. The first four providers in each tower (ABC Insurers) provided coverage for: 1) Side A coverage - losses from claims against Directors and Officers of Bancorp for individual acts; 2) Side B – losses from Bancorp's indemnification of its Directors and Officers, and; 3) Side C – losses sustained by Bancorp as a result of security laws violations. The subsequent four providers in each tower provided Side A coverage only. The ABC policies were similar, as where the A policies, although there were some differences between the two groups.

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Directors and Officers Insurers Win Summary Judgment on Specific Litigation Exclusion

Interrelated Wrongful Act Limitation

Both the Side ABC and Side-A policies limited their liability so any claim that arose from the same "interrelated wrongful acts" constituted a single claim. Furthermore, the policies noted all such "claims" would be construed as having been made at the time the first claim was made. The Side ABC policies defined interrelated wrongful acts as "wrongful acts which have as a common nexus any fact, circumstance, situation, event, transaction or series of facts, circumstances, situations, events or transactions." The Side-A policies defined interrelated wrongful acts as "any wrongful act based on, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving any of the same or related, or series of related, facts, circumstances, situations, transactions, or events."

Prior Notice Exclusion

The Side ABC policies excluded "any payment in connection with a claim based upon arising out of, directly or indirectly resulting from or in consequence of, or in any way involving: 1) any wrongful act or any fact, circumstance or situation which was been the subject of any notice given prior to the policy period . . . ." The Side-A policies excluded coverage for acts "based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving any fact, circumstance or situation, transaction event or wrongful act which, before the inception date of this policy was the subject of notice given under any other [D&O policy].

The Court again rejected the defendants' arguments that the language was ambiguous, noting further that the language described a broad relationship between subsequent claims and claims made during prior policies so that subsequent claims would be excluded under the Tower 2 policies. In this part, the Side ABC policies were equal to the Side A polices and broader than the Side ABC polices' interrelated wrongful acts limitation. The Court held the difference between the interrelated wrongful acts limitation and the prior notice exclusion was subtle. The interrelated wrongful acts limitation states claims that fall within the scope of "interrelated wrongful acts" will be deemed to have been made at the time that the first claim was made. The prior notice exclusion states that the policy does not provide coverage for claims that are broadly related to claims that were noticed during a prior policy period.

Tripp Litigation Exclusion

All of the Tower 2 policies excluded coverage for any claim "based upon, arising out of, directly or indirectly resulting from or in consequence of, or in any way involving the following: 1) the [Tripp Litigation]; or 2) any fact, circumstance, situation, event, transaction or series of facts, circumstances, situations, events or transactions underlying or alleged in the Tripp Litigation., regardless of any legal theory upon which such claim is predicated.

Court's Analysis

The opinion first discussed the three policy limitations. In each instance, the court held the exclusion was unambiguous, and further that the language described a broad relationship between the subsequent claims and the claims made prior to the policy inception date. The court specifically rejected the idea that this broad relationship made the exclusions ambiguous. The court also held that the policy language did not require "alleged wrongs to be temporally identical" for them to constitute interrelated wrongful acts. The opinion then applied its analysis to each of the 10 classes of underlying litigation, holding that all ten Underlying Actions were sufficiently related to the Tripp Litigation to be excluded under at least one clause of the policies.

Note: The decision has been appealed to the 9th Circuit Court of Appeals.

About Pete Dworjanyn

Pete Dworjanyn is a shareholder and chair of Collins & Lacy's Insurance Coverage Practice Group and founding author of the South Carolina

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Nationwide Mutual Ins. Co. v. Rhoden, Arrieta and Dickey

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In a 3-2 decision, the South Carolina Supreme Court has concluded that public policy is offended by a portability limitation clause which purports to prevent non-resident relatives from importing UIM coverage from an at-home vehicle's policy when the involved vehicle lacks UIM coverage. *Nationwide Mutual Insurance Company v. Rhoden, Arrieta and Dickey* (Op. No. 27131, June 13, 2012).

Kelly Rhoden and her daughters, Ashley Arrieta and Emerlynn Dickey, resided in the same household. The three were involved in an accident while riding in Arrieta's car. Arrieta was operating the car. Arrieta's Nationwide policy did not provide UIM coverage. However, Rhoden insured two cars through Nationwide under a policy that did have UIM coverage. The policy had a portability limitation clause which provided:

> 3. If a vehicle owned by you or a relative is involved in an accident where you or a relative sustains bodily injury or property damage, this policy shall;
>
> a) be primary if the involved vehicle is your auto described on this policy; or
> b) be excess if the involved vehicle is not your auto described on this policy. *The amount of coverage applicable under this policy shall be the lesser of the coverage limits under this policy or the coverage limits on the vehicle involved in the accident.*

Nationwide brought a declaratory judgment action seeking a finding of no coverage on the ground that Arrieta's policy had no UIM coverage and therefore clause 3(b) prevented any of the women from recovering under Rhoden's policy. UIM coverage, like UM coverage, is personal and portable; it follows the individual insured rather than the vehicle insured. The South Carolina Supreme Court discussed our state's well-settled public policy regarding the personal and portable rule and concluded that as to Rhoden and Dickey the portability limitation violated public policy and thus was unenforceable.

Nationwide Mutual Insurance Co. v. Rhoden, Arrieta and Dickey

The Supreme Court agreed that the denial of coverage to Arrieta, the driver and owner of the vehicle, did not violate public policy as public policy is not offended by an automobile insurance policy provision which limits the portability of basic "at-home" UIM coverage when the insured has a vehicle involved in the accident. Public policy is not offended when the insured is driving his own vehicle because he has the ability to decide whether to purchase voluntary UIM coverage.

The court noted S.C. Code § 38-77-160 does not apply in the non-stacking such as the case presented here. Stacking is defined as the insured's recovery of damages under more than one policy until all of his damages are satisfied or the limits of all available policies are met. A dissenting opinion was based in part on that code section.

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Jessco, Inc. v. Builders Mutual Insurance Co.: Part 1 - "Your Work," Late Notice, and the Duty to Indemnify

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A recent opinion of the United State Court of Appeals for the Fourth Circuit addressed a multitude of issues presented in litigation involving commercial general liability policies – the "your work" exclusion, late notice, and the duty to indemnify.

On March 29, 2012, in *Jessco, Inc. v. Builders Mutual Insurance Co.*, the Fourth Circuit affirmed in part, reversed in part, and remanded by unpublished per curiam opinion the judgment of the United States District Court for the District of South Carolina, thereby finding that Builders Mutual Insurance Co. ("BMIC") had a duty to defend Jessco, Inc. ("Jessco") in the underlying construction-defect action, but BMIC was not obligated to indemnify Jessco for the re-grading allowance it paid to the underlying plaintiff homeowners.

In *Jessco, Inc.*, the Mazycks hired Jessco to build a house in a North Charleston subdivision. After moving into the house in 2004, they provided Jessco with a punch list of items to be completed or repaired. These items were not resolved to the Mazycks' liking, and in 2005, they filed the underlying suit against Jessco, alleging, among other things, that their lot flooded due to improper grading. In 2006, the action was stayed so the claims could be arbitrated. In the fall of 2007, experts for the Mazycks identified water damage to the house caused by the flooding of the property.

In October 2007, after the escalation in the Mazycks' demands, Jessco finally notified BMIC of the underlying claims. BMIC concluded the claims were not covered by the Policy and Jessco failed to promptly notify BMIC of the lawsuit. Accordingly, BMIC refused to defend or indemnify Jessco with regard to the underlying suit. Jessco thereafter filed a declaratory judgment action seeking a declaration that the claims in the underlying action were covered by the Policy. BMIC counterclaimed, seeking a declaration that it was not obligated to defend or indemnify Jessco.

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Jessco, Inc. v. Builders Mutual Insurance Co: **Part 1 - "Your Work," Late Notice, and the Duty to Indemnify**

The arbitration hearing on the Mazycks' claims was conducted in late 2008. The arbitrator issued his award in April 2009, ordering Jessco to pay almost $55,000 in damages. As to the flooding issue, the arbitrator concluded the flooding was proximately caused by "the overcapacitation of the wetlands, caused by the overall design and development of the surrounding neighborhood." Although the arbitrator found that Jessco's work was "not the legal proximate cause of the flooding of [the Mazycks'] property," the award included a $10,000 allowance for re-grading of the lot. BMIC appealed, challenging the district court's determination that (1) BMIC had a duty to defend Jessco in the underlying action; and (2) BMIC had a duty to indemnify Jessco for the re-grading allowance.

Duty to Defend

In asserting it had no duty to defend, BMIC argued (1) coverage for the Mazycks' claims was excluded by the Policy's "your work" exclusion; and (2) Jessco failed to notify BMIC of the underlying lawsuit "as soon as practicable" as required by the Policy.

BMIC did not dispute on appeal that the allegations of the underlying complaint raised the possibility of "property damage" caused by an "occurrence," but instead contended it had no duty to defend because coverage for the claims was excluded under the "your work" exclusion, which excluded coverage for any claims of "'[p]roperty damage' to 'your work' arising out of it or any part of it." "Your work" was defined as "[w]ork or operations performed by you or on your behalf," a definition broad enough to encompass and preclude coverage for work done by the insured's subcontractors. Although the Policy included an exception restoring coverage for damage to work performed by a subcontractor, it also contained an endorsement removing the subcontractor exception.

BMIC argued all the work on the property was done by subcontractors on Jessco's behalf, and therefore, the "your work" exclusion barred coverage for all underlying claims. The court disagreed, noting "the exclusion does not withdraw coverage for any and all work done <u>by</u> the insured or its subcontractors; it withdraws coverage in cases where the insured causes property damage <u>to</u> work done by the insured or its subcontractors... 'It does not exclude coverage for a third party's work.'" (Emphasis in original) (quoting [*Limbach Co. v. Zurich Am. Ins. Co.*](), 396 F.3d 358, 365 (4th Cir. 2005) (per curiam)). Thus, the court concluded, "the Policy's elimination of the subcontractor's exception means that Jessco's subcontractors will not be viewed as third-parties for purposes of determining whose 'work' was damaged, but the elimination of the exception does not, as BMIC contends, preclude coverage if Jessco's work in fact damages the work of a third party."

The court determined the Mazycks' claims against Jessco created a possibility that a third-party's work or property was damaged by the faulty workmanship of Jessco or its subcontractors, noting the contract between Jessco and the Mazycks specifically contemplated that Mr. Mazyck would perform some of the work, and that Mr. Mazyck himself installed (or hired a subcontractor to install) the flooring and landscaping. Accordingly, the court found the "your work" exclusion did not bar coverage for the underlying claims.

With regard to "late notice," BMIC argued even if the Policy otherwise provided coverage, Jessco lost its right to coverage by waiting more than two years to give notice of the underlying suit. Assuming for purposes of the opinion that notice was untimely, the court noted that under South Carolina law, "recovery under the Policy is barred only if BMIC proves that it was substantially prejudiced by the late notice." *See* [*Vermont Mut. Ins. Co. v. Singleton*](), 446 S.E.2d 417, 421 (S.C. 1994) ("Where the rights of innocent parties are jeopardized by a failure of the insured to comply with the notice requirements of an insurance policy, the insurer must show substantial prejudice to the insurer's rights.");

Squires v. National Grange Mut. Ins. Co., 145 S.E.2d 673, 677 (S.C. 1965) ("The burden of proof is upon the insurer to show not only that the insured has failed to perform the terms and conditions invoked upon him by the policy contract but in addition that it was substantially prejudiced thereby.") Therefore, because BMIC failed to present any evidence of prejudice and "prejudice to the insurer may not be presumed," the court rejected BMIC's assertion that Jessco's delay in notification precluded recovery under the Policy.

BMIC also challenged the attorney fee award; however, it failed to substantively address the issue in its brief. Accordingly, the court found BMIC had abandoned the issue. *See Wahi v. Charleston Area Med. Ctr., Inc.*, 562 F.3d 599, 607 (4th Cir. 2009) ("Federal Rule of Appellate Procedure 28(a)(9)(A) requires that the argument section of an appellant's opening brief must contain the 'appellant's contentions and the reasons for them, with citations to the authorities and parts of the record on which the appellant relies.' Because Wahi has failed to comply with the specific dictates of Rule 28(a)(9)(A), we conclude that he has waived his claims . . . .").

Duty to Indemnify

BMIC also contended that the $10,000 re-grading allowance was not compensation for loss caused by a covered risk. Recognizing the Mazycks asserted contract and negligence based claims against Jessco in the underlying action, the Court determined that if the re-grading allowance was awarded by the arbitrator as compensation for negligence by Jessco in grading the property, Jessco's negligence would constitute an "occurrence," and the policy would provide coverage. Thus, the court first determined the legal basis for the re-grading allowance ordered by the arbitrator:

Although the arbitrator stated that Jessco and the Mazycks both "b[ore] some responsibility for the flooding," the arbitrator ultimately determined that the flooding was caused by "the overcapacitation of the wetlands, caused by the overall design and development of the surrounding neighborhood." The arbitrator concluded that the development and overcapacitation was "an unforeseen intervening cause," and Jessco's work was "not the legal proximate cause of the flooding of [the] property."

The arbitrator's determination that Jessco's work was not the proximate cause of the flooding necessarily amounted to a rejection of any negligence-based claim asserted against Jessco. *See, e.g., Hurd v. Williamsburg Cnty.*, 579 S.E.2d 136, 144 (S.C. Ct. App. 2003) ("It is apodictic that a plaintiff may only recover for injuries proximately caused by the defendant's negligence."). While there may have been some negligent conduct by Jessco, the proximate-cause determination means that Jessco could not have been held accountable to a third-party for that negligence. *See, e.g., Howard v. Riddle*, 221 S.E.2d 865, 866 (S.C. 1976) ("Plaintiff must show, as a matter of law, not only that defendant was negligent but also that his negligence was a contributing or proximate cause of the injury . . . ." (internal quotation marks omitted)).

Having established the arbitrator determined there was no actionable negligence on the part of Jessco, the court reasoned the re-grading allowance could only have been awarded as compensation for a breach of contract. Therefore, because the Policy unambiguously excluded coverage for breach of contract damages, the court found BMIC had no obligation to indemnify Jessco for the re-grading allowance paid to the Mazycks.

Having determined that BMIC owed a duty to defend Jessco in the underlying action, but did not owe a duty to indemnify Jessco for the re-grading allowance, the court vacated the district court's judgment and remanded for further proceedings consistent with the opinion.

On May 3, 2012, in *Jessco, Inc. v. Builders Mutual Insurance Co.*, upon remand by the Fourth Circuit, the United States District Court for the District of South Carolina amended its previous

Judgmentand deducted $10,000.00 from the total amount previously awarded, $78,695.20, finding Jessco, Inc. ("Jessco") was entitled to a judgment in the amount of $68,695.20 plus post-judgment interest. In the same order, upon Jessco's Amended Motion for Award of Fees and Costs After Remand, addressing an issue of first impression, the court held that Builders Mutual Insurance Co. ("BMIC") was obligated to pay Jessco's attorney's fees and costs incurred on appeal.

Citing *Hegler v. Gulf Insurance Co.*, 270 S.C. 548, 550-51, 243 S.E.2d 443, 443 (1978), the court noted South Carolina courts have found an insured may be entitled to reasonable attorney fees and costs incurred in successfully defending a declaratory judgment action brought by the insurer in an effort to relieve itself of coverage under an insurance policy, reasoning that:

> [A]n insured must employ counsel to defend — in the first instance in the damage action and in the second in the declaratory judgment action to force the insurer to provide the defense. In both, the counsel fees are incurred because of the insurer's disclaimer of any obligation to defend.
>
> If the insurer ***can force [the insured] into a declaratory judgment proceeding*** and, even though it loses in such action, compel him to bear the expense of such litigation, the insured is actually no better off financially than if he had never had the contract right mentioned above.

(Alteration and emphasis in original). However, whether an insured is also entitled to recover attorney fees and costs incurred *on appeal* when (1) the insurer appeals the trial court's ruling for the insured in a declaratory judgment action, and (2) the appellate court affirms the lower court's judgment with regard to the insurer's duty to defend, had never been addressed by the South Carolina courts.

In support of its motion for attorney fees and costs, Jessco argued that whether the fees and costs arose in the context of a declaratory judgment action or in its appeal makes no difference; because in either case, the insured is doing nothing more than attempting to protect its contractual right to a defense. Thus, Jessco argued, the rationale in *Hegler* for providing relief to an insured that is "forced" into a declaratory judgment action and wins should apply equally when the insured is forced to defend its rights in the appeal of that action and wins. In opposition, BMIC argued the reversal by the Fourth Circuit as to BMIC's duty to indemnify Jessco for the re-grading allowance necessitated a finding in favor of BMIC on Jessco's motion. The court rejected BMIC's argument, noting that South Carolina courts have established the duty to defend is separate and distinct from the duty to indemnify, and Jessco's motion sought payment for fees and costs as damages suffered by Jessco for BMIC's breach of its duty to defend, ***not*** its duty to indemnify. *See* *USAA Prop. & Cas. Ins. Co. v. Clegg*, 377 S.C. 643, 654, 661 S.E.2d 791 (2008) (quoting *Sloan Constr. Co. v. Cent. Nat'l Ins. Co. of Omaha*, 269 S.C. 183, 186-87, 236 S.E.2d 818 (1977)).

BMIC also argued there was "simply no legal authority" supporting an award of appellate fees and costs. However, BMIC failed to produce any authority demonstrating that *Hegler* did not apply to support such an award. In response, Jessco acknowledged that the motion presented a novel legal issue, but argued there was no logical reason why *Hegler* did not apply to fees and costs incurred on appeal. The court agreed with Jessco's reasoning, finding as follows:

When BMIC appealed the declaratory judgment action, it was still seeking to avoid its obligation to defend, just as it sought to avoid its' duty to defend at the trial level. Thus, after prevailing at the trial level, Jessco was forced into the appellate process by BMIC, thereby bearing the expense, just as it was forced to bring the initial declaratory action to protect and enforce its rights. Jessco prevailed at the trial level, and on appeal, the Fourth Circuit found BMIC had a duty to defend and affirmed this Court's judgment and damages award on that issue. *Hegler* held that an insured is entitled to recover attorney's fees and costs following a successful defense of a declaratory judgment ***action***. *See Hegler*, 270 S.C. at 548 (emphasis added). The holding in *Hegler* necessarily encompasses fees and costs incurred at the appellate level of that action. The appellate expenses, like the trial level expenses, are damages arising directly out of the insurer's breach of its duty to defend. Therefore, the Court finds that Jessco is entitled to recover reasonable attorney fees and costs of defending this action on appeal from BMIC, just as it was at the trial level. *See Hegler*, 270 S.C. at 551 ("After all, the insurer had contracted to defend the insured, and it failed to do so. It guessed wrong as to its duty, and should be compelled to bear the consequences thereof.").

The court also found that Rule 222, SCACR did not prohibit an award pursuant to *Hegler*, and further, did not divest the court of authority to make such an award:

Sections (a) and (b) of Rule 222 state: "When an appeal is affirmed or reversed in part or is vacated, costs shall be allowed only as ordered by the appellate court." "In addition, the party shall be entitled to recover an attorney's fee in an amount which shall be set by order of the Supreme Court." Rule 222(b). However, the Rule "`does not preempt an award of attorney's fees to which one is otherwise entitled.'" *Muller v. Myrtle Beach Golf & Yacht Club*, 313 S.C. 412, 416, 438 S.E.2d 248 (1993) (citing *McDowell v. S.C.D.S.S.*, 304 S.C. 539, 543, 405 S.E.2d 830 (1991)). Thus, the Court may grant an award pursuant to *Hegler* because the authority pursuant to *Hegler* and the authority vested in the court of appeals pursuant to Rule 222 are not mutually exclusive.

Noting that, upon remand, the district court had jurisdiction to enforce the judgment and take any actions consistent with the Fourth Circuit's ruling, and the *Hegler* rule did not limit the collection of attorney fees to a specific court or level of courts, the court found it could properly award appellate attorney fees and costs to an insured as damages flowing from an insurer's breach of its duty to defend. Accordingly, the court granted Jessco's Motion for Award of Fees and Costs After Remand.

About Logan Wells

Logan Wells is an associate practicing in the areas of premises liability, retail / hospitality / entertainment and insurance coverage. She received her undergraduate degree in history and political science from Furman University and earned her juris doctor from the University of South Carolina School of Law. During her undergraduate career, she worked for a law firm in Spartanburg as a legal assistant. While in law school, she worked as a summer associate for Collins & Lacy, before joining the firm as an attorney in the fall of 2009.

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Social Media

By Members of the Primerus International Outside Counsel Practice Group

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There has been a huge increase in the popularity of social media like Facebook, Twitter and LinkedIn. Social media has transcended languages, borders and cultures: through social media a vast amount of information is exchanged daily and globally. People often post personal and professional information. This information can be viewed not only by friends and relatives but also by colleagues, clients and employers. Consequently, as a Corporate Counsel, you cannot ignore social media in a corporate environment. Social media can be a powerful tool you can use to your advantage. On the other hand, inappropriate use of social media can influence the (online) reputation of the company in an unwanted way. But that is not all: social media can also play an important role in employment relationships. As a Corporate Counsel, you are likely to be faced with questions such as: “Are employers allowed to monitor what information (future) employees exchange and who they exchange it with?” and “How to deal with employees who are telling company secrets or are openly bad-mouthing their employer or their colleagues?”

Privacy legislation, which can vary from jurisdiction to jurisdiction, often plays an important role in employer-employee relationships. However, the key issues and pressure points are similar worldwide. More specifically, as regards employers, problems can arise throughout all stages of the employment relationship: that is, at the recruitment and selection level stage, during employment and after the termination of employment.

1. Recruitment and Selection

Questions regarding the use of social media may arise even before employment, namely as early as at the selection level stage. Employers wish to gather information on future employees to get an overall picture of a person. But to what extent are employers allowed to review social media profiles and to what extent can and may that influence the employer’s decision-making process? When hiring a sales professional, it is good to know who he is networking with. On the other hand, social networking with competitors can have a negative effect. Information on a person's situation at home or on private activities can be more important than expected. Think, for instance, of difficult care situations at home or of "dangerous" hobbies.

But how does this relate to, for instance, data privacy laws and anti-discrimination laws? In the US, job candidates need to provide the employer with a written authorization prior to a background check, whereas job candidates in the United Kingdom must be given the opportunity to check the accuracy of the online data collected about them.

In addition to privacy laws, anti-discrimination laws, and codes of conduct as implemented e.g. in France, user conditions of social networking sites themselves can also contain restrictions. User conditions (general terms and conditions) of social media or platforms may restrict the use of information for professional or recruitment purposes. In some jurisdictions, a difference is made between the types of social media. Employers in Germany and France may use information collected from professional social networks only (such as LinkedIn), but they are not allowed to use information from general social networking sites, such as Facebook.

2. During Employment

An employee has to observe the rules and regulations of the organization he works for, and he has to act as a good employee. Employees can thus be expected to act professionally and to behave like good colleagues, especially when it comes to the use of social media. Information revealed on the internet is hard to remove and spreads fast. This can have negative effects for both employer and employee. It is a completely different question, however, whether an employer is allowed to use information available through social media on the employee's private life. Can a Tweet (such as "Relaxing on the beach") by an employee on sick leave to his Twitter followers be used in a dismissal procedure? Is an employer allowed to monitor what an employee posts on Facebook about its manager or about the company? Is an employer allowed to check who an employee is linked with on LinkedIn? The answer to these questions depends on data privacy laws that vary from country to country.

2.1. Monitoring Of Employee's Usage Of Social Media

Whether or not employers are permitted to monitor the social network use of their employees and if so, what considerations and limitations apply, are additional questions to be answered by the different legislations. In most jurisdictions, employers are permitted to monitor social media use on work-provided devices on condition that the employee's privacy is respected. The European Court of Justice has ruled that in Europe employees enjoy their right to privacy and private life in their work environment as well, therefore a limited amount of private internet use must be allowed. Furthermore the European Court of Human Rights has determined that for example monitoring telephone conversations and emails should be announced beforehand.

Of course if the employer has a specific and good reason to suspect violations of the company policies, it will in general be allowed to investigate that specific situation. However monitoring internet use as a general policy is only allowed under certain conditions, or in some cases not at all.

In general, privacy rights of the employees must be balanced against the employer's legitimate interests to protect its business or IT. Some jurisdictions have established guidelines about appropriate monitoring in the workplace (e.g. UK and Switzerland). In others it is important to have a consistent policy about monitoring that has to be made known to all employees beforehand, either via a works council or individually (Germany, the Netherlands, France). In Spain monitoring is only permitted with the consent of the employee, and Switzerland does not allow preventive monitoring at all.

2.2. Dismissals due to inappropriate usage of social media

To what extent employees can be dismissed based on inappropriate use of social media depends on the national legislation. When it comes to inappropriate use of social media, in the US, the focus will be on whether or not it is related to "concerted activity". In Canada and in most European countries the reason given for dismissal will be checked. In Canada the criteria for inappropriate use of social media are (1) breach of the company policy, for instance, regarding confidentiality, computer use or anti-harassment and (2) damage to the company. Other considerations taken into account are whether it is a matter of frequent inappropriate use or one time inappropriate use only, and whether the employee has been warned.

A court in Australia considered an employee's 3,000 chat sessions in three years sufficient for the termination of the employment. In two recent decisions in France, the courts ruled that employees posting insulting comments about their employers on a social media website could be terminated for fault and also fined for the offence of public insult. It was held that comments posted on a social media site could not be considered private, since the posting were not set to be displayed only to friends.

This is not only an issue in France but also in Switzerland where employees must check the relevant privacy settings before posting derogatory comments. In France it was held that employees must be made aware about the possible sanctions and the consequences of inappropriate postings in advance. On the contrary, in the UK, an Employment Tribunal held that the employee's comments on Facebook were not in private even though the employee had set his privacy settings so that only his Facebook friends could see them. The Dutch court had the same line of reasoning about an employee posting an insulting remark about his employer to his friends on Facebook. According to the Dutch court the term 'friends' is a very relative notion on the internet because these friends can, and in this case they did, forward the message very easily. The employer's need to protect its reputation was weighted more important. In the US, a report was issued about the protection of disparaging comments on social media about employers.

2.3. Clear Rules Required

Therefore, it is important to lay down rules on the use of social media and on the employees' online activities as regards revealing information on the company they work for as well as the sanctions for non-compliance. In the best case, employees expressly consent to such rules, implemented either as policies or contractual provisions. Such rules not only facilitate proving whether or not an employee has broken company rules, but are also valuable in the event the employer intends to hold the employee responsible for damages the company or clients suffered due to information spread via social media. These rules may include, for example, if and to what extent employees are allowed to befriend business relations and whether employees will have to create separate accounts for business relations and for solely personal contacts. It is worth considering setting up employees' business accounts according to the company guidelines. It can also be included whether, and if so, which social media can be used during work hours and to what extent they may be used. This will often depend on the position of the employee and the type of company. A sales manager of a software company will be allowed more social media activity than an accountant of a food wholesaler. In this regard, it may be also taken into consideration how often and to what extent e-mails and telephone calls are permitted for private purposes.

3. After Employment

After the termination of employment, employer and employee are most likely to still be active on the internet. At this stage, issues such as duty of confidentiality and competition clauses are very important. It must be clear whether or not contacts with business relations and business-related social media and accounts will have to be cancelled. It is also advisable to make arrangements on whether LinkedIn contacts will have to be deleted or may be kept. You can include these guidelines, for instance, in a competition clause or a business relations clause. That way you can control that no business relations will be accepted as Facebook friends, or that the employer has a say in the management of a LinkedIn account. Arrangements like this can even be made if the above mentioned clauses have not been agreed upon, for instance in a special clause of the employment agreement or they can be included in the staff regulations.

4. Conclusion

There is not just one uniform way to deal with social media. After all, every country, every company and every human being is different from one another. A social media policy has to be tailored to fit the country, the company culture, the image of a company, the sensitivity level of information and safety aspects so that all employees know the company's rules and you can make them follow these rules. It is advisable to include such a policy as standard in the staff regulations.

The Primerus International Outside Corporate Counsel Practice Group (further: IOCC PG) aims at bringing together Primerus members who provide legal advice on the day-to-day business of the entrepreneur, with a focus on the following practice areas:

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- IP / Information and Communication Technology

Islamic Finance: When Things Go Wrong

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1.1 Islamic Finance: Background and Core Principles

In order to put into context the disputes that arise out of Islamic finance transactions, it is necessary to first understand the rules and principles that Islamic finance instruments and transactions are based on.

The basic principle of Islamic finance is the prohibition of investment in interest-based ventures and businesses that provide goods or services contrary to Islamic principles, such as tobacco, alcohol, gambling, and prostitution.

Islamic finance instruments should function in conformity with the principles of Islamic law (*Shari'ah*). *Shari'ah* is based upon the rules and principles found in its primary sources the (i) *Quran* and (ii) *Hadith* (teachings of the Prophet Muhammad (may peace be upon him)), and further clarified by secondary sources such as *Ijma* (scholarly consensus over the interpretation of the primary sources) and *Qiyas* (similarities drawn through analogy between modern day issues and those mentioned in the primary sources). Islamic finance instruments must, therefore, avoid:

- the payment or receipt of interest (*riba*)
- unconditional reward (some risk must be assumed)
- gharar (excessively tenuous/uncertain transactions); e.g. sale of an unborn calf, or items not in possession or not specified, or agreeing to a contract without specifying material terms of the contract
- maisir (speculative transactions); e.g., enrichment without labor (gambling), or possibly, hedge funds
- transactions involving haram (forbidden) goods or activities; e.g. illegal drugs, alcohol, pork, gambling, etc.

2.1 Popular Islamic Finance Products in the Market

Some of the more popular Islamic finance products in the market are outlined below.

2.1.1 *Musharaka*

Musharaka is a partnership between two entities or persons whereby each contributes assets to a venture. Profits are shared by pre-agreement and generally cannot accord a higher share to the silent partner than his contribution of assets warrants. Losses must be shared *pro-rata* to the share of assets contributed. One partner may not guarantee the return or the capital of another.

2.1.2 *Murabaha*

In *murabaha*, under current market constructs, the customer identifies goods, which the bank purchases from the seller at the market price. The bank then sells the goods to the customer at a mark-up (disclosed to the customer); the deferred purchase price and mark-up is paid back by the customer to the bank in instalments over a period of time.

2.1.3 *Mudarabah*

Mudarabah is a limited partnership where one partner (*rab al maal*) injects capital in a business whilst the other (*mudarib*) runs the business. The partners share in the profits derived from the business, in a pre-determined manner based on profit not capital, but the *mudarib* does not bear any losses, unless he is negligent.

2.1.4 *Ijara*

Ijara, meaning "to rent" in Arabic, involves selling the right to use an asset for an agreed upon lease period, during which the lessor retains ownership of the underlying asset. This is a common underlying construct employed in large project and property financing transactions.

2.1.5 *Istisna*

An *istisna* is a procurement agreement in which the price of the purchased goods or property (while agreed at the outset) may be paid up front, according to a schedule in instalments, in stages or at completion.

2.1.6 *Wakala*

Wakala is an Islamic agency agreement, and is jurisprudentially quite malleable to achieve varied commercial ends. In some cases, the bank, as its customer's agent, invests funds in *Shari'ah*-compliant assets for the purpose of generating returns for its customers.

2.1.7 *Sukuk*

Sukuk, wrongly called Islamic bonds (an oxymoronic term), refer to derivative ownership certificates. *Sukuk* are issued with respect to an underlying asset and various constructs, such as *musharaka, ijara or istisna*. Holding a *sak* (the singular of *sukuk*) represents ownership in the underlying assets and revenues generated from such assets.

Most market *sukuk* are structured so that at the end of the term, the issuer must either repay the original amount invested or, if this cannot happen (*i.e.*, the Nakheel potential default), then either the issuer renegotiates with the owners of the trade certificates, or sells the underlying asset and divides the proceeds amongst the owners of such certificates in amounts proportionate to their holding. Inevitably, this will result in a loss in the face value of the holder's certificates. Naturally, any guaranteed price redemption feature raises enforceability issues as, at its core, a *sak* is not meant to be a capital guaranteed product.

3.1 *Shari'ah* in the United Arab Emirates (UAE) and the Kingdom of Saudi Arabia (KSA)

The law in Saudi Arabia is largely derived from the *Shari'ah*, and generally based on the *Hanbali* school of jurisprudence. In the event that a dispute arises by virtue of a conflict between the law of the state and the *Shari'ah*, generally the latter will prevail. The Saudi government also promulgates, from time to time, rules and regulations in order to conform the laws of the state to the *Shari'ah*.

In addition to the courts, dispute resolution *fora* in Saudi include the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency ("SAMA"), the Commercial Paper Committee, the Grievances Board, and special committees formed by the Ministry of Commerce and Industry. SAMA's Banking Disputes Settlement Committee assumes jurisdiction over disputes of a banking nature, and the Commercial Paper Committee assumes jurisdiction over disputes involving promissory notes. The Grievances Board has jurisdiction over bankruptcy issues, and commercial disputes not related to banking, and also has exclusive jurisdiction over claims against the Saudi government. Prior judicial decisions are not legally binding on courts and other judicial and quasi-judicial authorities in Saudi, which, coupled by the fact that Saudi courts do not have a system of publicly reporting judgments, renders it difficult to conclusively determine the interpretation and application of the law by the courts and judicial committees.

It is notable that the SAMA Committee, in informal conversations, has indicated that it would assert jurisdiction over Islamic finance disputes. This is remarkable because the SAMA Committee's traditional jurisdiction extends to disputes of a banking nature involving banks and their customers. In its discretion, the SAMA Committee has read its jurisdictional ambit broadly to include disputes of an Islamic financing nature e.g., disputes that stem from *ijara*-based transactions. How the SAMA Committee actually adjudicates such disputes and the interpretation of constructs will be very important and instructive for the industry going forward. As yet, there is insufficient information to come to any considered position on this point.

UAE legislation expressly recognizes the *Shari'ah*, and the UAE Civil Code requires that courts be guided by the *Shari'ah* in the absence of legislation on point: "If the judge finds no provision in this Law, he has to pass judgement according to the Islamic Shari'ah." *See* UAE Civil Code, Article 1. The Code also delineates the order in which the four schools of thought will be referred to by the UAE courts, and requires that the judge search for "…the most appropriate solution from the schools of Imam Malik and Imam Ahmad bin Hanbal, and if none is found there, then from the schools of Imam al Shafi'i and Imam Abu Hanifa as most befits." Moreover, the UAE Civil Code expressly addresses certain *Shari'ah*-based transactions and legislates on the rules, procedure and remedies relating to such transactions. *See e.g.*, UAE Civil Code at Articles 568 to 579 (forward sales (*istisna*)), Article 582 (sale of unascertained goods (*juzaf*)), Article 583 (deferred sales), Articles 597 to 601 (sales by a terminally ill person), and Articles 614 to 653 (gifts (*hiba*)). However, whilst the basic structure of UAE legislation incorporates the *Shari'ah*, both expressly and by reference in the absence of an express law, it is well understood that each jurisdiction has its respective interpretation as to what is or is not *Shari'ah*-compliant. The dearth of case law does not lend itself to broad conclusions with respect to the UAE courts' approach to commercial disputes. In a dispute subject to the UAE's jurisdiction, we envision that the UAE courts will strive to ascertain the intent of the parties and give effect to substance over form with respect to the transaction under review. Indeed, such is the approach taken by at least one UAE court as noted below.

3.1.1 *Judgements Issued by the Dubai Courts*

Traditionally, market structures incorporating the *ijara* construct are agreements of lease to purchase. The customer identifies a property that the bank or financial institution purchases and then leases out to the customer. The rental payment constitutes a progressive payment of the capital amount and a variable component that covers the profit element for the finance institution. Along with the *ijara* agreement, the customer signs a purchase undertaking whereby he agrees to purchase the property at the end of the lease term and at certain other pre-agreed events.

In some circumstances, the bank enters into a sale undertaking.

We understand that recently there has been a case litigated in the Dubai Court of First Instance with respect to a matter involving default of an *ijara* transaction.[1] While details are still forthcoming, to the extent that the case was based on the traditional *ijara* structure described above, we understand that the court took an approach of applying substance over form. The court ascertained that the true intent of the parties, and the real objective of the transaction, as a whole, was for the customer to eventually buy the property. Thus, the court held that the transaction was in essence "a contract for sale of property on deferred payment terms, rather than a lease. Accordingly, all payments of rental under the Ijara are treated as payments by the customer towards the purchase of the property."[2] This was because the customer had identified the property and the transaction was structured towards an eventual sale of the property from the finance institution to the customer. The court granted the finance institution the remedy of specific performance of the purchase undertaking and the customer was ordered to purchase the property for the outstanding loan amount.

In upholding the intent of the contractual arrangements, and deviating from the form, the court adhered to the *Shari'ah* principle that substance transcends form. As such, the *ijara* agreement was deemed to be a sale and purchase agreement, rather than a lease to purchase arrangement. This judgement, while reaffirming the *Shari'ah* principle of substance over form, may implicate other *Shari'ah* issues as such agreements generally also envision the parties creating an interim lessor/lessee relationship during which time the risk of loss sits with the financier. Naturally, registering a lessee's name with the Dubai Lands Department further muddies the structural waters, as from a clear *Shari'ah* analytical perspective, such registration ought not to occur until the substantive ownership has passed between financier and customer. We surmise that there is much more development to occur in this area of the law with a multitude of cases that are making their way to the courts on the back of the economic downturn and resultant defaults.

3.1.2 *Sukuk and the Potential Nakheel Default*

Sukuk have become the flagship Islamic product of the Islamic finance industry, and the markets have an estimated USD 100 billion in *sukuk* issuances. *Sukuk* are considered the most significant mechanisms for raising Islamic finance in the international capital markets.

However, given that these are nascent structures in a developing and evolving marketplace, there is uncertainty surrounding how *sukuk* transactions will be finally adjudicated in the Gulf jurisdictions. S*ukuk* defaults have not yet been brought before the courts – so there is little indication as to how courts may approach such instruments. Many of the *sukuk* documents are drafted in accordance with and governed by English law. English courts have, in the final analysis, balked at effecting parties' choice of law provisions when they elect to apply *Shari'ah* principles. English courts have questioned whether *Shari'ah* is definitive enough to apply; even if it were considered to be sufficiently definitive (and discrete provisions were incorporated into the contract by reference), it would not likely be enforced if it were to conflict with English law. Therefore, enforcement of English judgements in relation to Islamic products/transactions would invariably require a *de novo* review to determine whether the English judgement was congruent with *Shari'ah*.

A case in point is the Nakheel *sukuk* – a *sukuk* that garnered the world's attention when it became apparent that Nakheel may be unable to repay its holders.

In the Nakheel case, holders of the subject trade certificates believed that they were guaranteed the return of their premium on

[1] *Ijara Enforcement Judgments in Dubai*, Al Tamimi & Company Banking & Finance Update, August 2010.
[2] *See id.*

maturity and a profit rate of 18.89% for the period of the *sukuk* issuance. They also believed that, in the event Nakheel was unable to pay its debts, Dubai World, and therefore by implication the Dubai Government, would guarantee the payments (including the premium). However, the Dubai Government had publically announced that it had never guaranteed the debts owed by the Dubai World to its creditors. As the development of Islamic finance is novel globally, the UAE had no established legal precedent on which the investors could rely on to make a claim over the *sukuk* assets, which are largely located in the UAE. For now, Nakheel has gained a temporary reprieve due to the Dubai Financial Support Fund making available sufficient funds to repay the first *sukuk* that matured on 13th May 2010. In December 2009, the Chairman of Dubai's Supreme Fiscal Committee, during the announcement of the Dubai bailout, also announced a new bankruptcy law, stating that "the law will be available should Dubai World and its subsidiaries be unable to achieve an acceptable restructuring of its remaining obligations."

While the Nakheel default has not yet been adjudicated before the courts, the problems posed by this default serve as a case study of the issues that the Islamic finance industry must address. At present, via Dubai Decree No. 57 of 2009, all disputes relating to Dubai World and its subsidiaries must be heard by a Special Tribunal that has been formed, rather than being referred to the Dubai Courts. Therefore it is with great anticipation that we wait to see if any action will be referred to the Tribunal and how the Tribunal, which does not comprise of *Shari'ah* experts, will deal with such a dispute. Naturally, for the Tribunal to have the requisite standing, it will need to consult with *Shari'ah* experts that bring in relevant background to assist the Tribunal in weaving its way through the labyrinthine maze of issues at play that include choice of law issues, interplay between *Shari'ah* and English law, as well as jurisdictional law considerations.

Deeper questions that are posed by market structures that depart from accepted *Shari'ah* wisdom or contain conventional bond defaults in *sukuk* garb, including whether such would be enforced in certain *fora*, are addressed in greater detail in "*Sukuk: default or no default?*," Legal Spotlight, Jan. 2010, Oliver Ali Agha and Claire Grainger.

4.1 Disputes before the English Courts

4.1.1 *Shamil Bank of Bahrain EC v Beximco Pharma Ltd and Others*[3]

The *Shamil* case is representative of the courts' approach toward the conflict of laws that arises when parties select, as the governing law, both English law (or a national system of law) and *Shari'ah*. In the *Shamil* case, Shamil Bank of Bahrain extended finance to various pharmaceutical companies in Bangladesh under a *murabaha* arrangement. Shamil Bank of Bahrain took the Bangladeshi companies and their directors (in their capacity as guarantors) to court because the companies failed to meet their payment obligations. The court found in favor of the Bank, and the Beximco defendants challenged the decision in the Court of Appeals on the basis of the governing law provision of the *murabaha* contract:

> *"Subject to the principles of the Glorious Sharia'a, this Agreement shall be governed by and construed in accordance with the laws of England."*

The defendants argued that the intended effect of this clause was to (i) choose the laws of England and Wales as the governing law, and (ii) subject the enforceability of the terms of the contract to conformity with *Shari'ah* principles. The defendants further argued that the *murabaha* contracts that formed the subject of the dispute were in fact "unlawful, invalid and unenforceable" under *Shari'ah* principles since the contracts were in fact "disguised loans" for interest. Since *riba* is universally accepted as unlawful under the *Shari'ah*, the contract would fail the test of validity under the *Shari'ah*. The *Shamil* court reasoned that

[3] [2004] EWCA Civ. 19 Court of Appeals, [2004] ALL ER 1072.

it has been well-established that a contract cannot be governed by two separate systems of law concurrently. Whereas parties to a contract may import specific provisions of a law from other than the system of law that they select as the governing law of the contract, a general reference to the principles of the *Shari'ah* is not an incorporation of a distinct set of rules. The court went on to reason that under the Rome Convention 1980, scheduled to the Contracts (Applicable Law) Act 1990, the reference to the choice of governing law for the parties must be to the law of a country, not to a "non-national system of law." The *Shari'ah* is not the law of a country, but a collection of principles. Therefore, the court held that, irrespective of the election of the parties to subject English law to *Shari'ah*, English law nonetheless applied because *Shari'ah* was not a governing body of law, but merely embodied the Islamic religious principles to which Shamil Bank held itself out as doing business.

The court's conclusion reflected an interpretation that leaned towards effecting the commercial purpose of the parties (as it ascertained from its reading of the documentation). The court asserted that it is "improbable in the extreme" that the parties intended for an English court to determine a dispute as to the compliance of a contract (based on Islamic finance constructs) to the principles of the *Shari'ah* when the *Shari'ah* contains opposing points of view. The court noted that, while it was possible to incorporate specific provisions of foreign law into a contract governed by English law, in this case no specific rules/principles were so identified. Implicit in the court's holding was the suggestion that even where foreign law is so referenced, naturally, at most one could expect such provisions to become part of (rather than trump) an English law contract. The court noted, "[i]t was plainly insufficient to contend that the basic rules of the Sharia were not controversial. Such 'basic rules' were neither referred to nor identified. Thus the reference to the "principles of . . . Sharia" stood unqualified as a reference to the body of Sharia law generally. As such, they were inevitably repugnant to the choice of English law as the law of the contract and rendered the clause self-contradictory and therefore meaningless."[4]

The court further noted that, for the purposes of the bank's own regulation, the views of the bank's own regulatory board are sufficient to monitor its compliance to its internal policy and mandate. Since the defendants did not concern themselves with the *Shari'ah* compliance of the form of the contract at the time of signing, or at any time prior to the proceedings in court, it was held that *Shari'ah* compliance was not of the essence from the perspective of the defendants and therefore not a valid defense to failing to meet their contractual obligations.

4.1.2 *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others* [5]

This case is of significance because it is the first instance of an English court ruling on a transaction based on Islamic finance constructs. In this case, the Islamic Investment Company of the Gulf (Bahamas) Ltd. entered into a *murabaha* financing agreement with Symphony Gems N.V. Under this agreement, Symphony would identify a supplier for the precious stones and gems that it intended to purchase for its inventory, and Islamic Investment would then buy these stones and gems from the supplier and sell them to Symphony at an agreed mark-up. Symphony would pay Islamic Investment the marked-up price in instalments. However, under the agreement, Symphony agreed to make the payments regardless of whether or not delivery of the stones and gems was ever made or whether there was a defect, loss or breach; such payments were guaranteed by two guarantors from Symphony. Further, delivery of the purchased stones and gems was to be made directly to Symphony. Thus, even though Islamic Investment was buying the stones and gems and then selling them on to Symphony, it did not at any point undertake any of the risks associated with the

[4] *Id.*
[5] 2002 WL 346969 (Q.B. Com. Ct. Feb. 13, 2002).

transaction. It was agreed that the agreement was to be governed by English law.

The dispute under the agreement arose when one of the suppliers failed to deliver diamonds that Islamic Investment had bought pursuant to a request from Symphony. Symphony then failed to make payments to Islamic Investment in respect of the transaction. Islamic Investment sought to enforce the guarantee by filing for a summary judgement.

In its defense, Symphony claimed that since the subject agreement was a sale and purchase contract, the absence of delivery amounted to a breach on the part of Islamic Investment, due to which it could not make a claim for non-payment from Symphony. However, the court rejected this on the basis of the clear wording of the agreement, which did not make payment subject to delivery. Symphony argued that the agreement suffered from illegality under the laws of Saudi Arabia, where part of the transaction took place, and it further argued that since Islamic Investment's charter prohibited it from entering into contracts that were not compliant with the *Shari'ah*, the agreement was *ultra vires* and thus unenforceable. The court rejected both these arguments on the basis that the transaction did not have a sufficient connection with Saudi Arabia for it to be rendered unenforceable under the principle of illegality. The court further held that the agreement was not *ultra vires* under the law of the Bahamas, where Islamic Investment had been formed. The court did not examine whether or not the agreement was a valid *murabaha,* but ruled that even if the agreement was beyond the scope of the stated objects of Islamic Investment, it was not void *ab initio*. Symphony further invoked the *Shari'ah* to defend against a claim for liquidated damages on the basis that such would amount to the payment of interest. However, the court held that the claim had been brought before an English court and by a company operating under the laws of the Bahamas, and as such, the grant of the remedy would not be subject to the laws of the *Shari'ah*.

While this judgement, naturally, is relevant in the jurisdiction of decision, it may well suffer enforceability issues in Islamic *fora* because Islamic courts, *e.g.*, in the Kingdom of Saudi Arabia (when they assert jurisdiction over a case) are likely to ascertain compliance with the law of the land before giving effect to foreign judgements that rule on matters that posit *Shari'ah* arrangements at their core.

4.1.3 *The Investment Dar Company v. Blom Developments Bank Sal* [6]

In the *Dar* case, pending trial as of the date of this publication, Investment Dar Company ("Dar"), a bank incorporated in Kuwait, entered into a *wakala* agreement with Development Bank SAL ("Blom Bank"). Under the agreement, Dar guaranteed to Blom a specified rate of return on the capital investment at the end of the investment period, characterized as "anticipated profit," payable regardless of whether or not the capital sum generated a profit in the hands of Dar. The investments made by Dar were not successful, and Dar failed in meeting its payment obligations under the *wakala* arrangements. Blom Bank sued Dar for repayment of the capital invested as well as the specified rate of return. In its defense, Dar argued that the *wakala* agreement was not *Shari'ah* compliant, and that under its constitutional documents, Dar was prohibited from engaging in non-*Shari'ah* compliant activities, thus rendering Dar's assent to the *wakala* agreement an *ultra vires* act not binding on Dar. The governing law provision of the *wakala* arrangements provided that English law will be applied, and placed a condition that Dar will use the funds only for *Shari'ah* compliant investments.

Dar claimed that a guaranteed rate of return is essentially *riba* and based the *ultra vires* argument on Article 5 of its memorandum of association:

> *"The objectives for which the company is established shall be Shari'ah compliant. None of the objectives shall be construed and interpreted as permitting the company to*

[6] [2009] EWHC 3545 (Ch).

> *practice directly or indirectly any usury or non-Shari'ah compliant activities."*

Dar survived Blom Bank's summary judgement motion on the *ultra vires* defense. The court held that the case would proceed to trial (despite expressing some skepticism on the soundness of the *ultra vires* argument). However, the court awarded summary judgement to Blom Bank for the capital sum, reasoning that, even if Dar's *ultra vires* defense prevailed, such would only apply to the fixed rate of return (*i.e.*, the anticipated profit), and Blom Bank would still be entitled to restitution and thus the original capital sum. The main questions for the trial court to consider are (i) whether the *wakala* agreement was *ultra vires*; *i.e.*, whether Dar lacked the legal capacity to enter into the *wakala* agreement, and (ii) whether to enforce a contract on the basis that it is not *Shari'ah* compliant, although the non-enforcement of the contract would ironically inure to the benefit of a party whose *Shari'ah* board initially (and subsequently) affirmed the *Shari'ah* compliance of the contract.

5.1 Conclusion

The foregoing analysis shows that some of the most significant issues involving Islamic finance transactions are rooted in (i) the governing law and dispute resolution clause of the underlying transaction and (ii) the shortfalls of the structure from a *Shari'ah*-compliance standpoint.

In the cases that have been examined here, the English courts have approached the cases with English law only and have set aside *Shari'ah* law. This opens the door to several issues; most notably, parties that sought to enter into a contract based on *Shari'ah* principles will be subject to remedies that may be in contravention to Islamic jurisprudence, including paying or receiving damages that include interest payments. Further, a judgement obtained by an English court that contravenes *Shari'ah* principles will not be enforceable in an Islamic jurisdiction such as the Kingdom of Saudi Arabia, where one of the parties may be registered or where enforcement may be sought. Thus, the parties that sought to conduct business in compliance with the *Shari'ah* but chose English law/courts as the preferred forum of dispute resolution may, if matters went to court, end up with remedies that are neither in line with the *Shari'ah* nor enforceable in the home jurisdiction.

Where disputes are adjudicated in Islamic *fora*, judges are likely to examine the underlying construct through a critical lens, and where structures are found to have been developed outside of accepted parameters and established *Shari'ah* principles (*e.g.*, AAOIFI guidelines), judges may, per their judicial prerogative, apply substance over form.[7]

Therefore, when structuring Islamic finance instruments, any provisions that run afoul of the law of the jurisdiction may render the instrument of tenuous enforceability, and the form of a product may well be unravelled to effect substance over form. Notably, even where the law of the jurisdiction has been followed, to the extent the instrument posits a structure that runs afoul of core *Shari'ah* principles, an Islamic adjudicative forum may still treat the instrument as a conventional instrument (and therefore undo the transaction, reverting parties to status quo ante, pre-transaction).

Whilst entering into Islamic finance transactions, it is thus imperative to (i) ensure that the contract is based on a sound structure that does not suffer from inherent flaws from a *Shari'ah* perspective and (ii) avoid selecting a governing law and dispute resolution forum that reaches a result that may contravene core *Shari'ah* principles. Otherwise, the parties to the contract may have, for at least one of the parties, unexpected and unpleasant surprises at adjudication.

[7] Judges in Islamic *fora* have broader discretion to exercise than their common law counterparts and have a duty to effect justice rather than give due effect to the strict construction of the contract when doing so would have problematic or impermissible results. From a *Shari'ah* perspective, a judge is to lean towards effecting justice between parties and lean away from the strict construction of a contract when giving effect to it would result in an egregiously unfair or impermissible result.

Forum Selection Under the Law of the People's Republic of China

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We came across an interesting clause regarding forum selection in China when we were engaged to review "General Terms and Conditions for Purchasing" by a European company's China subsidiary ("ABC Company"). The document says, in pertinent part: Place of Jurisdiction for all disputes arising from orders placed by the ABC Company shall be Shanghai. The ABC Company also has the right to legal recourse at the supplier's place of business. We suppose such a choice of jurisdiction must be valid in that European company's own country. Unfortunately it is invalid under the laws of the People's Republic of China.

Wikipedia ([http://en.wikipedia.org/wiki/Forum selection clause](http://en.wikipedia.org/wiki/Forum_selection_clause)) gives a template forum selection clause. It says: A simple forum selection clause covering both the proper law of the contract and the forum for resolving disputes might read:" This contract is governed by the laws of England and any dispute shall be finally resolved by the English courts." But if "England" is changed into "China" and "English" into "Chinese", this template clause will become invalid under the laws of P.R. China.

The provisions about choice of jurisdiction were set forth in the Civil Procedure Law of the People's Republic of China ("Civil Procedure Law"), codified in 1991 (revised in 2007) and the Supreme People's Court's Opinions on Several Questions regarding the Application of the Civil Procedure Law ("Opinions") in 1992 (revised in 1998). PRC laws allow contracting parties to choose a particular court or an arbitration committee for dispute resolution with the following restrictions:

1. Chosen Court Must Be Linked To The Contract In Certain Point

If a contract has no link to a particular court, the contracting parties can not choose that court for jurisdiction. According to Clause 25 of the Civil Procedure Law, the contracting parties are allowed and only allowed to choose a court

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located either in the plaintiff's domicile, or in the defendant's domicile, or in the performance place of the contract, or in the execution place of the contract or in the place of the contract subject.

2. Only one court or one arbitration committee can be chosen

Forum selection clause calls for express specificity .If more than one court, or more than one arbitration committee, or one court and one arbitration committee are chosen, the choice of jurisdiction shall be invalid. For example, if the parties simply say that their dispute shall be submitted to the arbitration committee in Beijing for settlement, then such choice is invalid; because there are more than one arbitration committees in Beijing including the Beijing Arbitration Committee and the China International Economic and Trade Arbitration Commission ("CIETAC"). As another example, if the choice is written as "court in the place of execution of the contract or in the place of plaintiff's domicile", such clause is also invalid as there are two choices. Needless to say, if a contract says "Shanghai court" or "Beijing arbitration committee", according to the PRC Laws, it shall be invalid too.

That's why we say that the clause used in that European company's "General Terms and Conditions for Purchasing" is invalid. For the ABC Company, the choice of jurisdiction is unspecified and uncertain, and this is not allowed under the PRC law. For the same reason, a forum selection clause can not say that any dispute shall be finally resolved by the Chinese courts.

3. Forum Selection Clause Can Not Violate Exclusive Jurisdiction Regulations

For some particular types of contracts parties are not allowed to choose place of jurisdiction. The so-called "exclusive jurisdiction regulations principle" under the Civil Procedure Law, stipulates that:

"The following cases shall be under the exclusive jurisdiction of the people's courts herein specified:

(1) A lawsuit concerning real estate shall be under the jurisdiction of the people's court located in the place where the real estate is located;

(2) A lawsuit concerning harbor operations shall be under the jurisdiction of the people's court located in the place where the harbor is located; and

(3)A lawsuit concerning an inheritance shall be under the jurisdiction of the people's court located in the place where the decedent was domiciled upon death, or where the principal portion of the decedent's estate is located."

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Shaping Internet Intermediaries' Liability in Europe – A Brief Overview of Recent Developments

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On 20 April 2012, the Regional Court in Hamburg issued an important decision concerning online service providers' (OSPs) liability for copyright infringements. In the case GEMA[1] v. YouTube, the Court ruled that the popular video sharing site is responsible for the content uploaded by its users, if it fails to implement certain controls and procedures. Having provided the means through which the infringements were committed (the hosting platform), YouTube was found liable for contributing to the infringements by its users, for the reason that it did not take down without delay the infringing material. Furthermore the Court held that while YouTube had no obligation to monitor all the material on the service so as to prevent copyright infringement, it will have to implement measures to avoid any future uploading and infringement of the GEMA repertoire. In practice this means that You Tube will have to improve its current filtering software and procedures, as a proactive measure against future infringements.

The German decision is not yet final (both GEMA and YouTube have appealed the decision). It nevertheless already helps to outline what in practical terms OSPs need to do to avoid liability for copyright infringements, in particular following the recent CJEU case law, summarised briefly below.

In the L'Oréal v. eBay case (Case C-324/09, 12 July 2011), the Court, referring to the popular online auction site, stated that the exemption from

[1] GEMA is the German authors' society that represents the copyright of more than 64.000 members.

liability in Art. 14(1) of Directive 2000/31/EC[2] does not apply to the operator that *"should have realised that the offers for sale in question were unlawful and, in the event of it being so aware, failed to act expeditiously in accordance with Article 14(1)(b) of Directive 2000/31"*. The decision therefore seems to confirm that constructive knowledge is the standard that triggers the OSP's duty to act. Likewise, the CJEU affirmed that following Article 11 of the Enforcement directive (Directive 2004/48/EC of the European Parliament and of the Council of 29 April 2004) Member States are obliged to ensure that online operators can be ordered by national courts to adopt appropriate measures to prevent both current and *future* infringements, thus imposing a more proactive regime for the operators.

In the Scarlet (Case C-70/10, 24 November 2011) and Netlog (Case C-360/10, 16 February 2012) cases the Court stressed the need for a fair and proportionate system of copyright protection, balanced with the other fundamental rights protected under the Charter of Fundamental Rights of the European Union (the freedom to conduct a business, the right to protection of personal data, the freedom to receive and impart information). The Court subsequently stated that the European Copyright directive (Directive 2001/29/EC of the European Parliament and of the Council of 22 May 2001) and the Enforcement directive obliged Member States to provide for the possibility to seek injunctions against intermediaries whose services are used by third parties to infringe copyright. However, the Court held that national courts could not order such intermediaries to monitor all of the traffic in their systems, a priori, at their own cost, and without the express support of a national law provision to do so. The Court also noted such a sweeping order would breach the prohibition against "general monitoring", set out in Article 15 of the European E-Commerce directive (Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000).

Meanwhile in the U.S. the U.S. Court of Appeal for the Second Circuit issued its decision (on 5 April 2012) in the landmark Viacom v. YouTube case. The U.S. District Court had previously found that YouTube was entitled to the protection guaranteed by the *safe harbour* provision provided by the U.S. Law – notably Section 512 of the USCA that provides broadly similar liability limitations to OSPs as the European E-Commerce directive – stating that the defendant did not have the awareness (regarding the infringing material) required in order for the OSP to fall outside the safe harbours. The Court of Appeals reversed the decision stating that *"a reasonable jury could conclude that YouTube had knowledge or awareness…at least with respect to a handful of specific clips"*, remanding the case to the District Court in order to evaluate whether YouTube was ineligible for the safe harbour protection (wilfully blind).

In the light of the above, it seems that the CJEU and national courts' case law is starting to shape the concrete liability regime for online operators, defining, on one hand, the minimum measures that OSPs are obliged to take in order to be eligible for the safe harbour protection granted by the European E-Commerce directive and, on the other, the forms of orders that can be sought against OSPs, including the "upper limits" for measures that OSPs can be ordered to take to prevent copyright infringements. In other words, the recent case law has shed some light over the boundaries of OSPs' liability, reducing the "grey area" that currently affects OSPs' duties.

[2] Art. 14(1) of Directive 2000/31/EC states that *"where an information society service is provided that consists of the storage of information provided by a recipient of the service, Member States shall ensure that the service provider is not liable for the information stored at the request of a recipient of the service, on condition that:*
(a) the provider does not have actual knowledge of illegal activity or information and, as regards claims for damages, is not aware of facts or circumstances from which the illegal activity or information is apparent; or
(b) the provider, upon obtaining such knowledge or awareness, acts expeditiously to remove or to disable access to the information."

The Franchise in Panama

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Law 35 of 1996 whereby provisions concerning industrial property were enacted established in its Article 126 that there exists a franchise when, by means of the user license of a trademark, a technical know-how is transmitted or technical assistance is provided so that the person to whom the franchise is granted may produce or sell goods or provide services in the same manner and with the operational, commercial and administrative methods established by the owner of the trademark in order to maintain the quality, the prestige and the image, which the trademark represents.

Panamanian legislation does not deal with the basic requirements of a user license contract by which a franchise is established. It only indicates that it is to be considered a franchise when technical know-how is transmitted or when technical assistance is provided in order to develop the business in the Republic of Panama while complying with certain quality standards.

This means that under Panamanian legislation both the franchiser and the franchisee shall only have the obligations and the rights contained in the user license contract, which is submitted to the Directorate General of Industrial Property of the Ministry of Commerce and Industries (DIGERPI) for its registration. Under Article 122, the following requirements have to be fulfilled in order to obtain the registration of a user license:

1. Personal or corporate name, nationality, place of organization, number of identity certificate or personal identity of the parties.
2. Denomination and/or description of the trademark, together with an indication of the number and date of registration.
3. Specifications of the products or services covered by the authority to use the trademark.
4. Type and term of the user license.

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For a user license to be registered with the Directorate General of Industrial Property of the Ministry of Commerce and Industries (DIGERPI), the trademark must be already registered, otherwise the application will not be processed until the Certificate of Registration of the owner of the trademark has been issued.

The franchise contract in Panama is governed by the principle of the autonomy of the will of the parties as provided by the Civil Code, since the franchiser and the franchisee may freely establish their rights and obligations, as well as the jurisdiction to which they will submit in the event of a conflict arising from the franchise contract concerning a specific activity.

In order to establish a franchise in Panama, it only has to comply with the existing legislation concerning industrial property and the other conditions required for a corporation to operate, such as the Notice of Operation (commercial license), and in the case of franchises of food, it must have the respective health permits.

The first franchise to be established in Panama was in the year 1957 concerning the vehicles of frozen products of Tastee Freeze, and two years later, that is in 1957, the Dairy Queen franchise which still remains in the market. The franchises that have more extensively developed in Panama are the McDonalds, Kentucky Fried Chicken, Pizza Hut and Burger King.

There are also national franchises such as Pio Pio and Don Lee. The Authority of the Micro, Small and Medium Enterprises, known as "AMPYME" in Spanish, is now developing models of franchises for such smaller enterprises in the Republic of Panama, and its main goal is the development of the methods of a system of franchises in four stages:

1. Knowledge Stage: during which the investor shall have the opportunity to learn every detail of what should be understood as a franchise.
2. Planning Stage: reviewing and establishing the strategy to adopt in the development of the franchise and the guidelines to follow.
3. Execution Stage: all of the manuals discussed in the planning state are executed and developed.
4. Establishment Stage: advisory services are provided concerning the establishment and actual operation of the franchise system in real time.

AMPYME is, with its model, mainly seeking to create a document for investors involved in the Franchise System, to use as an instrument for planning, induction and consultation, in order to achieve knowledge of the franchise in its strategic, commercial and operational aspects, while at the same time identifying the expectations of the franchiser and the objectives to achieve in the development of the project.

AMPYME has identified the following advantages or contributions of franchises to the national government:

- Fostering the development of "micro, small and medium" enterprises
- Creating jobs
- Fostering self-employment
- Increase in the quality and productivity of commerce and the services
- Increase in the GIP
- Increase of consumption
- Development of the investment
- Receipt of foreign currency due to export of franchises
- More offer of products and services in distant zones
- Regional development

Due to the construction of new commercial centers, there are now more than 200 franchises in Panama taking into account both the local and the international ones. The international ones are the ones prevailing in the market, and this is one of the reasons why AMPYME has chosen ten concepts to develop for the creation of franchises, such as beauty salons, ceviche sales, ice cream, roast meat restaurants, laundries, shoemakers and tailor shops, popular drugstores, child care centers, bakeries and sweets producers.

Finally, the success of franchises in Panama is based on the trust and smooth communication of the parties and the enterprise will of the franchisee, as well as the professional administration of the franchiser.

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Taxation of American Trusts in Germany – A Frequently Overlooked Aspect In Wills And Estate Planning

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American trusts are created for several purposes as asset protection, privacy, tax avoidance and wills planning. Trusts are therefore very popular as an instrument for estate planning. All too frequent it is hereby overlooked that in case there is a nexus to Germany, German tax may be levied.

In principle American trusts are unknown to German civil law. However, with the purpose to stop tax avoidance by transferring assets to a foreign trust the German legislator implemented some regulations which take several actions concerning foreign estate like American trusts under taxation. As it is laid down in Section 3 Para 2 (1) and Section 7 Para 1 (8) and (9) German Estate Tax Act the provision of a trust and all the distributions to beneficiaries are laid down under estate tax or gift tax (both types are regulated in the German Estate Tax Act and are handled similar). Precondition of the taxation is that there is a nexus to Germany. Such a nexus exists in case the settlor, the trustee or the beneficiary has his residency in Germany or is a German citizen with residency abroad up to five years. However, these new regulations keep several open questions which haven't yet been answered neither by the courts nor the tax authorities.

In many cases with nexus to Germany the beneficiary resides in Germany. Even if the settlor's residency is in the US and the trust is an American one with all real estate located in the US, as soon as the beneficiary takes up residency in Germany he may be affected by German taxation although he is an American citizen. Principally the American-German Estate and Inheritance Tax Treaty refers the place of taxation to the country where the testator or donor has its primary residence. But pursuant to Art. 11 of that treaty Germany has reserved its right to levy estate tax from the heir regardless where the settlor's residency is.

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As it is laid down in Section 7 Para 1 (9) in conjunction with Section 9 Para 1 (2) German Estate Tax Act, in principle all distributions during the existence of the trust and the final distribution of all the principal to the beneficiary is subject to German gift tax or estate tax at the time of the distribution. If the beneficiary achieves an irrevocable expectant right on all principal and distributions upon the settlor's death the question may arise, whether this expectant right will already cause German estate tax. There is a regulation laid down in Section 15 Para 1 German Foreign Transaction Tax Act, which ascribes principal and income to beneficiaries for taxation purposes in case they have an expectant right on it. But this principle doesn't apply for estate tax (Section 15 Para 1(2) German Foreign Transaction Tax Act), so for estate tax or gift tax purposes the expectant right is of no significance. Estate tax will only be levied in case of actual inflow.

But all this depends on the trust category. Even though the main structure of trusts is similar there are many varying types depending on the characteristics and the purpose of the trust. The German Estate Tax Act on the other hand takes only trusts under taxation whose purpose is the tying up of assets. This German specification of the trust has to be taken under examination in every individual case as it depends not only on the American category as a revocable or an irrevocable trust. A trust with the purpose of tying up assets may not be assumed in case the trust is revocable, terminable without any requirements, the trustee is bound to the instructions of the settlor and the settlor has a significant influence to investment decisions. But it is highly controversial, when the purpose of a trust is the tying up of assets, and this aspect should therefore be taken under examination carefully. Only in case the trust is one with tied-up assets, German estate tax will be levied from the beneficiary not before the time of the distribution. If the trust is not one with tied-up assets the beneficiary receives the assets right upon the settlor's death and be levied with estate tax immediately. So, first of all the German category of the trust has to be resolved by an expert under consideration of current judicial decisions.

If the beneficiary hasn't yet resided in Germany for ten years, Art. 4 Para 3 American-German Estate and Inheritance Tax Treaty would eventually eliminate estate tax at all. According to the letter of that regulation estate tax will not be levied in case the decedent (with residency in Germany upon his death) has stayed in Germany for not longer than ten years. It is controversial if this provision is applicable to the heir, too, although this point of view might be vindicated with good reason. But one should not trust on it without obtaining expert advice for one's individual case.

In case estate tax was levied, in principle the heir would get some tax credit in Germany for estate tax paid in USA. Pursuant to Art. 11 Para 3 lit. b American-German Estate and Inheritance Tax Treaty principally the tax credit method would be applied, so that Federal estate taxes paid in the USA would be deducted from the German estate tax (for estate tax of member states Art. 11 Para. 4 DBA-E USA is applicable). But the American estate tax situation should be examined carefully. The tax deduct could be different in individual cases, for example if the US gave some tax breaks.

In view of the extensive implication and the not distinct legal consequences in all cases, the legal classification of the trust category and the tax effects also considering the American-German Estate and Inheritance Tax Treaty should be taken under examination in good time to have an early opportunity for changes in estate and gift tax planning. To avoid any German tax effects the time of residence in Germany has to be kept in mind with regard to Art. 4 Para 3 American-German Estate and Inheritance Tax Treaty. But no decision should be taken without having recourse to legal advice before.

In cases where the settlor's residency is in Germany principally the creation and provision of a trust is taken under German taxation pursuant

Taxation of American Trusts in Germany – A Frequently Overlooked Aspect in Wills and Estate Planning.

to Section 3 Para 2 (1) and Section 7 Para 1 (8) German Estate Tax Act. This provision also presupposes that the trust is one with tied-up assets. On contrary to the case mentioned above (where the nexus to Germany is the beneficiary's residence) Art. 4 Para 3 American-German Estate and Inheritance Tax Treaty will exclude estate tax if the settlor with American citizenship resides in Germany up to ten years. Anyhow, to assess the tax situation properly and to avoid any risk, settlors with residence in Germany should obtain early expert advice.

Despite of the settlor's and beneficiary's residence, the residence of the trustee has to be taken under consideration, too. If the trustee's residence is in Germany the tax authority could consider the management of the trust as situated in Germany. In case the settlor with residence in the US founds a trust or provides an already existing trust with further assets this could be levied with gift tax pursuant to Section 7 Para 1 (8) German Estate Tax Act. Additionally it may not be overlooked that even if neither the settlor's, the trustee's nor the beneficiary's residency is in Germany, assets situated in Germany could be subject to German taxation (limited tax liability). Pursuant to Section 2 Para 1 (3) German Estate Tax Act and Art. 5 Para 1 American-German Estate and Inheritance Tax Treaty real estate in Germany could be subject to German taxation. Tax credit might be given by the American tax authority pursuant to Art. 11 American-German Estate and Inheritance Tax Treaty.

Despite of estate and gift tax the income tax situation has to be taken under consideration. Usually assets are held in the trust which produces income such as from renting out or leasing real estate or income from savings and capital investments. In case the settlor with residence in Germany has significant influence to investment decisions the income may be attributed to the settlor with the consequence of income taxation even if there are no distributions. But even without significant influence by the settlor income tax may be levied if the management of the trust is considered in Germany because of the trustee's residence there. Despite of influence on investment decisions the income tax situation depends also on the question whether the trust is a so-called family trust. A trust will be considered as a family trust if the settlor, his relatives or their children are beneficiaries to more than half of the income or estate. Pursuant to Section 15 German Foreign Transaction Tax Act in this case the income will be attributed either to the settlor or the beneficiary with residency in Germany.

According to all the tax consequences mentioned above the will and estate planning will have to contemplate German taxation if there is a nexus to Germany. The taxation of trusts in Germany is highly controversial in many points and the risk of being levied with German tax should not be evaluated without considering individual aspects. In cases with an expected nexus to Germany early expert advice is highly recommended.

Is Islamic Finance a Failure? A No-Holds Barred Assessment of the Industry's Current State

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The Islamic finance industry is reported to be valued at over one (1) trillion dollars, with an estimated annual growth rate of ten (10) percent. (Global Islamic Finance Report, 34 (Humayon Dar et al eds., BMB Islamic ed. 2011)). The industry is continuing to grow despite its inherent problems, and market analysts project that it will be valued at anywhere from three to five trillion dollars by 2016.

Today, Islamic finance is beset with problems including those relating to credibility, regulatory, enforceability, uniformity (including Shari'ah issues), lack of scholarship/training and being fundamentally out of sync with its spiritual and ethical mandate.

Credibility/Reputational Problems

More often than not, people have said to me – Islamic finance is a sham. They don't see the difference between Islamic banking and conventional banking and cannot differentiate between conventional and Islamic products. Some of this criticism is unfair and due to a lack of understanding of the difference in the actual risk profiles between the two (e.g., in an Islamic ijara project/property finance transaction, the financier assumes the risk of loss of the asset which is markedly different than that in a conventional mortgage situation where the mortgagee (bank), as lender rather than owner, does not assume such risk of loss); however, in other products such criticism is warranted. A case in point is the term 'Islamic bond' – this oxymoron used so commonly by practitioners and the media suggests that Islamic finance can offer a debt instrument that generates an interest-based return – a complete absurdity. A study of some market sukuk structures, however, reveals that the term 'Islamic bond' is correctly applied to such 'market' structures. However, to call a sakk (singular of sukuk) an Islamic bond is tantamount to calling Johnny Walker Whisky 'Islamic Booze.'

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Some of the structures relied on to solve the 'problem' of 'uncertainty' in an insurance transaction are a prime example of fundamentally unenforceable structures. To obviate the uncertainty (lack of knowledge of the actual date of occurrence of a risk of loss) in an insurance transaction, structures were devised where the premium payer 'gifts' the premium (with no expectation of return) to the credit of the takaful fund and then the takaful fund (while having no obligation to pay) 'gifts' back the proceeds (assuming enough of a balance remains in the fund) upon the occurrence of an event of loss. This way the parties are just making the gifts and 'not really getting into a contract.' But they are and expect it to serve as an enforceable obligation! However, based on Shari'ah precepts, once a gift is made there can be no expectation of a return. Thus, the entire construct is built on a false premise and the contract is invalid (this excludes those contracts where conditional contributions are made to a pooling arrangement). This sort of circumvention (hila) by making two unilateral 'gifts' (circumventing the risk of supposed uncertainty in a contract) effects the seemingly proscribed transaction through a sham arrangement. Ironically, the 'uncertainty' inherent in such transactions is not even of the proscribed type in any case (for greater detail, *see* Oliver Agha, *Tabarru in Takaful: Helpful Innovation or Unnecessary Complication?* 9 UCLA J. Islamic & Near E.L. 101 (2010)).

Such constructs demean the Islamic finance industry and spur the hackneyed adage that 'Islamic finance is a sham.' In truth, there is substantive basis for the development of Islamic insurance (which should be based on mutual arrangements and a commitment to refund premia on certain events upon non-occurrence of events of loss).

Lack of Regulatory & Legal Framework; Governmental Action

Legal and Regulatory frameworks in countries are generally severely deficient (with some exceptions e.g., Malaysia and Pakistan) and do not provide a framework for the fluidity required for efficacious transactions; nor does the system envisage the requisite Islamic procedures/laws/dispute resolution systems – Islamic finance is not understood and in some instances (and in Islamic jurisdictions) is not even treated on par with conventional finance.

More needs to be done at the Governmental levels, including formulating Legal and Regulatory frameworks that (i) delineate standards applicable to the products/constructs in the industry (AAOIFI guidelines are helpful but not dispositive and in some areas need review and revision to reflect consistency and cogency) (ii) develop substantive laws on property/real estate transactions that detail the rights and obligations of Islamic financier vs. developer vs. customer (clearly mortgage laws have little application in an Islamic ijara financing as the financier/property owner cannot properly be granted a mortgage on property that it owns) (iii) otherwise 'level' the playing field between conventional and Islamic banking (e.g., reduce transfer fees in Islamic banking that need to occur twice where in conventional there is just one property transfer) and (iv) simultaneously address the issue of transactions that have Shari'ah Board approval but are in stark contravention of the law of the Country (e.g., beneficial ownership is not dispositive while registered ownership is when pursuing a defaulting customer).

Not surprisingly, the relevant authorities have little understanding of how to handle Islamic disputes – in some instances authorities have sent ijara disputes to rent committees to sort out. This completely misses the picture as the underlying transaction requires careful consideration from an overall Islamic lease to purchase transaction with a fine understanding of the other elements that such transaction contain, including complex (and sometimes tenuous) purchase undertakings and in some cases, deeply problematic 'forward lease constructs' that are neither forward leases nor necessarily enforceable from a Shari'ah or a legal perspective.

Our experience in litigating complex Islamic transactions in GCC jurisdictions reveals that judges may be at a loss to properly adjudicate complex modern-day Islamic transactions. As a result, there is confusion amongst Islamic financiers, consumers and the other stakeholders about exactly what they can expect in court when things turn sour. This in turn does not augur well for the development of the Islamic finance industry, if left unchecked.

Enforceability

Assuming that there is a judicial system that is capable of dealing with Islamic disputes/arbitrations, there are a host of complex enforceability issues at play in Islamic transactions that seem to be lost on issuers, banks and more importantly not highlighted to consumers.

A case in point is a deal where parties elected to subject English law to 'Shari'ah' in a contract as per their agreement. In other words, the Islamic instrument was to be enforced in accordance with English law, but always in accordance with applicable Islamic law precepts. However, English Courts in such a situation have not applied Shari'ah because it was deemed not to be a governing body of law but a mere embodiment of Islamic religious principles. In the Shamil Bank case, the court noted that the Rome Convention 1980, scheduled to the Contracts (Applicable Law) Act 1990, only contemplated and sanctioned the choice of the law of a country, not a religious principle. Furthermore, the court held that "the reference to Shari'ah law was repugnant to the choice of English law and could not sensibly be given effect to." One can surmise then that when extraneous law is clear and specified, it will still not be applicable if there is a conflict with English Law.

Given such pronouncements, Islamic jurists will invariably revisit English judgments on a 'de novo' basis to determine whether there is genuine compliance with Shari'ah principles. How scholars have signed off on deals where such an election of laws is specified is mystifying. Perhaps, an explanation could be that the impact of conflict of laws (a highly complex subject) was not explained to them in the deals on which they were opining.

Uniformity (Shari'ah Scholar Issues)

The lack of standardization in Islamic finance creates confusion across the World of the dependability of structures and consistent application of principles across the board. While AAOFI, IFSB and World Islamic Finance Institute (WIFI, a newly established European body with an ambitious mandate) are Islamic bodies that work on developing standards, uniformity and developing communications among the stakeholders, there is much work that needs to be done on a faster track and with a deeper involvement of the stakeholders from different realms of the Islamic finance industry. There is, unfortunately, a lack of an overall vision and such disparate endeavors lack a cohesive, cogent and comprehensive approach to tackle the key issues facing the industry. Closer coordination must occur between these bodies and a comprehensive approach developed.

The Shari'ah scholars have largely done well in handling the inexorable demands placed on them and deep pressure to yield to structures that are cleverly crafted to appear compliant but lack substantive compliance. However, they need to make some clear strides in certain areas to develop the Islamic finance industry. Their opinions need to be published and clearly set forth with their legal reasoning. Individual diktats that lack basis in Islamic law must be questioned – the doctrine of necessity which at law was used sparingly mostly in life and death situations (e.g., permissibility to eat pork to survive if starving) is not appropriate to sanction instruments that serve economic convenience and would never independently be acceptable under Shari'ah. The fee arrangements under which the scholars operate need to be transparent and avoid any suggestion of undue compensation or reputational considerations that create an innuendo of a conflict of interest. There needs to be consistency in methodology and approach and acknowledgement of precedent; the oft hackneyed phrase that 'Shari'ah does not acknowledge precedent' is overly simplistic. Islamic Law simply gives the judge greater discretion in determining whether to apply a previous judgment based on a broad consideration of whether there are any different factors present in the case before them at that time. When an Islamic judge (Qadi) applies analogical reasoning (Qiyas) and reviews an earlier case, the earlier ruling is applied if the underlying cause ('illa) of the old case is present in the one before the court. A judge is not bound to blindly apply precedent but on the same hand it would be very unusual for a judge to disregard precedent capriciously and without any ameliorating circumstances, while staying true to the correct application of the law.

Human Capital

There is a dearth of human capital in the Islamic finance industry. At the core, there are few western style Islamic institutions that attract and educate the best and brightest in the Islamic World. Generally, many lawyers practicing as Islamic finance lawyers have little knowledge of Islamic law and have just worked on a subset of transactions without an independent study of the core sources of Islam or Islamic Law. Imagine a Securities Lawyer practicing Securities Law in the US without having read the Securities Acts or a Tax Lawyer who has never studied the Tax Code!

Conventional bankers largely seem enthused about the market opportunity which exists but in most cases without a due appreciation for the spiritual principles that underlie Islamic finance. When you go through the challenges confronting the Islamic finance market, it is a wonder that it has survived at all; in fact, it continues to grow despite the endemic and extraneous pressures. In sum, Islamic finance has survived and grown despite the mistakes/inadequacies of the stakeholders/practitioners.

Solutions?

The Solutions are relatively simple to enumerate – but harder to implement.

- The Islamic World needs visionaries that take on the mantle of ethical finance and seek to develop it along the lines it was meant to be developed, i.e., a spiritual system of finance that builds partnership and risk-sharing constructs rather than exploitative or adversarial contracts that leave no room for accommodation in a downturn. There is a crying need for prominent magnates to show that money can be made (and success achieved) in this world while keeping spiritual principles in mind.
- Governments need to establish Islamic finance task forces in their countries to critically assess the state of Islamic finance; such groups need to comprehensively review the regulatory and legal structures, promulgate laws that fill in the much needed gaps, and create proper dispute resolution centers.
- Governments need to devote significant amount of funds in developing Islamic scholarship – the Islamic World does not need to spend money on nuclear warheads (a weapon that is inherently un-Islamic based on a study of salient Hadith (saying of the Prophet (pbuh)) and a topic perhaps for a different article) but devote more resources on developing fine institutions that can offer Harvard, Yale or Oxford style education to craft trained, sophisticated and integrated Islamic jurists as well as financiers, lawyers and accountants.
- Conventional dispute resolution centers need to be recalibrated to handle Islamic disputes – with a rework of the applicable rules/procedures.

Is Islamic Finance a Failure?
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- Corporations, Islamic Banks and Insurers need to reflect best practices as suggested by AAOIFI, by having at least three scholars on their board as well as a financial advisor and a lawyer who are well-versed in Shari'ah. Otherwise, the opinions/fatwas may reflect problematic gaps.
- As importantly, individual consumers need to examine what they are offered and ask questions if anything seems to be in basic conflict with Shari'ah principles; Islamic finance is not rocket science. It is a simple discipline made unnecessarily complicated sometimes to achieve impermissible ends. Consumers should make their opinions known and write to the Islamic banks and institutions with an effort to help develop the industry and failing that to the quasi-regulatory bodies noted above.

Perhaps the greatest philosopher in Islamic history, Ghazali, noted when asked about his quest in discerning the truth from error:

> *[M]y daring in mounting from the lowland of servile conformism to the highland of independent investigation . . . what I found loathsome among the methods of the devotees of ta'lim, who restrict the truth to uncritical acceptance of the Imam's pronouncements . . . what I seek is knowledge of the true meaning of things . . . sure and certain knowledge is that in which the thing known is made so manifest that no doubt clings to it, nor is it accompanied by the possibility of error and deception, nor can the mind even suppose a possibility.* ABU HAMID MUHAMMAD AL-GHAZALI, AL-GHAZALI'S PATH TO SUFISM 17-20 (R.J. Mc- Carthy trans., Fons Vitae 2000).

Islamic banking should also serve as a stabilising force in the global economic order. The financial crisis of the past few years has led to an increased awareness of the problems with conventional banking. The crisis has led to enhanced regulatory attention and plans to control 'risk' in the conventional banks. The 'risk' in these systems is multiplied by the very nature of fractional reserve banking, which gives conventional banks the discretion and power to simply create or eliminate credit, albeit subject to apparently stringent rules. For example, when asset prices increase at a fast pace, conventional banks seize the opportunity by granting more credit (based on deposits which are the bank's liabilities, for each additional dollar deposited many more are loaned out under the fractional reserve system) that as the crisis reveals can become problematic. Deposits in Islamic banks (which are not loans but true investment deposits on a mudaraba basis), however, are reinvested in the real economy to create new flows of goods and services without any artificial money expansion. The 'choking' of credit and its devastation on the economic system has highlighted the fragility and inherent weakness in the interest bearing debt-based financial system. These factors should result in a closer look at the equity-based constructs that are a mainstay in the Islamic system and one more reason that should spur the development of Islamic finance.

So, is Islamic Finance a failure? No; it is never fair to blame a discipline for the failures and shortcomings of its adherents. However, for it to continue to have the continued correct growth it must come back to its spiritual underpinnings best reflected by the motto: 'Principle before Profit."

Oliver Agha, Founding Partner of Agha & Co/Agha & Shamsi, the World's first Shari'ah-compliant firms, Board Member of AAOIFI and Secretary General of the World Islamic Finance Institute (WIFI).

Cyprus International Trusts Reborn

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A. Introduction

On the 8th of March 2012 the House of Representatives enacted the long awaited International Trusts (Amending) Law of 2012 effecting various structural amendments to the International Trusts Law of 1992.

The amendments effected to the International Trusts Law of 1992 were necessary in order to adapt the Cyprus law on trusts with the current needs of international investors having in mind the new opportunities and the current investment practices.

The amendments are also aimed to strengthen Cyprus as an international financial center and increase its attractiveness as a trust jurisdiction.

A new era on Cyprus trusts begins with a new modern law on trusts in place.

B. The Main Amendments – New Provisions

The below are the new provisions as enacted by the amending law.

Possibility for the Settlor and beneficiaries to relocate to Cyprus after the establishment of the Cyprus International Trust

According to the provisions of the 1992 Trust Law it was not clear whether the settlor or the beneficiaries could relocate to Cyprus after establishing a Cyprus International Trust. The new law clarifies this uncertainty and gives the opportunity to the settlor and to the beneficiaries to relocate to Cyprus and become tax residents of Cyprus on the condition that both of them were not residents of Cyprus during the calendar year which precedes the year of the establishment of the trust. Such relocation, if takes place, does not affect the validity of the Cyprus International Trust.

Trustee

The notion of the trustee has now been clarified to include any legal or physical person who holds the trust property; (a) to the benefit of

Settlor

Means a legal or natural person, who grants trust property or makes a disposal for will purposes, subject to trust terms or to a trust.

Beneficiary

Means, legal or natural person including a person not yet born on the date of the establishment of the trust or part of a class of persons, who have a right or interest in property, which is subject to a trust.

Protector

The protector is identified as a person other than the trustee to whom powers of any nature have been granted by the deed establishing the trust, including the power to advise the trustee regarding the exercise of his powers or with regards to the right of the protector to consent or to veto and includes also the power to appoint or cancel the appointment of the trustee.

Trust Enforcement Supervisor

A new person has been introduced as a part of the members of a trust, namely, the trust enforcement supervisor. The trust enforcement supervisor is the person or persons whose duty is to secure the execution of a Cyprus International Trust established for not charitable purposes.

Resident of Cyprus

The notion of resident of Cyprus has been clarified and has now the meaning given to it by the Income Tax Laws. In effect, a physical person is considered as resident of Cyprus if he/she resides in Cyprus for a period which exceeds in aggregate 183 days in a tax year. A company is considered as resident of Cyprus if its management and control is exercised in Cyprus.

Clarification of Other Various Terms

The meaning of: "objects of a discretionary trust", "judgment", "creditor", "disposal", "right to an estate", "trust property", "intention to defraud", "personal relationship", "obligation", have also been defined in the new law.

Powers of a Trustee, Protector, Settlor and Trust Enforcement Supervisor

The powers and authorizations granted by the new law to a trustee, protector, settlor and trust enforcement supervisor respectively, are in addition to the powers and authorizations, which may have been granted to them under the trust deed. The powers and authorizations granted by the law apply only if and to the extent that there is no contrary intention expressed in the terms of the trust and apply subject to it terms.

Validity of Cyprus International Trusts

Any matters in relation to the validity, interpretation, amendments and revocation and inter alia administration of a trust are determine in accordance to the law in force in Cyprus without reference to the law of any other jurisdiction.

Further, the existing legislation of Cyprus or the legislation of any other country regarding inheritance of succession does not affect according to the new trust law in any way the transfer or disposal or validity of the Cyprus International Trust. In effect, with this new provision the terms of the Cyprus International Trust prevail over any legal provisions as to inheritance of property.

The validity of the Cyprus International Trust is also not affected or the eligibility of any settlor, trustee, trust enforcement supervisor, protector, beneficiary cannot be disputed and none of the above persons have any liability or obligation or may be deprived of any right, claim or interest by virtue of: (a) any provisions of any law in any jurisdiction which do not recognize the notion of trusts or (b) that the trust or the disposal : (i) cancels rights, claims or interests, arising from the legal provisions of any jurisdiction due to personal relations with the settlor or beneficiary or due to rights in an estate or (ii) the trust or the disposal is contrary to any law, judgment or order in any other jurisdiction.

Cyprus International Trusts Reborn

Asset Protection Clause

The existing asset protection clause has been amended giving additional protection to trust property in such a way that no action can be brought against assets of the trust which have been transferred to a Cyprus International Trust in case of subsequent bankruptcy or liquidation of the settlor or in case of actions brought by the creditors against the settlor irrespectively of the fact that the trust has been set up without consideration or to the benefit of the settlor or his/her wife or his children or to anyone of them, unless it can be proved that the Cyprus International Trust has been set up with the intention of the settlor to defraud his creditors at the time of transferring of his assets to the trust. The existing two-year time limit to file such an action has not changed.

Extended Powers To Settlor

The new law specifically permits the settlor to reserve for himself certain powers and such reservation of rights, do not affect in any way the validity of the trust or the execution of it. Such powers may include any one of the following:

(a) to revoke, amend the terms of the trust;
(b) to grant, distribute, pay or dispose in any form, of income or capital of the trust or give instructions as to the above;
(c) to exercise the powers of a director or officer or give binding instructions regarding the appointment or removal of any director or officer of any company, which is owned wholly or partly by the trust;
(d) to give binding instructions to the trustee in relation to the purchase, retention, sale, administration, financing, pledging or encumbering of the trust property;
(e) to appoint or remove any trustee, enforcer of the trust, protector or beneficiary;
(f) to appoint or remove any investment manager or investment advisor;
(g) to change the applicable law which governs the trust or the forum of administration of the trust;
(h) to restrict the exercise of any power or discretion of the trustee demanding that these are exercised only with the consent of the settlor or any other person expressly referred to in the terms of the trust.

Duration of a Cyprus International Trust

The new trust law expressly provides that the Cyprus International Trust may exist in perpetuity and in effect cancels the previous existing limitation which restricted the duration of Cyprus International Trusts up to one hundred years.

Charitable Trusts – Purpose Trusts

The new law lists further purposes which constitute a trust to be a charitable trust.
The law also recognizes trusts established for a particular purpose and such a trust is enforceable by the settlor or his personal representatives or the trust enforcement supervisor.

Approved Investments By The Trustees

The new law has given extended powers to the trustees to invest as if they were the absolute owners of the trust property and also give them express freedom to invest in any property, movable or immovable, situated anywhere in the world including Cyprus.

Immovable Property Situated In Cyprus

It is now permitted for Cyprus International Trusts to invest in any movable or immovable property situated in Cyprus. The law makes specific reference as to the possibility of investments in shares of companies registered in Cyprus.

Amendment Clause

The provisions of the trust deed may be now amended according to the specific clauses of amendment provided in the trust deed itself. Amendments following an application in court are also possible.

Confidentiality of Cyprus International Trusts

The existing confidentiality provision has been extended. The new law provides that unless a court order is issued, the trustee, the protector, the enforcement inspector or any other person, cannot disclose to any person any documents or information, related to the trustees or to the beneficiaries, referring to the exercise of the powers of the trustees or related to the accounts of the Cyprus International Trust. The court may issue an order directing the disclosure of information provided it will consider such a disclosure order is important for the administration of justice. The trustees have the discretion whether they will disclose any account of the trust to the beneficiaries.

Application To Court For An Order For Directions

The trustee may apply in court to receive directions as to how he/she will act in relation to a particular matter. Also, the court may issue any relevant order as to the trust and such an application may be filed by the trustee, protector, trust enforcement supervisor or any other person.

Taxation In Relation To Trust Property And Distributions To Beneficiaries

The income and gains of a Cyprus International Trust which are acquired or deemed to be acquired from sources inside and outside of Cyprus, are subject to taxation imposed in Cyprus only in the case where the beneficiary is a tax resident of Cyprus.

In the case where the beneficiary is not a tax resident of Cyprus, then, only the income and gains of the Cyprus International Trust which are acquired or are deemed to be acquired from sources inside Cyprus, are subject to taxation in Cyprus.

Income and gains of Cyprus International Trusts acquired or deemed to be acquired outside Cyprus and provided the beneficiaries are not tax residents of Cyprus, are not subject to any tax in Cyprus.

Governing Law of the Trust

As per a new provision in the law any trust is governed by the law which the settlor has chosen according to the terms of the trust deed. Where no applicable law has been chosen the trust is govern by the law that is more closely related to. There are certain guidelines in the law by which the court will identify which is the law more closely related to the trust.

Exclusive Jurisdiction of Cyprus Courts

According to a new provision in the law, Cyprus courts have exclusive jurisdiction on a Cyprus International Trust once it is provided that the applicable law of the trust is the law of Cyprus or the trustee is a resident of Cyprus or any asset of the trust is situated in Cyprus or the administration of the trust is carried out in Cyprus or the parties accept the jurisdiction of Cyprus courts or the trust deed establishing the trust provides that any dispute will be decided by the Cyprus courts.

In case of a foreign court judgment dealing with any issues of Cyprus International Trust on which Cyprus courts have exclusive jurisdiction, then a foreign court judgment might not be enforceable in Cyprus as being contrary to public policy issues.

Election of Cyprus Law in Cyprus International Trusts

In the case where the Cyprus International Trust is governed by Cyprus Law, then the provisions of the new law apply irrespectively of any contrary provisions in any other law in Cyprus and as provided in the new law, the provisions of the trust law are of superior power of any other law in Cyprus and are considered to be provisions of public order.

Enforceability of Foreign Trust In Cyprus

Foreign trusts are enforceable in Cyprus unless the court declares that they contravene public interest.

Express Duty of The Trustee

The trustee is obliged to comply and apply the provisions of the Prevention and Suppression of Money Laundering Activities Law and hence is obliged to carry out proper due diligence by implementing the "know-your-client" principle and maintain an adequate record-keeping procedure.

Retrospective Effect of the Law

According to a particular provision the new law its provisions are applicable to all Cyprus International Trusts whenever established and the relevant provisions of the law do not affect the validity of any precedent valid, disposal or transfer.

C. Conclusion

The Cyprus law on trusts has been reborn. Trusts in Cyprus begin their new era giving a favourable trust regime ensuring that international investors, settlors and beneficiaries enjoy the highest possible decree of protection in a modern and attractive favourable environment.

Settlors, trustees and beneficiaries are highly protected as the provisions of the international trust law clearly provide that in case the trust is governed by Cyprus law any foreign jurisdiction laws can not affect their rights as identified in the trust deed. In addition strict confidentiality is secured prohibiting any disclosure of information unless a court order is issued.

From the tax aspect, in case the beneficiaries are not residents of Cyprus and the generated income of the trust is acquired from sources outside Cyprus, then there is no taxation on the income and gains of the trust.

Cyprus as a trust jurisdiction has now become an important player and prime location in the field of international trusts.

D. Disclaimer

This publication has been prepared as a general guide and for information purposes only. It is not a substitution for professional advice. One must not rely on it without receiving independent advice based on the particular facts of his/her own case. No responsibility can be accepted by the authors or the publishers for any loss occasioned by acting or refraining from acting on the basis of this publication.

Our Firm

Kinanis LLC, a law and consulting firm, is one of the leading business law firms in Cyprus and advises the international investor and private clients on all aspects of law, tax and accounting.

Kinanis LLC continues the business of Kinanis & Co established in 1983. The firm started its operation as a traditional law firm. Experience and practice over the years brought forward the need for transformation from a traditional law firm to a more innovative multidisciplinary firm providing a full range of services combining law and accounting with the extensive expertise in corporate and tax advice to ensure that our clients will obtain the best possible spherical advice.

Our involvement and participation in international transactions over the years, have established our firm as one of the key players in the field.

The firm is staffed with over 80 young, energetic and ambitious professionals, including lawyers, accountants and administrators who provide prompt, efficient and high quality services and who are capable of meeting the current demanding challenges of the local and international business environment.

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A. Introduction

On the 13th of March 2012, the Cyprus VAT Authority has launched a scheme making Cyprus one of the most attractive EU jurisdictions for yacht registration. According to this scheme, a Cyprus company can enter into a lease-sale agreement of a yacht with a third party, paying VAT only on a considerably reduced VAT rate than the standard rate which is 17%, calculated on a percentage of the time that the yacht is deemed to sail within EU waters as is analytically explained below. The effective VAT rate through the use of this scheme can be as low as 3,4%, which is increased to 4,42% when taking into account the required profit condition as it will be explained below.

B. Interpretation Of Terms - VAT Treatment

A lease-sale agreement of a yacht is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of a yacht. In addition, the lessee has the option to acquire ownership of the yacht by the end of the lease agreement at a percentage of the original price.

The leasing of a yacht for VAT purposes is considered to be a provision of a service. This kind of service is subject to the standard VAT rate of Cyprus (17%) but only to the extent the lease is *taking place within EU waters* (please refer to tables 1 and 2 in section D). It should be noted that the lessor of the yacht should be a Cyprus tax resident company registered with the Cyprus Registrar of Companies, whist the lessee can be any person or company irrespective of their place of residence or establishment.

C. Conditions

In order for the aforementioned VAT treatment to be applicable, ALL the following conditions should be met:

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1. The lease-sale agreement of the yacht should be made between a Cyprus company (lessor) and a person or company irrespective of their place of residence or establishment (lessee).
2. The yacht should sail in Cyprus within one month from the date the lease-sale agreement of the yacht becomes effective. An extension to this deadline can only be given by the Cyprus VAT Authority. It is to be noted that the extension cannot exceed the period in which the lessee can exercise his option to buy the yacht.
3. The lessee should initially pay the lessor at least the 40% of the value of the yacht.
4. The lease payments should be made on a monthly basis and the lease agreement should not exceed the period of 48 months.
5. The lease agreement should result in profit for the lessor amounting at least to 10% of the yacht's original value. Thus, at the inception of the lease agreement, the total amount of the lease payments on which the VAT is accounted, is increased by the half of the profit i.e. 5%. The remaining 5% of lessor's profit will be paid along with the final instalment.

Example:	*€*
Original Value of the yacht	*15.000.000*
Required Profit on installments - 5%	***750.000***
Total Value including 5% of the profit	*15.750.000*
Less Downpayment -40% of the original cost	*6.000.000*
Due in Installments (Up to 48 months)	*9.750.000*
Residual Value 5% of the original value to be paid along with the final instalment	***750.000***
Total amount including 10% of the profit	*16.500.000*

6. The lease agreement will grant the lessee the option to buy the yacht at the end of the lease period at a price which must be not less than 5% of the original value of the yacht. The last payment made by the lessee to the lessor is subject to VAT 17%.
7. An application along with a certificate determining the value of the yacht and the lease agreement, should be given in advance to the VAT Authority, requesting approval of the yacht's value and the applicable percentages of its use within the EU.

D. Computation Of The Percentage Of The Lease Taking Place In Eu Waters

Due to the practical difficulties in calculating the exact time the boat sails within EU waters and the time that it sails outside EU waters, the VAT Authority has determined that the percentage of the lease taking place in EU waters will depend:

- upon the type of yacht involved e.g. sailing yacht, motor yacht, and
- upon the length of the yacht concerned

Cyprus Yacht Registration – New Preferable VAT Treatment

The VAT Authority presumes that:

TABLE 1: Motor Boats		
Length of the yacht	Percentage (%) of use within EU	Effective VAT Rate %
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Boat with permitted crusing use only within protected waters	100%	17,00

TABLE 2: Sailing Boats		
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Length betwen 10,01 and 20 meters	50%	9,78
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E. VAT Paid Certificate

Once the lessee becomes the owner of the yacht and VAT thereon has been paid in full, the VAT Authority will issue a Yacht VAT paid certificate in the name of the lessee indicating that VAT has been paid in full.

F. How The Scheme Can Work

By making use of this scheme the effective vat charge payable on the yacht's increased value (including lessor's profit) instead of 17%, can be reduced as low as 4.42%.

For example, if a person would like to buy a motor boat of more than 24 meters length for EUR 15.000.000, in order to take advantage of the scheme the following steps should be taken:

1. He proceeds with the incorporation of a Cyprus company which will buy the yacht in its name.
2. He transfers EUR 15.000.000 for the purchase of the yacht to the Cyprus company i.e. in the form of a shareholder loan.
3. The Cyprus company to enter into a lease agreement (at the capacity of the lessor), for a period up to 48 months with the interested person to use the yacht (the lessee) which in this case can also be the shareholder of the company.
4. Application to the VAT Authority accompanied by documentation supporting the value of the yacht and a copy of the lease agreement concluded between the two parties, as prior approval of the yacht's value and the applicable percentages of its use within EU needs to be obtained by the VAT Commissioner.
5. The yacht should sail in Cyprus within one month from the date the lease-sale agreement of the yacht becomes effective.
6. In this case, as the lessee will be the shareholder who provided the original funding for the purchase, the initial deposit of 40% plus the monthly instalments can be set off against the loan. The only real additional cash outflows would be the actual VAT liabilities.
7. The Cyprus company will be liable to pay the Cyprus VAT Authority the VAT amount designated by the VAT Authority as VAT on initial contribution (€204.000) which is due at the inception of the agreement and VAT on monthly

instalments (€6.906,30) which is due on a monthly basis.

8. The lessee may purchase the yacht at the end of the lease period (48 months) for a final consideration of not less than 5% of the value of the yacht which will be subject to 17% VAT, thus the effective VAT rate at the end of the lease period is 4.42%.

G. Other Taxes

- Stamp Duty Tax

In order to be able to obtain the approval of the VAT Authority to use the above scheme, the lease agreement must be duly stamped. Stamp duty is calculated on the value of the agreement at 0.15% for the first €170.860 and at 0.2% thereafter, having as ceiling the amount of €17.086 per agreement. The due date for such stamp duty payment is within 30 days from the day of the signing of a document which is considered to be subject to stamp duty.

- Income Tax

The Cyprus company acting as the lessor will need to account for at least 10% profit on the value of the boat. This profit will be taxable at the normal corporation tax rate of 10%.

H. Conclusion

The proposed scheme provides a very tax competitive and efficient method of owning and enjoying yachts within European Union. Cyprus's ideal location and well developed infrastructure in combination with the favourable tax regime is able to become the most attractive EU jurisdiction for yacht registration.

We are ready to discuss all the aforementioned with you, and provide support for the implementation of the scheme by:

- Incorporating and administrating the Cyprus legal entity which will acquire the boat,
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Our involvement and participation in international transactions over the years, have established our firm as one of the key players in the field.

The firm is staffed with over 80 young, energetic and ambitious professionals, including lawyers, accountants and administrators who provide prompt, efficient and high quality services and who are capable of meeting the current demanding challenges of the local and international business environment.

Cyprus Yacht Registration – New Preferable VAT Treatment

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A. Introduction

On the 13th of March 2012, the Cyprus VAT Authority has launched a scheme making Cyprus one of the most attractive EU jurisdictions for yacht registration. According to this scheme, a Cyprus company can enter into a lease-sale agreement of a yacht with a third party, paying VAT only on a considerably reduced VAT rate than the standard rate which is 17%, calculated on a percentage of the time that the yacht is deemed to sail within EU waters as is analytically explained below. The effective VAT rate through the use of this scheme can be as low as 3,4%, which is increased to 4,42% when taking into account the required profit condition as it will be explained below.

B. Interpretation Of Terms - VAT Treatment

A lease-sale agreement of a yacht is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of a yacht. In addition, the lessee has the option to acquire ownership of the yacht by the end of the lease agreement at a percentage of the original price.

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How Incentives Can Help When a Company Enters the U.S. Market or Relocates or Expands its U.S. Operation

By Linda McCarty, Esq. and
Patric Zimmer

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Although incentives can be an important means to increase the bottom line for a company that is either entering the U.S. market or relocating or expanding its operations within the U.S., they are often overlooked or not fully explored or understood by companies.

To set the stage, there is an inherent competition among states to attract job and revenue creating companies. To recruit companies, states use a wide variety of statutory and discretionary incentives, including tax credits, property (real and personal) tax exemptions, project grants, grants to improve infrastructure, donations of land, grants associated with capital investments, workforce training and wage assistance, and utility discounts, just to name a few.

The competition for companies continues at the local level where each individual county within a particular state does its part to try to attract companies to set up operations within its particular county. This too is done through a wide variety of incentives.

So, why are incentives so often overlooked by companies? Perhaps the most common reason is that most companies don't know what to ask for. Companies often rely on state and local authorizes to tell them what incentives are available, failing to recognize that a state or county will only be forthcoming with incentives if there is a fear that the project may go to a competing jurisdiction

There are typically two types of incentives, statutory and discretionary, available to companies that are seeking to enter the U.S. market, or expand or relocate existing operations in the U.S.

Most companies are familiar with and have used statutory incentives. Statutory incentives generally include income tax credits that a company qualifies for by meeting certain criteria, generally through job creation and capital expenditures. These are the incentives that a state will first offer up to a company that is looking to

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relocate or expand its operations in the state. Statutory incentives are non-discretionary. In other words, any company that meets the specific statutory criteria is eligible to take advantage of them. With statutory incentives in hand, companies often think that they have maximized the incentives that are available to them, failing to explore discretionary incentives all together.

Unlike statutory incentives, discretionary incentives must be negotiated with the respective state and local authority. Generally, discretionary incentives have a more direct impact on a project, in that these incentives directly provide for a reduction in the capital costs or operating costs. For that reason, discretionary incentives are often referred to as impact incentives. Impact incentives can take a number of different forms including cash grants, property tax reductions, land or lease buy-downs, building or land improvement offsets, utility costs reductions and infrastructure installations. A well negotiated incentive package should represent between 10 to 20 percent of the total capital investment by a company in a project.

As a company considers expansion or relocation in the U.S., it should consider the following:

<u>Assemble and know your team</u>. Assemble a team of professionals, knowledgeable in site selection and incentive negotiations. Chose the team wisely so that that the company enters the new community as a partner and not an adversary. For instance, an aggressive, take no prisoners, negotiator may obtain the result the company is looking for in terms of incentives, but may also accomplish a public-relations nightmare in the local community before the company sets it foot within city lines.

<u>Do not negotiate incentives in a vacuum</u>. Incentive negotiations should be viewed as a piece of a three-dimensional puzzle and should never be negotiated in a vacuum. Performance requirements under many incentives can have a direct impact on other non-incentive agreement, such as leases, land acquisitions and construction contracts.

<u>Know your incentives</u>. Before initiating contacts with a state or local community, the company should have reviewed all available incentives, discretionary and statutory. The company also should determine the performance requirements of each incentive, including requirements regarding job creation, capital expenditures, loss of incentives, and time limitations. This information is critical when determining if a particular incentive meets a company's needs.

<u>Evaluate the benefits the project will bring to a particular location</u>. A compelling application for incentives should be prepared for each state in which a company is considering relocation. Each application should outline and analyze the benefits a state will obtain if the company locates it operations there.

<u>Keep the project confidential</u>. Companies always should avoid making any public (or non-public) announcements until the negotiation of the incentive package, including accompanying agreements, have been finalized. Many incentives can be revoked by the state or local authority if the company announces the location of a project before the incentives have been finalized. Also, once the location has been announced, the company loses all leverage since there will be no reason for the state or local authority to offer addition incentives.

About the Authors:

Linda McCarty, Esq. is a partner with the law firm Wall Esleeck Babcock, LLP in Winston Salem, North Carolina. Her practice is focused on commercial business transactions, particular at the international level. Linda devotes a significant portion of her time assisting clients at all stages of corporate relocation or expansion of operations in the United States. She is a director of Wall

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Esleeck Babcock Consulting, LLC, a wholly owned subsidiary of Wall Esleeck Babcock, LLP. Wall Esleeck Babcock Consulting, LLC specializes in negotiations of state, local and private economic development incentives for companies across the United States. Through its strategic alliance with Development Advisors, LLC, it offers its clients a comprehensive platform for the negotiation and structuring of incentives.

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Patric Zimmer is the founder and president of Development Advisors, LLC. Founded in 1996, Development Advisors has leveraged over $6 Billion in capital investment creating over 6,000 jobs. Development Advisors has worked with clients throughout the United States including projects ranging from $2 million to over $450 million in capital investment. Their highly skilled team includes bother former public sector officials and senior business executives. Their diverse industry sector knowledge, subject matter expertise, and market understanding will consistently add value to their client's capital investment decisions.

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The New Portuguese Insolvency Code – Law 16/2012

By Maria Tavares, Esq.

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Due to the structural crisis of the economy, Portugal felt the need for focusing and framing the loan contracts in the current situation and also finding new solutions and alternatives to the insolvency issues.

The changes, in force since 20th May, aim to provide a new emphasis on promotion of the recovery of the companies in pre-insolvency situation, focusing, whenever possible, on maintain the companies in a working state, before getting straight to the liquidation of its assets (which was the previous legal approach).

Creditors and debtors are encouraged to analyze the company's financial viability and decide jointly whether recovery or liquidation is appropriate, and in what terms.

Main changes:

- Reduction of legal deadlines aiming at a quicker and more efficient Insolvency proceeding.
- Simplifying the procedural formalities now managed electronically.
- Reinforcement of debtor's responsibility on their insolvency situation.
- Intensification of Insolvency Administrator's powers and better definition of its role and responsibilities.
- Better coordination between the Insolvency and Executive proceeding.
- New Special Revitalization Process, designed to define general principles of voluntary restructuring of loans, with the final purpose of the debtor's recovery through debt renegotiation:
    - It can be requested by the debtor in financial difficulties or in imminent insolvency situation, but still capable of recovery, or by any of its creditors, by means of a written statement of the debtor and at least one creditor, expressing the intention to start negotiations.

- If the creditors approve the payment plan presented by the debtor, they settle a period of "standstill" – preventing the introduction of any debt recovery lawsuits and suspending ongoing lawsuits with the same purpose, these will be extinguished as soon as the payment plan is adopted and approved.

The new legal framework seeks to promote the recovery of insolvent companies, through renegotiation of debt or payment plans, facilitating access to these kinds of mechanisms both to creditors and debtors.

The purpose is to have a greater use of extrajudicial procedures for conciliation between the parties, as well as greater communication leading to negotiations and, therefore, avoiding liquidation of assets and closure of companies.

Maria de Athayde Tavares is partner with Athayde de Tavares, Pereira da Rosa & Associados practicing in civil and commercial law, tax law, and litigation.

Sukuk: default or no default?

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Issues With Non-Competition Agreements that Cross State Lines

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Either by statute or court decisions, non-competition provisions in employment agreements are often treated differently than non-competition provisions included in the sale of a business. Counsel should be aware of the potential for competing public policy interests to better anticipate possible alternatives.

Essentially, all states consider keeping individuals from working as a restraint of trade. Because non-competition agreements are a restraint of trade, many states take a strict construction of the drafting and enforceability of a non-compete agreement. Consequently, unless the specific requirements of the particular state are met, employment non-competition provisions will generally not be enforced. For example, as part of its statute allowing non-competition agreements, Louisiana requires listing the actual parishes where the employee is precluded from competing. Various court decisions have held that simply listing an area of non-competition rather than the actual parish names violates the statute and; therefore, the non-competition agreement would not be enforceable. On the other hand, other states would consider it appropriate to describe a non-competition provision in terms of miles, such as within 100 miles of an office. Because of the differences between states, it is important to understand the potential issues that can arise in the location where a non-competition agreement is intended to be enforced.

Many agreements attempt to avoid issues of differing laws between the states by having a "Choice of Law" provision. A Choice of Law provision seeks to ensure that the interpretation and application of an agreement is consistent regardless of the state in which enforcement is sought. For example, it may be that an agreement provides that the parties agree that the law of Delaware would apply to the interpretation and enforcement of an agreement. Depending on the terms involved and the particular activity to be enforced, the parties' Choice of Law provisions are generally enforceable <u>unless</u> the court decides that to do so would be a violation of the public policy of the particular state.

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Issues With Non-Competition Agreements that Cross State Lines

Importantly, cases in a number of states have concluded that whether a person is allowed to engage in any form of employment within a state's borders is to be determined by the law of the state where the activity is taking place. So, regardless of the parties' Choice of Law provision, states generally apply their own state law when deciding if a non-compete is enforceable within its borders. For multi-state companies, this burden must be considered when drafting enforceable non-competition agreements.

Non-competition clauses associated with the sale and purchase of a business are often treated differently than non-competition provisions solely related to employment. The reason to have the clause in a purchase transaction is apparent – a person does not want to buy a business to have the former owner compete against him. Some states have separate statutory provisions for business purchases. However, even when no statute exists, courts have generally recognized the enforceability of non-competition agreements in purchase agreements.

There is no standard non-compete agreement that can be used all the time, for all situations, regardless of the states involved. As we recently observed with the *Marsh* decision in Texas, even when a specific statute exists outlining the requirements of a provision, non-competes are regularly the subject of judicial interpretation since so much is dependent on public policy. This can sometimes lead to divergent results. For example, often the sale of a business includes the employment of certain key persons, frequently the persons who just sold the business. Assume the agreements provide that they are to be interpreted and applied consistent with Delaware law, but the business actually being sold is in Louisiana and that is where the employment of the seller is to take place. I have found at least one case that was faced with this fact pattern. The court applied the parties' Choice of Law provision with respect to a non-competition agreement in the purchase agreement, but the employment non-compete was interpreted under local state law regardless of the Choice of Law provision.

Because of the ever changing nature of public policy, it is recommended that all agreements contain a "blue pencil" or reformation provision to allow for the potential myriad of enforcement interpretations. This will allow the court to apply the agreement at least to the extent that the state would allow. Without an appropriate provision, some courts have gone so far as to indicate that if specific statutory and/or judicial requirements are not met, the non-competition provision is void. An appropriate blue pencil or reformation provision would allow the court to modify the provision to meet the state requirements and then be enforced. To be sure, not all courts will apply a blue pencil or reformation provision in the same manner, but if the alternative is no enforcement at all, in most situations having such an option is preferable.

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Immigration Enforcement and Compliance in the Workplace

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Immigration enforcement remains inconsistent, seemingly changing year to year (or month to month). Most immigration trends are politically motivated. While aiming to expand opportunities for legalization of both family-based and employment-based immigrants, the Bush administration placed great emphasis upon worksite enforcement. The Obama administration has attempted no significant efforts at immigration reform, and deportation numbers are at an all time high.

The prospect of employment lures people to the United States. If the government circumscribes the availability of jobs for illegal immigrants, then the incentive to come to the U.S. also declines. Accordingly, the government has deputized employers, requiring them to enforce the border in the office place, and punishing those who fail to do so – sometimes even in criminal court.

Immigration requirements change often. Because the area is regulatory in nature, little notice is required to alter the requirements placed upon employers. For this reason, every business should be well acquainted with qualified immigration counsel. The attorney must be familiar with immigration law from a compliance/employment standpoint, and should have experience working with HR professionals and company principals. He or she should also be practiced in federal criminal defense (or at least ensure the immigration attorney works with a good defense attorney) as the two areas of law often overlap.

No business is insulated from enforcement actions, and every employer must maintain an immigration policy. In addition to keeping immigration counsel at the ready, below are some of the major considerations for a business to formulate or refine its existing procedures:

Have the Basic Components of a Good I-9 Policy

The I-9 form is the document that an employer must complete for every new employee (NOT just foreign employees). It demonstrates an employer's commitment to immigration compliance, and if an investigation or raid ever occurs, the I-9 forms will become either the best friend or the worst enemy of the employer.

By completing the form properly, on time, and uniformly, the business protects itself from a claim that it had "constructive knowledge" if an unauthorized employee turns out to be working. Most employers know that they cannot hire someone they already know to be unlawfully present in the U.S., but a willful policy of "looking the other way" can be just as dangerous. The goal of the I-9 is for a business to comply in good faith, regardless of whether an unauthorized individual slips through the cracks.

The form is deceptively simple. Making mistakes on the one-page document can lead to technical violations and/or fines, should the U.S. Department of Homeland Security conduct an audit. Remember – the employee must complete Section 1 on the first day he or she works for pay, not a day sooner. The employer must ensure that the information listed is clear and legible. The employee must then be given a list of documents he or she may present for verification of identity, authorization to work, or both. The employer must never ask for a specific document.

By day three, the employer (through a manager or HR professional) must review the documents presented, and complete Section 2. Afterwards, the I-9 is simply maintained on file with the employer. For a variety of reasons, businesses should keep the I-9s in a separate file or binder from the personnel file for the employee.

One great resource for I-9 procedures is the M-274, Handbook for Employers, available for download, along with the I-9 form, at *www.uscis.gov*.

Don't Forget About Proper Social Security No-Match Procedures

Because an employer must balance the duty to verify against the duty not to discriminate, companies should have written policies in the employee handbook to ensure uniform procedures. The policy should include a clearly outlined procedure in the event the employer receives notice from the Social Security Administration that the employee's name does not match his or her Social Security number. If an employer reacts too strongly, or in a non-uniform manner, the response could be deemed discriminatory.

States are increasingly involved in the immigration enforcement game. For instance, E-Verify is now mandatory in some states for certain employers. E-Verify is an internet-based system that boasts "instant" ability to verify an employee's eligibility. In fact, the program merely checks the employee's name with agency records to determine if a match exists.

E-Verify is a good option for employers who wish to go the extra mile. The speed of verification is greatly increased; however, the results are subject to error. Consequently, employers who utilize the program must still maintain a written, uniform procedure for responding to non-confirmation results.

Audit, Audit, Audit: Better You Than Them

Each company should hire an external firm to conduct yearly audits of I-9 files, and respond quickly to any recommendations in the audit report. The government will consider these audits as evidence of the employer's "good faith" efforts at compliance. As such, managers should be regularly briefed by immigration counsel regarding local and federal changes to law and procedure.

Know What to Do if an Investigator Visits Your Office

An Employer could get a visit from an investigating official from the U.S. Department of

Labor or from the U.S. Department of Homeland Security sub-agencies. These visits can occur without prior warning. Sometimes the official is investigating possible fraud in employment-based immigration applications, such as an H-1B visa for foreign skilled workers. Other times, DHS may be interested in conducting an audit of the company's I-9 forms.

A manager should always politely request to view the agent's identification and obtain a business card. The company may request an attorney's presence.

Know What to Do if Your Workplace is Raided

A raid is different from an investigation. An immigration raid indicates that the United States government has targeted an employer for criminal activity, and likely believes that the business has employed a large number of undocumented immigrants. A fraudulent document scheme may have taken place on-site, and the company management may have been completely unaware of it. By the time a raid occurs, the company has been under investigation for a protracted period of time.

Anyone within a company, especially anyone involved with hiring, can be implicated criminally for immigration violations. A lower level manager may be targeted by federal agents hoping to gain information against higher level managers and owners.

In the event of a raid, the employer should obtain the search warrant and fax or email it to counsel. At the outset, any illegal employees likely will abscond. The employer should never assist them in any way, but allow law enforcement to handle such issues.

At that time, the agents will also attempt to interview individuals. No one is obligated to engage in such an interview, and any discussions with agents should wait until an attorney can be present. The risk of not having counsel present is the inadvertent disclosure of incriminating information. These unprotected statements and the information derived from them may be used to bolster the prosecution's case.

Audits and raids are not entirely preventable, but vigilance minimizes business owner/manager culpability for any issues that may arise. Take time to revisit your company's immigration compliance. Carefully crafted policies and procedures bring peace of mind, and enable employers to worry about the most important things – the business of The Business.

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The Company Administrator as the Liable Party in Spanish Law

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The aim of this article is not to provide a detailed analysis of the applicable rules and case law on the topic generated by the Spanish courts, which is very extensive. Such an analysis would far exceed the scope of this article, which merely aims to provide a short, general, practical view that may be helpful in business and professional relations with Spain.

Obviously, liability only comes into play when someone acts as an administrator, i.e., when acting as a company body performing the functions of administrator.

The system used in Spain to enforce administrator liability has traditionally been based on culpability, though the introduction of certain cases of nearly objective liability has led some authors to speak of a new kind of professional liability.

The liability system is public and therefore any statutory resolutions that alter or modify it are considered null and void. Liability is joint and several, i.e., it applies to all members of the administrative body who perform a detrimental act or adopt a detrimental resolution. The law only relieves those administrators from liability who did not intervene in the adoption and execution of the resolution and who can either prove that they did not know of its existence or, if they were aware of it, did everything in their power to prevent damages or expressly opposed the adoption of the resolution. Blame is applied collectively to all those who adopt or execute a detrimental resolution.

In Spain, the job of administrator can be performed individually or by a Board of Directors. With regard to the individual, the liability of the sole administrator in the case of joint performance, either when acting jointly and severally or by common consent, is clear.

The following is worth highlighting due to its special nature and importance:

1. The Board of Directors and, more specifically, the Chair of the Board. Delegating powers does not relieve the delegating Board

The Company Administrator as the Liable Party in Spanish Law

Members from liability for the culpable actions performed by the delegated parties. In general, delegated administrators must answer for any actions they take that are detrimental to the company. Administrators who are not delegated are usually charged with liability for illicit acts due to their failure to perform their duties of supervision and to intervene when necessary; otherwise, it could be understood that they did everything they could have to prevent damages. Moreover, the fact that delegated administrators were following the instructions of the delegating Board of Directors is not sufficient cause to exonerate them from liability.

2. Liability is applicable until the administrators' dismissal or resignation is entered in the Mercantile Register, provided it is not considered fraudulent. If the situation causing damages occurs after the administrators are dismissed or resign from their positions and the dismissal or resignation was not entered in the Mercantile Register for reasons that cannot be attributed to the dismissed or resigning parties, it is clear that third parties cannot logically attempt to demand liability of someone who is not an administrator.

3. The real administrators, i.e., those who do not formally occupy a position in the company, but actually control and effectively govern the company instead of the administrators or exert decisive influence over them. In these cases, since the law was amended in 2003, it provides for the application of the same degree of liability, though the courts had confirmed liability in different decisions.

The following is of note regarding legal action:

Corporate Liability Action

Corporate action is actually a form of legal action for compensation when the damages caused by the administrators harm the company's interests. Therefore, any compensation obtained is earmarked for company assets, not the shareholders.

The first requirement for taking this legal action is having the **right to take such action**. There are three parties that are entitled to take such action.

First. The company may take legal action by adopting a resolution by simple majority at any time. Statutory clauses that establish a different form of majority for adopting resolutions whose object is to take corporate liability action are prohibited. It is therefore not possible to establish a greater majority than the legal majority and, if such a majority is stipulated in the bylaws, it is considered inapplicable.

Second. The shareholders may take legal action after requesting that a General Meeting be held to adopt a resolution to take action and at least 5% of the subscribed share capital must be present. A minimum of 5% of the share capital can therefore act as plaintiffs, and can act jointly if the 5% does not rest with a single shareholder.

Anyone who was a shareholder when the detrimental act or omission took place or when the resolution was adopted to enforce accountability, but who loses the condition of shareholder due to an inter vivos transfer when the lawsuit is filed is not entitled to take action. This is not true in the case of a mortis causa transfer, given that the heirs are entitled to take legal action if the deceased party started taking preliminary legal action, such as by requesting that a General Meeting be called.

Third. The company creditors can take corporate liability action against the administrators when the company or the shareholders have not taken action, provided that company assets are insufficient to cover what is owed to creditors. It is a subsidiary action instead of a suit filed by the company or the shareholders. It is not necessary for insolvency to be declared by the court, though the debt must be mature, liquid and due.

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For corporate and individual liability action to be successful, the following requirements are necessary: a culpable action or omission, the existence of damages and a causal link between the two.

Damages must be caused for action to be taken. Damages consist of what is caused when the administrators do not comply with their obligations, either as determined by law, the company bylaws or actions and behavior considered enforceable (due diligence).

The burden of providing proof of damages is on the creditor claiming compensation. "Damages" must be understood to mean the reduction in company assets and any unearned profit when the situation is compared to the hypothetical development of the company if the administrators' behavior had been appropriate. It must therefore be established whether the damages are the direct, immediate result of the action or omission in question, i.e., whether there is a causal link between the action/omission and the damages caused. This criterion must be applied to determine the resulting damages (reduction in company assets) and the loss of profits (unearned profit).

It is not always easy in practice to determine the existence of a causal link, given that many actions taken by administrators that are not in compliance with their obligations do not result in any damages to the company. In other cases, administrators' decisions may involve major costs to the company, but such actions form part of the sphere of the administrators' freedom to make decisions.

Liability must arise as a consequence of actions that:

a. Go against the law, basically but not exclusively the Capital Companies Act.
b. Go against the company bylaws, though the obligation of observance only applies to valid and licit clauses and, therefore, failure to comply with clauses that are null and void does not give rise to a case of liability.
c. Are performed without the due diligence that corresponds to the job position. Although the concept of "due diligence" may seem abstract, due diligence calls for professional behavior and a certain level of professional training to perform the job.

Individual Liability Action

The law also provides for the liability of administrators who directly harm the interests of shareholders or third parties. It is direct and primary action that shareholders and third parties are entitled to take to recover their own assets.

As with the previous case, a direct causal link is required between the administrator's action or omission and the damages caused to the shareholder or third party, along with the attendant guilt or negligence. For the action to be successful, it is not necessary for a General Meeting to be called, a company resolution adopted or a minimum number of shareholders to agree.

Shareholders and third parties are entitled to take such action, regardless of whether or not they are creditors.

Direct detriment to the creditor's interests must be proven. The damages must be estimable and specific proof of these damages to the creditor's assets must be established. There must also be a direct connection between the administrator's action or omission and the damages caused to the shareholder or creditor, in addition to the attendant and duly proven guilt or negligence.

There are many different cases in which this liability may arise: illicit company actions resulting from the performance of company activity, such as unfair competition, environmental damage, putting defective products on the market, and unlawful interference in shareholder relations with the company through such actions as unlawful redemption of shares and providing false information on balance sheets or reports.

The Company Administrator as the Liable Party in Spanish Law

In both corporate and individual liability action, the time bar for taking action is four years after the administrator's dismissal or resignation.

Special Reference to the Responsibility of Promoting Company Liquidation or Filing for Bankruptcy

Besides the cases mentioned above, there are two other highly relevant cases of administrator liability that are in fact the ones that involve the most lawsuits. They arise when the company is in the legal process of liquidation or in a state of insolvency and the administrators do not take action to help move the situation forward. This failure to comply may lead to objective liability regarding the administrators who do not comply with their legal obligations, though this objectivity may be qualified in practice by the courts, which call for a claim of guilt or an aggravating factor or incident causing the effective damages.

The reasons for liquidating a company are defined in the law and can be summarized as follows: so-called **voluntary reasons**, based on shareholder wishes, and **obligatory reasons**, which include fulfilling the terms established in the bylaws, fulfilling the company object, the impossibility of achieving the company object, the corporate governance bodies' inability to take action, and losses that reduce company assets to an amount less than half the share capital.

Two different situations should be distinguished when the company is liquidated by resolution of the General Meeting:

- Liquidation agreed upon by the General Meeting without cause; in this case, the requirements of the attendant circumstances must be met, as well as the formal majorities established in the Capital Companies Act.
- Necessary liquidation; when obligatory conditions are fulfilled, the administrators must call a General Meeting within a period of two months to adopt a suitable resolution on company liquidation. A shareholder may also request that the administrators call a General Meeting if the shareholder believes there is legitimate cause for liquidation.

Any interested party may request court-ordered liquidation, including the administrators. This entitlement arises when the requested General Meeting is not called, i.e., when the administrators do not attend to any shareholder's request for a General Meeting within a period of two months. This kind of liquidation can also be called for when the requested General Meeting is called, but not held (e.g., due to a lack of quorum) or, finally, when the General Meeting is held, but the resolution adopted goes against liquidation. If the administrators do not comply with this obligation, they must respond jointly and severally to the company obligations that arise after the materialization of the legal reason for liquidation.

Moreover, regardless of whether or not liquidation criteria are applicable to each case if, in general, the company does not regularly comply with its obligations, i.e., if it lacks the means of payment and is insolvent, bankruptcy law will also come into play and the administrators will have to present the corresponding declaration of insolvency. The analysis of the need to apply for a creditors' meeting or bankruptcy, as well as the legal steps and requirements, is the subject of another article, as this one only provides a general overview without going into specific details.

In summary, besides individual and social liability action, the three main cases of administrator liability are as follows:

- Failure to comply with the obligation of calling a General Meeting
- Failure to comply with the obligation of filing for court-ordered liquidation
- Failure to comply with the obligation of filing for bankruptcy

Finally, the circumstances mentioned above may be mitigated or aggravated, depending on whether or not the courts play a moderating role, in light of the specific circumstances of the case, especially in periods of economic recession like the present one.

The Effective Board of Directors: Limiting Risk/Maximizing Return

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This article is written from the perspective of a trial lawyer who was brought in shortly before the commencement of a two-week trial to defend the chief executive officer and the executive vice president of a large financial institution who were defendants with the company in a shareholder derivative suit. This is not a tome on fiduciary duties of directors replete with footnotes and commentary on the nuances of the latest cases out of the Delaware Chancery court. Rather, this article is a short distillation of a presentation given to boards of directors coupled with some insights gained from trial – one of the few, if not the only, shareholder derivative cases ever tried in Georgia. The goal is to help directors not only lessen the likelihood they will become embroiled in a shareholder suit, but also to perform their responsibilities as a director more effectively which should, in turn, help their companies function better and more profitably.

A Real Case

The Clients – The CEO and EVP of a $1+ billion Georgia financial institution. Both had long, distinguished careers at their company, serving in multiple positions. The company was also a defendant.

The Plaintiff – A shareholder who also was the chairman of the county commission in the county where the case was to be tried.

The Claims – Breach of fiduciary duty arising out of the disposition of collateral from a foreclosed business/ real estate loan.

Plaintiff's Attorneys – A very large, national firm headquartered in Atlanta, Georgia.

Time of Engagement – Two months before a specially set trial.

Challenges – Multiple:

1. No dispositive motions had been filed by the previous defense lawyers.
2. No exculpation provision in the charter.

3. No motion to recuse the judges of the superior court had been filed although the court received 30 percent of its budget from the county commission of which the plaintiff was the chair.

4. Substantial pre-trial publicity had occurred.

5. Plaintiff was a very powerful, influential businessman and politician in a relatively small county where the case was to be tried.

6. Finding an unbiased jury willing to rule against the chair of the County Commission.

7. Witnesses who were unwilling to testify on the defense's behalf because of the plaintiff's ability to influence zoning, tax, business incentive or other issues significantly affecting their business interests.

Potential Exposure – Plaintiff was seeking substantial compensatory damages plus attorney's fees and punitive damages.

Principal Defense – Business judgment rule articulated in plain, ordinary common sense terms the jury could understand.

Trial – Eight days **Verdict** – Defense verdict

Seven Major Issues for a Board to Address

1. Strategic Planning

The strategic plan should encompass both macro and micro components. On the macro level, the board should define what the company hopes to achieve and how to accomplish those objectives. On a micro level, the board should have specific benchmarks for how the company can achieve its vision. These benchmarks should include both financial – cash flow, profit, liquidity – as well as specific product, customer or market share criteria.

2. Choose the Right Team Members

If a vacancy occurs in either the CEO position or for board slots, the directors should first agree on the challenges and opportunities confronting the company and the criteria for addressing them. Then the directors should agree on three to four specific skills and abilities for the candidates. Finally, vigorous, objective vetting of candidates should occur. Even in mid-market companies, gone are the days where officers and directors were selected based on the "good old boy" network.

3. Establish and Properly Staff Committees

A board should have audit, compensation and governance committees. The committee members should be selected based on their experience and expertise in the area of the committee's responsibility.

4. Succession Planning

The directors should be aware of who is in the company's leadership gene pool. The directors should know the skills and capabilities of the top officers and insure that the right person is in the right position.

5. CEO Compensation and Performance Evaluation

At least annually, the board and/or the compensation committee should evaluate the CEO's performance and compensation. The compensation should be a mix of quantitative and qualitative measures such as leadership, strategic planning, financial results, succession planning, human resources, communication with shareholders, and working effectively with the directors.

6. Monitor Health, Risk, and Performance

All of the directors should be regularly reviewing and analyzing the information prepared by reliable and competent persons inside or outside the company.

Defeating a Shareholder Claim

Following is an action plan directors should follow if they receive a demand letter from a shareholder alleging wrongdoing or if they or the company are sued in a shareholder suit.

1. Make sure the corporate charter documents contain an exculpation provision.

2. Notify the directors and officers insurance carrier immediately and insist on participating in the selection of counsel. The directors should be represented by a lawyer who has substantial corporate governance experience including trying a shareholder derivative case. Surprisingly, very few of these lawyers exist. The case will be prepared, defended, and presented at trial very differently by lawyers who have trial experience than those who do not.

3. Take the shareholder complaint/demand/lawsuit seriously. Many suits can be avoided if the board does not ignore or dismiss out of hand the allegations of wrongful conduct. While it is natural for the directors to be upset and disappointed and adopt a circle the wagons mentality, this is the wrong approach.

4. The directors need to conduct an independent investigation of the factual allegations in the demand or the lawsuit. This can be conducted by independent directors assisted by independent counsel. The company's regular outside counsel should not be used because it is too closely tied to the company.

5. The directors need to be educated about the case and kept informed.

6. Directors should not be "dumbed down" when preparing to testify during their depositions. Too many officers and directors are prepared by their lawyers to place responsibility on others, claim they were not directly involved, or to testify they just do not recall the details of what transpired. The problem with this approach is that if the case is not won on a dispositive motion, it makes it virtually impossible for the officers and directors to testify credibly during a jury trial. Yet, these senior officers and directors can be the most effective witnesses if they are informed, well prepared, and credible.

7. The business judgment rule is a safe harbor. Although the business judgment rule is a legal concept, it can be readily understood by most lay people, once put into common sense, practical terms, that the business people, while not infallible, tried to exercise their best judgment on behalf of their company. If the process is reasonable, the result does not have to be perfect.

Bottom line, if the board functions as it is supposed to, the likelihood of being sued is substantially diminished. If directors are sued, finding competent counsel will greatly assist the directors in satisfactorily resolving the case.

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Frequently Asked Questions on Employees and Independent Contractors in Ontario

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What is an "employee"?

An employee is someone who has entered into an agreement (whether written or oral) to provide services to an employer, and that employer controls how the employee's services are performed and the employee's compensation. In exchange for the employee's services, the employee receives hourly wages or a salary.

Full-time employees usually work exclusively for one employer and often have access to benefits (such as health insurance or a pension plan) offered by their employer. An employee usually uses the employer's tools, office or work space, and resources to complete the work which he or she performs for the employer. An employee reports to his or her employer, and the employee's performance may be evaluated by the employer.

Employers and employees owe one another many duties. Generally, the duties of the employer are more onerous. This is because the two parties have unequal bargaining power, and the law gives the employee (as the weaker party) greater protection.

What is an "independent contractor"?

An independent contractor also provides services to another party in exchange for payment. However, an independent contractor provides services as part of the contractor's own business. The party engaging the contractor has less control over how the independent contractor performs the services than it would have over an employee. Typically there will be a written contract describing the services to be provided, and other contract terms resulting from negotiations between the parties.

In law, an independent contractor is considered to have equal bargaining power with the party receiving the services. Independent contractor relationships are governed by commercial law, and not employment law.

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Frequently Asked Questions on Employees and Independent Contractors in Ontario

It is not always easy to tell if someone is an employee or an independent contractor. The determination cannot be made by one single and universal test. Instead one needs to look at the "total relationship" between the parties and to ask whether the person who has been engaged to perform the services is really performing them as part of his or her own business. A central issue is the amount of control the party receiving the services has over the other's activities.

Generally, a true independent contractor will:

- have control over the timing and performance of his or her work;
- own his or her own tools or equipment required to perform the work;
- have a chance of profit and a risk of loss (e.g. receive a fluctuating payment based on actual work done);
- not work full-time for one organization;
- work for (or have the option of working for) more than one organization;
- have the authority to hire his or her own workers;
- have his or her own office or work space;
- not have vacation entitlements, car allowances, insurance benefits or other benefits from the other party to the contract;
- not be required to report to an organization to show it followed the organization's instructions.

What are some differences between employees and independent contractors?

Employers owe many duties to their employees, and must comply with various laws. For example, an employer is required to comply with Ontario's Employment Standards Act, 2000 (the "ESA"). Among other things, the ESA provides for vacation and holiday entitlement, minimum wages, and protected leaves (such as maternity leave).

If an employer decides to terminate an employee's employment without "cause" (misconduct), it must provide the employee with reasonable notice or pay instead of reasonable notice. "Reasonable notice" will be different in each scenario, and will depend on factors such as:

- the character of employment (i.e. is the employee a lower-level employee or a senior manager);
- the employee's length of service;
- the employee's age; and
- the availability of similar employment (having regard to the experience, training and qualifications of the employee).

Minimum notice periods for employee terminations, or pay instead of notice, are established under the ESA. However, courts often award longer notice periods, or pay instead of notice, than the minimums found in the ESA. Even if the employee and employer have included a specific notice period in a written employment contract, there can be circumstances when a court will grant the employee a longer notice period, such as where the employee's relationship with the employer has changed substantially or where the employee has served the employer for many years.

If an employer imposes unilateral changes on an employee (such as a reduction in pay or a demotion), then the employer may be held to have "constructively dismissed" the employee and may have to pay the employee compensation for terminating the employment relationship.

An employee also owes his or her employer duties, including a duty of loyalty. An employee should protect confidential information received through his or her employment. An employee should also avoid competing with his or her employer while employed.

An employer will often be "vicariously liable" for the actions of its employees. For example, if an employee is working and makes a mistake and someone gets injured as a result of that mistake, then the employer may be responsible for the injury. Vicarious liability does not usually apply to the actions of independent contractors.

A person or company's relationship with an independent contractor is governed by commercial law, and the agreement between the parties. While an employer is generally expected to provide an employee with an office or work space, tools and equipment, these things do not need to be provided to an independent contractor, unless the parties agree otherwise.

Many independent contractor agreements include specific notice periods with regard to terminating the contract. The parties must provide the notice described in the agreement between them, unless they mutually agree that the relationship can be immediately terminated. These notice periods will not generally be extended even if the parties have had a long-standing relationship. If there is no specific notice period in the independent contractor agreement, then one party must provide the other with a "commercially reasonable" notice if it is terminating the contract. What is "commercially reasonable" will vary depending on the industry and the parties' relationship.

Another difference between contractors and employees is that contractors generally bill for the work they are performing. While some employees may be asked to keep track of the number of hours they work, employees do not submit invoices.

What is a "dependent contractor"?

The idea of a "dependent contractor" has developed in recent years. Like independent contractors, people falling into this hybrid category usually have their own businesses and do not have all of the "hallmarks" of employment (e.g. health benefits, vacation entitlements). However, dependent contractors often work exclusively for one company and may perform essential functions for that company.

Unlike independent contractors, dependent contractors usually lose all (or substantially all) of their business if the relationship with the other party ends. To minimize the economic impact of terminating the relationship, courts usually determine that dependent contractors are entitled to longer reasonable notice if the other party intends ends the relationship.

This entitlement to longer reasonable notice is the main difference between independent and dependent contractors. The amount of notice will take into account the time required to find replacement(s) for the business lost. Finding replacement(s) often takes longer for dependent contractors than for independent contractors.

Dependent contractors are usually treated as "self-employed" (not employees) for income tax purposes.

What are some risks if someone is classified as a contractor, but he or she is actually an employee?

Employment Consequences

Merely calling someone an independent contractor (even if that term is used in a written agreement) or merely having a separate corporation through which the person is paid does not mean that the person is an independent contractor.

Courts and tribunals will do their own assessment as to whether the person is really an employee or an independent contractor. This determination is usually based on the degree of control exercised by the party receiving the services. The final assessment will not always be influenced by what the parties call themselves or how a person is paid.

If a person is actually an employee and his or her employment is terminated by the employer without cause, courts and tribunals will generally award that employee reasonable notice (or pay instead of reasonable notice) plus legal costs.

Tax Consequences

If a person is incorrectly treated as an independent contractor when she or he is, in fact, an employee, there can be serious tax consequences for both parties.

Parties can ask the Canada Revenue Agency (CRA) to review the status of a worker. This is best done at the commencement of the relationship, if there is any doubt as to the worker's tax status. This is done using Form CPT1. If so requested, the CRA will advise if it regards the worker as an employee or a contractor for the purposes of statutory deductions. Parties should consider making this request to the CRA if they are uncertain as to a worker's status. If the relationship is an existing or on-going one, obtaining tax advice is recommended before approaching the CRA for a ruling.

An employer must withhold and remit an employee's:

- income tax based on his or her employment; and
- statutory deductions (such as the Canada Pension Plan and Employment Insurance contributions).

If an employer fails to properly withhold and remit these items, the employer can be found liable and be made to pay interest and penalties. Employers must also pay Employer Health Tax in Ontario.

Contractors, on the other hand, are required to make their own remittances to the government. The person or company who received their services will not be liable if the contractor failed to properly remit the required amounts.

The labour provided by employees to their employers is not subject to Harmonized Sales Tax (HST). Contractors charge HST for their services. Contractors should consult with their tax advisors about HST, "input tax credits" and what needs to be remitted to the government.

*This article does not deal with employers and employees in the context of a unionized labour force. For more information on this topic, or other areas of employment law, please contact Roger Nainby (rnainby@houserhenry.com, 416.860.8017) or Michael Henry (mhenry@houserhenry.com, 416.860.8021).

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Frequently Asked Questions about Employee Terminations

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Issues concerning employment and employees need to be approached with sensitivity, diligence and caution. One of the most emotional, and therefore delicate, areas of employment law is terminations. This article deals briefly with some of the issues that employers should consider in deciding to dismiss an employee.

Are there "at will" employees in Canada?

No. The concept of "at will" employees does not exist in Canada. Employees are either employed for specific length of time (e.g. a one year contract) or for an indefinite period of time. If employees are employed on an indefinite basis, they must generally be given notice (or pay in lieu of notice) if their employment is going to be terminated without cause (explored below). Generally, the longer an employee has served, the longer the notice period will be.

Explaining the types of dismissal

Whether or not an employee is entitled to receive notice of termination and/or other compensation depends on how and why their employment is being terminated.

Without Cause

Most dismissals are done without "cause" (a valid reason). This means that the dismissal is not because of any specific charge or problem in the employee's performance or behaviour (e.g. theft or violence in the workplace). Dismissals without cause are sometimes also called "wrongful dismissals." Most often this type of dismissal is simply a business decision rather than a truly "wrongful" act by the employer.

An employee who is dismissed without cause is entitled to receive reasonable notice of termination or, alternatively, pay in lieu of notice if the employer wishes to terminate the employee's employment immediately.

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Frequently Asked Questions About Employee Terminations

Just cause

To be dismissed for cause, an employee must be guilty of significant misconduct that is not condoned by the employer. Where the dismissal is justified due to the employee's actions, there is no entitlement to notice or compensation.

However, "just cause" for termination of employment must be clearly established and documented. This can be difficult because:

- what an employer may regard as just cause may not be viewed the same way by the court; and
- an employer's failure to promptly discipline or reprimand an employee for his misconduct may be viewed as condoning the behaviour.

Employers in Canada must engage in "progressive discipline." If an employee engages in particularly egregious behaviour, then his employment can often be terminated immediately. However, if the employee only commits minor misconduct (e.g. consistently arrives late for work), then an employer generally cannot immediately terminate that employee's employment. The employee must be given a warning, and sometimes a short unpaid leave (if appropriate). The level of discipline can increase if the employee commits the misconduct again. If, however, an employee fails to correct his behaviour after he has been progressively disciplined, then his consistent misconduct may have developed into just cause for termination.

Employers are well advised to seek legal counsel before dismissing an employee when they believe there is cause for termination.

Constructive dismissal

An employer cannot unilaterally change a material term of a person's employment unless:

- the employee agrees to the change; or
- the change is specifically permitted by a written employment contract.

If an employee does not accept a material change, but the employer insists upon implementing it, then the law will treat this as a "constructive dismissal" of the employee.

The courts are quite liberal in favour of employees in interpreting what constitutes a material or fundamental change. For example, a constructive dismissal usually occurs when an employer significantly reduces an employee's salary or changes the employee's work location, hours, authority, position or benefits (e.g. extended health insurance) in a negative way.

Constructive dismissal may also occur if an employer harasses or abuses an employee, condones such conduct by other employees, or gives an employee an unreasonable ultimatum. It can occur because of a single change, or over time, if the result of a series of minor changes is a fundamental alteration of the terms of employment.

Constructively dismissed employees are entitled to the same notice (or pay in lieu of notice) and other compensation as if they were dismissed without cause.

An employee who accepts a fundamental change to their employment without complaint or who accepts "consideration" (a pay raise or something else of value) in exchange for the fundamental change may lose the right to later claim constructive dismissal. However, employers should be wary of relying on this. If the employee protests, but continues to work, or if he continues to try to re-negotiate the change, then it is unlikely that the court will consider that the change was condoned by the employee.

Early dismissal

If an employee is hired for a fixed period of time and then dismissed before the end of the term, the employer must pay the employee for the balance of the term, unless an employment contract provides otherwise or unless the employee was dismissed for cause.

An employee who agrees to a fixed employment period is not entitled to notice (or pay in lieu of notice) or other compensation which extends beyond that term. Accordingly, if the termination occurs at the end of the fixed term (e.g. the employee is not hired back for another term), the employee is not entitled to any notice (or pay in lieu of notice).

Employers should remember that any extension of a fixed contract must be done before the contract expires. If an employee continues to be employed after the fixed term has expired without a new or extended contract, he will become an employee for an indefinite term of employment, and will be entitled to notice (or pay in lieu of notice) if his employment is later terminated without cause.

What compensation are employees entitled to on dismissal?

The compensation an employee is entitled to receive on dismissal is established by the written employment contract between that person and the employer, and if there is no contract, then by common law and legislation.

What are the minimum standards upon termination without cause?

If an employee is terminated without cause, the employer must meet minimum standards set out in the *Employment Standards Act, 2000* (Ontario) (the "Act"). Most Canadian provinces have legislation regulating employment standards.

The Act establishes minimum standards for notice of termination (or pay in lieu of notice) and for severance pay.

Termination notice is based on the length of an employee's service:

- employees having more than three months but less than one year of service are entitled to one week notice;
- employees with more than one year but less than three years of service are entitled to two weeks notice.

Thereafter one additional week of notice is added per year of service, up to a maximum of eight weeks.

As noted above, employers can pay an employee in lieu of giving notice, if they wish for an employee's employment to cease immediately. This is generally a lump sum payment equivalent to what the employee would have been paid if he had worked for the employer during the notice period.

Severance pay is in addition to the notice of termination minimums provided under the Act. It applies where an employee with five or more years of service is dismissed without cause, and:

- the employer has a payroll of $2.5 million dollars (CAD) or more; or
- the dismissal is in connection with the permanent discontinuance of all or part of the employer's business at an establishment, and 50 or more employees are terminated within six months.

Based on the requirements above, severance pay is usually only required to be paid by employers with significant business operations.

If severance pay applies, each dismissed employee is entitled to notice of termination (or pay in lieu of notice) and to severance pay. The Act provides a formula for calculating severance pay, and the maximum severance pay is currently 26 weeks.

The Act also requires that in addition to notice of termination (and severance pay, if applicable) employees must be paid accrued and unpaid vacation pay. Vacation pay will vary depending on how much annual vacation the employee receives.

Payment of wages on termination

Under the Act, all wages owing to an employee to the date of termination, including accrued and unpaid vacation pay, and pay in lieu of notice, must be paid by the later of:

- the next regular pay date; or
- seven days from the date of termination.

Wages cannot be withheld for any reason. Severance pay can be paid in instalments, but only with the employee's or Director of Employment Standards' consent.

What wages and benefits must be given to an employee during the notice period?

Under the Act, if an employee works during his or her notice period the employer may not alter the employee's rate of wages, benefits, or any other term or condition of employment.

Wages in lieu of notice

Under the Act, if an employee is paid instead of working during the notice period, the employee must receive his or her usual wages for the notice period. The employee's benefits must also be maintained during the notice period.

What is reasonable notice?

It is very important to note that the minimums above as just that: absolute minimums. **Even employment contracts cannot provide lower standards than would be given to an employee under the Act. Ontario courts typically award <u>much longer</u> notice periods than those provided for under the Act.** Therefore, when an employer is considering how much notice to give an employee, the employer should be aware of common law entitlement.

Ontario common law requires an employer to give an employee "reasonable notice" of termination (or pay in lieu of reasonable notice), unless the employee is dismissed for just cause.

The purpose of a notice period is to give an employee a reasonable period of time to find another comparable job (usually with comparable pay) in the same general area. The amount of notice required depends on various factors, which usually include:

- the character or nature of the employment (e.g. was the employee a manager or a lower-level employee?);
- the length of the employee's service;
- the employee's age;
- the availability of similar employment, having regard to the experience, training, qualifications and the responsibilities of the employee;
- the circumstances surrounding the hiring of the employee; and
- any written employment contract between the employee and employer.

Employees are typically given pay instead of notice since dismissal is likely to affect the employee's productivity and morale, and may have an adverse effect on the workplace in general if he were to continue coming in.

At common law, the compensation payable is based on the employee's total compensation. If the employee's compensation includes commission, bonus and benefits, these will usually be factors in determining the pay in lieu of notice. All of these factors can be varied by a written employment contract.

The courts have generally interpreted reasonable notice for employees to be in the range of 3 to 4 weeks per year of service, usually up to a maximum of 24 months. The notice required can increase substantially for senior management and/or older employees, in recognition that increased time is often required for such employees to find comparable employment.

Reasonable notice required by common law usually substantially exceeds the legislated minimum standards. As such, employers should consult with legal counsel to ascertain what reasonable notice would be in each particular circumstance.

Can an employer force an older employee to retire?

Generally speaking, "mandatory retirement" no longer exists in Canada, and an employer cannot force an older employee to retire or quit at a particular age. Employees cannot discriminate against employees on the basis of age. If they do so, they could face allegations that they have violated Ontario's human rights legislation (see the similar discussion involving disabled employees below).

What if I want to terminate the employment of a disabled employee?

Disabled employees are protected under human rights legislation in Ontario. As such, employers cannot discriminate against employees on the basis of their disability. It should be noted that in certain circumstances, alcoholism or drug addiction may be considered a disability.

If an employer terminates the employment of a disabled employee, that employee may allege that the employer terminated his or her employment due to his or her disability. If this happens, the employee could bring a claim against the employer (at no cost to the employee) at Ontario's Human Rights Tribunal. Defending against this claim could be timely and expensive for the employer, even if the employer is successful.

An employer should avoid terminating the employment of a disabled employee without first obtaining legal advice about all of the obligations the employer may owe that employee.

Practical suggestions:

- BE WELL PREPARED. Carefully review the facts of the situation and any contracts. Make sure that all required documentation is prepared in advance of your meeting with the employee.
- BE CLEAR AND SUCCINCT. Make certain the employee understands that he is being dismissed. Give only general reasons and avoid being drawn into a debate.
- TIME IT APPROPRIATELY. Meet with the employee in a private room at the office towards the end of the day. Try to avoid meeting on Friday afternoons, dates of significance to the employee (e.g. birthday, anniversary, etc.), or immediately before a public holiday.
- NEVER DO IT ALONE. Always have another manager present at the meeting.
- CONFIRM IT IN WRITING. Give the employee a letter confirming the termination and summarizing what the employer is offering. Do not ask the employee to accept an offer or sign anything at the meeting. Allow the employee reasonable time to consider it. Suggest that the employee obtain legal advice regarding your offer.
- GET A RELEASE. If the employer is offering more than what is required by the Act, make the offer conditional on receiving a full and final release of all the employee's claims against the employer.

Terminations should be planned; dismissing an employee should be done carefully and calmly. The right documentation must be prepared and the employer must ensure that all obligations under the Act are observed. Employers should consult with their legal advisor(s) well in advance of actually terminating an employee's employment.

*The information in this article only relates to Ontario law and the termination of non-union employees. If you would like more information about this or any other area of employment law, or if you would like to discuss your particular situation, please contact Roger Nainby (rnainby@houserhenry.com, 416.860.8017) or Michael Henry (mhenry@houserhenry.com, 416.860.8021).

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Asbestos Jurisdictional Highlights: Laws In Flux, Courts In Crisis

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Introduction

While the old saying would have us believe that "the more things change, the more they stay the same," the exact opposite is true with regard to asbestos litigation. This article provides a synopsis of recent legal and procedural developments in several "hot button" jurisdictions across the country, and their resulting impact on legal practice and advocacy.

Highlights From Asbestos "Battleground" Jurisdictions

California

The continuing economic downturn, and a steady decline in filings in general (and asbestos in particular), has led to budgetary problems which have negatively impacted the trial court system statewide. Courts have been forced to limit hours, lay off personnel (including court reporters and clerks), and to review long-standing practices and procedures in an effort to increase judicial efficiency and keep courtroom doors open. In so doing, courts in the Bay Area and Los Angeles—both of which still have significant numbers of asbestos cases on their dockets—have adopted different approaches to managing asbestos litigation.

a. San Francisco/Alameda

In prior years, the San Francisco Superior Court allowed the informal pre-trial "grouping" of similar asbestos cases for discovery and sometimes trial. After numerous challenges to this system were made by the defense bar, led by Primerus member firm Brydon Hugo & Parker, the Court dissolved all existing groups, and indicated that no future cases would be consolidated.[i]

Taking another step towards reform, the San Francisco court recently decided to phase out most of the General Orders applicable to asbestos litigation by the end of 2013. Although still considered "complex" litigation warranting its own court division and presiding judge, the revised General Orders serve notice that asbestos matters will not be given any sort of preferential treatment. Further, the revised orders reaffirm the Court's determination to require discovery to be conducted separately in each case, and not as part of some collective group. No time limits have been put on the defense examination of a plaintiff in non-preference cases, but a twenty-hour limit has been imposed in cases in which trial preference has been (or will be) sought.

In Summer 2012, blaming the San Francisco courts' continuing fiscal problems, Asbestos Presiding Judge Teri Jackson has taken the unprecedented step of requiring all parties who requested a jury trial to submit jury fees *in advance* for the entire estimated length of the trial *before* assigning the matter to a courtroom. Attorneys for both plaintiffs and defendants have asserted the impropriety of Judge Jackson's order; whether appellate review (if and when sought) will support Judge Jackson's *sua sponte* fee collection efforts remains to be seen.

Alameda County, just across the Bay, is also suffering from court budgetary issues, but to a much less significant extent than other courts. Like San Francisco, the Alameda court has rescinded most of its previous asbestos general orders, but retained orders requiring plaintiffs to file preliminary fact sheets and respond to standard asbestos interrogatories in personal injury and wrongful death cases.

b. Southern California

Like its sister courts to the north, the Los Angeles Superior Court has been hard-hit by the state's budget crisis; 56 courtrooms were closed, and approximately 600 court personnel were laid off. Unlike those courts, however, the Los Angeles court (along with the superior courts in Orange and San Diego counties) has seen a significant increase in its asbestos docket in the past few years. To handle this uptick, and following the San Francisco example, the Los Angeles court sought and obtained an order from the Judicial Council of California to coordinate *all* asbestos cases pending in Los Angeles, Orange, and San Diego counties under the management of one Superior Court judge. Unlike the informal "groupings" previously utilized in San Francisco, however, each case is still treated for discovery and trial purposes on an individual basis.

c. Recent Asbestos Decisions

Two recent published decisions—one from the California Supreme Court, the other from the Second District Court of Appeals—addressed critical issues of duty and damages in the context of asbestos litigation.

i. Campbell v. Ford Motor Company

In *Campbell v. Ford Motor Company* (2012) 206 Cal.App.4th 15, the plaintiff sued Ford Motor Company, alleging that her mesothelioma was caused by her para-occupational exposure to asbestos dust brought home by her father and brother from a Ford Motor plant where they worked as insulators. Ford appealed an adverse verdict, arguing that a property owner was not responsible for injuries caused by the acts or omissions of an independent contractor.

The Second District reversed, finding that the true issue presented by the case was a broader one—whether "pass through" exposure claims could ever result in a duty of care on premise owners. (*Campbell, supra*, 206 Cal.App.4th at 29.) While the *Campbell* Court agreed that a property owner had a duty to maintain premises under its control in a reasonably safe condition, it noted that this duty was only owed to persons "who it is reasonably foreseeable may be injured as the result of [the premise owner's] conduct." (*Campbell, supra*, 206 Cal.App.4th at 31.) The Court held:

> [W]e conclude that a property owner has no duty to protect family members of workers on its premises from secondary exposure to asbestos used during the course of the property owner's business. While the overall policy of preventing future harm is ordinarily served, in tort law, by imposing the costs of negligent conduct upon those responsible, the policy question is "whether that consideration is outweighed, for a category of negligent conduct, by laws or mores indicating approval of the conduct or *by the undesirable consequences of allowing potential liability*."

(*Campbell, supra*, 206 Cal.App.4th at 34 [emphasis in original].)

ii. Howell v. Hamilton Meats

California law has long recognized that an injured party who received medical treatment for tortiously-caused injuries suffers a compensable economic loss, and is entitled to an award of damages for any reasonable charges for that treatment. When the costs of that medical treatment were paid in whole or in part by a third party, such as a medical insurer, the "collateral source rule" held that any compensation received by an injured party "from a source wholly independent of the tortfeasor, such payment should not be deducted from the damages which the plaintiff would otherwise collect from the tortfeasor." (*Helfend v. Southern Cal. Rapid Transit Dist.* (1970) 2 Cal.3d 1, 6.)

The California Supreme Court, in its recent opinion in *Howell v. Hamilton Meats & Provisions, Inc.* (2011) 52 Cal.4th 541, resolved a long-standing split of authority over the proper measure of damages for past medical expenses incurred by or on behalf of an injured plaintiff (or the decedent in a wrongful death action). The Court held that an award for past medical expenses must be limited to the amounts actually *paid* by or on a plaintiff or decedent's behalf, as opposed to the amounts that may have been *billed* by their medical care providers. (*Howell, supra*, 52 Cal.4th at 548-549.)

Pennsylvania

In recent years, the Philadelphia Court of Common Pleas had come under intense scrutiny, largely as a result of a perception that its procedures for mass tort cases favored plaintiffs and were unbalanced. However, after a change in judicial leadership at the Court, a new General Court Regulation (Regulation No. 2012-01.3) was issued on February 15, 2012, which has completely revised the rules governing asbestos and other mass torts cases. The order significantly limited the consolidation of cases for trial (absent agreement of the parties), and pro hac vice appearances by out-of-state attorneys.

The Court's order also eliminated the practice requiring the "involuntary reverse bifurcation" of asbestos trials. Under that former practice, during the "first phase" of an asbestos trial, the jury would be asked to decide only the issue of general causation (i.e., whether the plaintiff's injury resulted from exposure to asbestos), and then, if asbestos causation was established, the extent of the plaintiff's compensatory damages. Questions regarding product identification and a particular defendant's liability were reserved for a second phase, which would take place only if the parties (after judicial encouragement) did not settle. The Court's order, importantly, not only reaffirmed the Court's practice of deferring punitive damage claims in asbestos cases, it also extended it to apply to all mass tort cases.

The change in atmosphere in the Philadelphia courts has been noticed by defense lawyers and juries. A recent example involved Primerus member John Brydon (of the Brydon Hugo & Parker firm), who—after obtaining a defense verdict in an automobile friction case—successfully resisted the plaintiffs' efforts to set it aside.[ii]

Asbestos Jurisdictional Highlights: Laws in Flux, Courts in Crisis

New York

In New York, New York, a new special master (Claire Gutekunst) was recently appointed to replace former special master Laraine Pacheco (originally appointed in 1999), who had faced charges that she had overbilled asbestos lawyers by $400,000 over a span of several years. Ms. Gutekunst, a lawyer with the Proskauer Rose firm in New York City for over three decades, has never litigated any asbestos cases, but brings significant experience in dispute resolution to the New York bench. In addition, a financial management company has been retained to handle billings and collections, relieving the special master of those obligations.

The validity of a long-standing NYCAL Case Management Order requiring asbestos plaintiffs to produce copies of any bankruptcy trust claim submissions has been challenged by the Weitz & Luxenberg firm. Shortly after her appointment, Special Master Pacheco issued a recommendation in December 2011 enforcing the trust disclosure provisions after defendants claimed the Weitz firm had not complied with its discovery obligations under the CMO, which was adopted by Administrative Judge Sherry Klein Heitler after a hearing on April 18, 2012. Although Weitz & Luxenberg has sought to reverse Judge Heitler's order, it appears likely that their effort will be unsuccessful.

Hawaii

A rarely-used procedural device has allowed the Ninth Circuit to undertake an immediate review of an order denying a plaintiff's motion to remand in a case with potentially wide-ranging significance. In *Leite v. Crane Co.*[iii], Crane Company—a supplier of asbestos-containing products to the United States Navy for use in the construction of ships—removed an asbestos personal injury action to the District Court of Hawaii pursuant to the "federal officer" removal statute (28 U.S.C. § 1442(a)(1)). Crane relied on the federal "government contractor" defense as articulated in numerous cases, including *Getz v. Boeing Co.*, 654 F.3d 852 (9th Cir. 2011), for the proposition that in order to establish a "colorable" federal defense—and thus justify removal and the assertion of federal jurisdiction—it did not have to show that the Navy specifically prohibited asbestos warnings in its specifications and plans. The District Court—after an order denying remand had been handed down—allowed an interlocutory appeal of that order, requesting the Ninth Circuit address and resolve this long-standing and divisive legal issue.

Delaware

In two separate opinions[iv], the New Castle County (Del.) Superior Court has held that a manufacturer defendant was not liable for asbestos-containing replacement parts added to its products after sale. In both cases, the asbestos plaintiffs alleged asbestos exposures attributable to equipment aboard Navy ships manufactured by the defendants many years after the original installation of the equipment; the defendants argued, in support of their motions for summary judgment, that any asbestos exposures the plaintiffs might have had would have come from asbestos contained in replacement parts they neither manufactured or supplied. The New Castle court granted summary judgment in both cases, ruling that there was no duty owed by the defendants for having failed to warn the plaintiffs of risks created by the use of products it neither manufactured nor placed into the stream of commerce.

Federal Asbestos MDL No. 875

Late last year, Judge Eduardo Robreno of the United States District Court for the Eastern District of Pennsylvania, the judge who oversees MDL No. 875—the federal Asbestos MDL—reported that the backlog of cases in that had been largely eliminated, and that he anticipated that all cases presently pending before the court would be adjudicated, settled, or remanded by the end of 2012.. As a result, Judge Robreno suggested to the Judicial Council on

Multidistrict Litigation that they their practice of issuing orders transferring so-called "tag-along" cases (i.e., asbestos cases involving the same party or counsel as one already pending in the MDL) to the Eastern District of Pennsylvania be largely discontinued. An order adopting Judge Robreno's recommendations was issued by the JPML on December 13, 2011. In its order, the JPML noted that the parties in any new federal asbestos actions which would proceed in the individual federal district courts 'should be able "to avail themselves of the discovery already obtained in the MDL,'' and that ''the judges presiding over those actions will almost certainly find useful guidance in the many substantive and thoughtful rulings that have been issued during the lengthy course of the multidistrict proceedings.

Conclusion

Asbestos cases have been, and will continue to be, a significant litigation engine across the United States. While there have been changes in filing patterns, with some previously popular jurisdictions losing favor, and other jurisdictions growing in case filings, these changes are highly dependent upon the perceived attractiveness (or lack thereof) of a state's or locality's substantive legal doctrines or procedural rules, judicial case management practices, and attitudes of judges and juries toward asbestos plaintiffs and defendants.

Many of the current "popular" jurisdictions, as noted above, are in states of flux, because of recently-changed case handling procedures or new judicial leadership. Significant changes are underway in the federal Asbestos MDL as well. In sum, what might be "known" or "settled" today might not be tomorrow—which is the "nature of the beast" in asbestos litigation.
For more information, please visit Brydon Hugo & Parker's website: www.bhplaw.com.

Endnotes

[i] Beyer, *Management of Asbestos Claims Questioned*, S.F. Daily J. (May 18, 2008) page 1.
[ii] See pertinent records in court file for *George T. Webber and Tina Webber v. Pneumo Abex LLC, et al.*, Court of Common Pleas, Philadelphia County, December Term, 2010, Case No. 1348.
[iii] *Leite v. Crane Company, et al.* (D.Haw. May 31, 2012, Civ. A. No. 11-00636 JMS/RLP, 2012 WL 1982535.)
[iv] The two opinions are *In Re Asbestos Litigation (Anita Cosner)*, __A.3d ___ (Del.. May 14, 2012, Civ. A. No. N10C-12-100 ASB, 2012 WL 1694442) and *In Re Asbestos Litigation (Thomas Milstead)*, __A.3d ___ (Del.. May 31, 2012, Civ. A. No. N10C-09-211 ASB, 2012 WL ______.)

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A Brighter Line between Governmental and Private Entities: An IRS Project in the Retirement Area

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Utilities, airports, hospitals, nursing homes, charter schools, and similar institutions are commonly organized in corporate form and operate like businesses. Most are governed by a Board, the seats on which are filled by nomination or election by the remaining members of the Board. However, many of these organizations perform governmental functions, are closely associated with local governments, and have long been treated as agencies or instrumentalities of political subdivisions. The Internal Revenue Service ("IRS"), working with the Department of Labor ("DOL") and the Pension Benefit Guaranty Corporation ("PBGC"), has developed draft regulations that, at least in the retirement area, would create a brighter line between entities that the IRS considers to be private and those that will be treated as governmental entities exempt from many IRS retirement plan qualification rules. Some organizations that currently enjoy governmental status as an agency or instrumentality of a political subdivision may find it hard to fit within the proposed test the IRS recently set forth in its Advance Notice of Proposed Rulemaking on the Determination of Governmental Plan Status ("ANPRM"). Section 414(d) of the Internal Revenue Code ("Code") defines a governmental plan as one that is "established or maintained for its employees by the Government of the United States, by the government of any State or subdivision thereof, or any agency or instrumentality of any of the foregoing."[1] However, § 414(d) does not define key terms that provide the basis for determining whether the entity sponsoring the plan is "governmental." Thus, the IRS has resorted to various tests to classify an entity.[2]

[1] I.R.C. § 414(d).
[2] The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies, any plan of an international organization which is exempt from taxation under § 414(d)(2), and certain plans of Indian tribal governments and related entities.

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Current Plan Classification Methods

The courts have long applied the test from NLRB v. Natural Gas District of Hawkins County, Tennessee, 402 U.S. 600 (1971), to determine whether an entity is an agency or instrumentality of a State or political subdivision of a State, and therefore eligible to sponsor a governmental plan. In Hawkins, the United States Supreme Court set forth a two-prong test: whether the entity has been "(1) created directly by the state, so as to constitute departments or administrative arms of the government, or (2) administered by individuals who are responsible to public officials or to the general electorate."[1] In addition to the two-prong test, the Supreme Court considered additional factors such as whether the utility's property and revenue were exempt from State and local taxes, whether the utility was required to maintain public records, whether the utility's commissioners were appointed by an elected county judge, and whether the utility had the power of eminent domain.

The IRS has developed its own guidance for determining whether an entity is an instrumentality of a State or political subdivision. For example, in Revenue Ruling 57-128, 1957-1 C.B. 311, the IRS provided guidance on determining when an entity is a governmental instrumentality for purposes of exemption from certain employment taxes. The Revenue Ruling considered six factors: (1) whether the entity is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner; (4) whether control and supervision of the organization is vested in a public authority; (5) if express or implied statutory authority is necessary for the creation and/or use of such an instrumentality; and (6) the degree of financial autonomy and the source of its operating expenses.[2] Revenue Ruling 89-49, 1989-1 C.B. 117, applied similar factors to determine whether a retirement plan was a "governmental plan within the meaning of section 414(d),"[3] but stated that one of the most important factors is the degree of control that a Federal or State government wields over the everyday operations of the entity.[4]

The lack of specificity in the current definition of a governmental entity and the use of multiple tests have led to several issues regarding the classification of entities. The IRS is concerned about a growing number of plans trying to take advantage of "governmental" status, but whose relationships to States or political subdivisions of States are increasingly remote.[5] Additionally, the variety of approaches taken by courts and agencies to classify governmental entities has resulted in uncertainty for entities trying to ascertain what statutory and regulatory requirements apply to their retirement plans.[6] In response to these issues, the IRS issued an ANPRM that suggests draft definitions and multi-factor tests intended to create a coordinated criterion to determine whether a retirement plan is a governmental plan within the meaning of § 414(d).[7]

ANPRM Draft Definitions

The ANPRM provides draft definitions of several terms in § 414(d). However, one specific term, "agency or instrumentality of a State or political subdivision of a State," and the proposed test for determining whether an entity fits within the definition, may have the most impact on local entities such as utility boards and charter school systems. In its current form, application of this

[1] NLRB v. Natural Gas Util. Dist. of Hawkins County, Tenn., 402 U.S. 600, 604-05 (1971).

[2] Rev. Rul. 57-128, 1957-1 C.B. 11.
[3] Rev. Rul. 89-49, 1989-1 C.B. 117.
[4] *Id.*
[5] Determination of Governmental Plan Status, 76 Fed. Reg. 216,69178 (proposed Nov. 8, 2011).
[6] *Id.*
[7] *Id.* at 216,69174 and 216,69178.

"facts and circumstances" test might result in re-classification for some entities, causing major changes for retirement plans forced to comply with different requirements under the Code.

The "facts and circumstances" test set forth in the ANPRM for determining whether an entity is an agency or instrumentality of a State or political subdivision under § 414(d) is comprised of "major" and "other" factors that encompass certain aspects of previous tests. "Satisfaction of one or more of the factors is not necessarily determinative of whether an organization is a governmental entity."[8] The major factors are whether:

1. The entity's governing body is controlled by a State or political subdivision;
2. The members of the governing board or body are publicly nominated and elected;
3. The entity's employees are treated in the same manner as employees of the State (or political subdivision thereof) for purposes other than providing employee benefits (for example, the entity's employees are granted civil service protection);
4. A State (or political subdivision thereof) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity's plans); and
5. In the case of an entity that is not a political subdivision, the entity is delegated, pursuant to a statute of a State or political subdivision, the authority to exercise sovereign powers of the State or political subdivision (such as, the power of taxation, the power of eminent domain, and the police power).[9]

As drafted, the first factor, that the entity's governing body is controlled by a State or political subdivision, cannot be a "mere legal possibility."[10] The ANPRM states that control would be a mere legal possibility when there are intervening corporations between the entity and the State, or there are numerous governing entities, none of which could be found responsible in the event of a failure to exercise control.[11]

In addition to the "major" factors, there are "other" factors to be considered, including whether:

1. The entity is created by a State government or political subdivision pursuant to a specific enabling statute that prescribes the purpose and powers of the entity, and the manner in which the entity is to be established and operated;
2. The entity is directly funded through tax revenues or other public sources;
3. The entity is treated as a governmental entity for Federal employment tax or income tax purposes (for example, whether the entity has the authority to issue tax-exempt bonds under section 103(a) of the Code) or under other Federal laws;
4. The entity's operations are controlled by a State or political subdivision;
5. The entity is determined to be an agency or instrumentality of a State or political subdivision thereof for the purposes of State law (for example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the State attorney general represents the entity in court under a State statute that only permits representation of State entities);
6. The entity is determined to be an agency or instrumentality of a State or political subdivision thereof by a State or Federal court for purposes other than § 414(d);

[8] *Id.*at 216,69180.
[9] Determination of Governmental Plan Status, 76 Fed. Reg. 216,69180.
[10] *Id.*
[11] *Id.*

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7. A State, or political subdivision thereof, has the ownership interest in the entity and no private interests are involved; and
8. The entity serves a governmental purpose.[12]

The IRS sought comments on whether any final regulations should eliminate the proposed distinction between main and other factors.[13] It also asked for input on the order and application of the main and other factors. Additionally, the IRS sought comments on whether the final regulations should include a safe harbor standard or "bright-line" test that would allow an entity to be treated as an agency or instrumentality if it satisfies certain factors.[14] The factors the IRS expressed interest in include: (1) whether a majority of the entity's governing board is controlled by a State or political subdivision thereof or is elected through periodic, publicly-held elections and (2) whether a State or political subdivision has fiscal responsibility for the general debts and other liabilities of the entity.[15] The ANPRM states that a safe harbor provision might only be available to entities created by a State government or political subdivision pursuant to a specific enabling statute.[16]

The IRS also proposed three new requirements for "establishing and maintaining" a § 414(d) governmental plan. First, the plan must be established and maintained by an employer within the meaning of § 1.401-1(a)(2) of the Income Tax Regulations. This requires, for a qualified pension, profit-sharing, or stock bonus plan, that there be a definite written arrangement of the plan communicated to the employees.[17] Second, the employer must be a governmental entity. Third, the only participants who may be covered by the plan are employees of the governmental entity.[18] This final requirement may be a concern for some entities, and the IRS asked for comments on whether there should be special rules in place for existing practices where a small number of private employees participate in what would otherwise be a governmental plan.[19]

The proposed changes in the ANPRM could result in some entities losing their governmental statuses. Accordingly, the ANPRM provides draft rules governing the transition of plans from private to governmental and governmental to private. The IRS proposes that "if an employer becomes a governmental entity or a governmental entity becomes the employer under the plan…, the plan will be treated as a governmental plan established by a governmental employer on the date of the change."[20] The Treasury Department and the IRS anticipate that there will be a reasonable transition period following the final regulations for a plan to revise its arrangement to avoid the adverse tax consequences of failing to comply with newly applicable Code requirements.[21]

Conclusion

Entities that are currently classified as agencies or instrumentalities of a State or political subdivision, such as airports, charter schools, and utility districts, need to be aware of the draft amendments in the ANPRM. Not only may plan classifications change, resulting in a new set of rules by which plan administrators must abide, but there would be a limited time period for plan administrators to complete the transition. However, the definitions and tests in the ANPRM are not final. The next step is expected to be a proposed regulation, including a further opportunity for comment.

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[12] Determination of Governmental Plan Status, 76 Fed. Reg. 216,69180-81.
[13] *Id.* at 216,69183.
[14] *Id.*
[15] Determination of Governmental Plan Status, 76 Fed. Reg. 216,69183.
[16] *Id.*
[17] 26 C.F.R § 1.401-1(a)(2).
[18] Determination of Governmental Plan Status, 76 Fed. Reg. 216,69181.
[19] *Id.* at 216,69183.
[20] *Id.* at 216,69182.
[21] *Id.* at 216,69184.

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Qualification Requirements That Do Not Apply To Governmental Plans

- Title I and IV of ERISA
- § 401(a)(10)(B)(iii) exempting governmental plans from the top heavy requirements of § 416
- §§ 401(a)(5)(G) and 401(a)(26)(G) exempting governmental plans from minimum participation standards and nondiscrimination requirements
- § 410(c)(1)(A) exempting governmental plans from the minimum participation provisions of § 410
- § 412(e)(2)(C) exempting governmental plans from minimum funding standards of § 412
- § 403(b)(1) exclusion allowance
- § 403(b)(12)(C) exempting governmental plans from the nondiscrimination requirements of § 403(b)(12)

How Non-Profits, Particularly In Health Care, Can Obtain Federal Funds Now:

Focus on Federal Agency Grants

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In this difficult economic environment, the U.S. government has targeted non-profits for the continued distribution of funds through a number of continually-evolving mechanisms, some of which we have discovered *do not involve "traditional" competitive grant requests*. As explained below, at least one $230 million health care program we've found is formula-based -- meaning eligible applicants who submit a properly completed application will be funded.

The federal government's support of non-profits makes sense in light of an alarming study by the Nonprofit Finance Fund released in April. That study showed that seven-in-eight non-profits are seeing increased demand for services, but over half reported they only have enough cash on hand to sustain their operations for three months or less.

As has been widely reported in the media, the U.S. Supreme Court earlier this year upheld much of The Patient Protection and Affordable Care Act (PPACA). The PPACA authorized a wide range of new programs that were instituted for non-profit organizations within the past two years by the U.S. Department of Health and Human Services (HHS).

Various programs within PPACA fund hospitals, medical research, federally-qualified health centers (FQHCs), telemedicine programs, rural health, and a long list of other initiatives. Since enactment of the health law in March 2010, particular agencies within HHS, including the Centers for Medicare and Medicaid Services (CMS), the Health Resources and Services Administration (HRSA), and the Centers for Disease Control and Prevention (CDC) have created numerous opportunities which provide a steady stream of funding for purposes unique to each agency's particular mandate. As long as PPACA remains on the books, funding authorized for these new initiatives will continue to be distributed to eligible non-profits as discretionary, competitive or formula-based grants.

How Non-Profits, Particularly in Health Care, Can Obtain Federal Funds Now: Focus on Federal Agency Grants

One example of such an opportunity is a program designed to create consortia among hospitals, universities, and community health centers. Specifically, the Teaching Health Center Graduate Medical Education (THCGME) program funds community-based ambulatory care training sites such as health centers, in collaboration with hospitals, universities, and/or medical schools to educate primary care physician residents and dentists. And, while certain grants are considered strictly "competitive," meaning they are awarded at the discretion of the agency after careful review of all applicants, this grant is "formula-based." This means eligible applicants who submit a properly completed application will be funded. This is a $230 million, five-year initiative.

Funding for other types of non-profit entities remains widely available, too. Examples include:

- Urban Areas Security Initiative (UASI) grants provided by the U.S. Department of Homeland Security (DHS) to non-profit organizations deemed to be at high risk of terrorist attack (i.e., those located in New York, New Jersey, Los Angeles, Atlanta, the National Capital Region and others). Non-profits apply for these grants in the spring of each year through their state administering agencies (SAA), who decide which applicants should receive support to increase and enhance domestic security in the face of possible terrorist attacks.
- Global Threat Reduction Initiative (GTRI) funding provided by the U.S. Department of Energy is directed to organizations that seek to better secure, remove and dispose of radiological materials they use as part of their normal business operations. The funding is available upon request, which means the Department will provide its expertise and funding on a voluntary basis to domestic organizations which seek government assistance. The program applies to civilian sites where nuclear and radiological materials are used for legitimate and beneficial commercial, medical and research purposes. The voluntary security enhancements complement but do not replace requisite national and state controls on nuclear and radioactive materials. Currently the program provides funding for equipment, structural and even transportation enhancements at so-called "soft targets," meaning hospitals, universities, food producers, blood banks, and organ/tissue donor organizations to help them secure radiological materials used in radiosurgery machines (Cyberknife, Gamma Knife) and to irradiate blood, tissue and food products.
- The CMS Innovation Advisors Program is yet another, unique type of funding proposal, which provides fellowships to create best practices and improve education. The CMS Innovation Advisors Program provides a one-year fellowship to train health professionals in finance and related areas for six months. In total, 73 advisors from 27 states and the District of Columbia were chosen in January 2012; going forward, interested parties can be notified when the agency reopens its next application cycle.

These are just a few examples of a multitude of funding streams that are available to interested non-profits through Primerus members' efforts, efforts likely improved through coordination with knowledgeable advisors who work regularly with agency officials in pursuit of federal dollars.

How Best To Obtain Federal Funds Provided by These Agencies

The probability of success in obtaining federal funds from these and other agencies requires a different approach than the traditional one used in the "earmark-era", that being one of seeking assistance only from Members of Congress.

How Non-Profits, Particularly in Health Care, Can Obtain Federal Funds Now: Focus on Federal Agency Grants

While the support of Congressional offices remains important, today such monies remain available but are awarded by federal agency officials and their staff. Consequently, non-profits are more likely to be funded if they lay the groundwork for their grant requests and applications with federal officials long before their grant applications are due. With proper guidance, applicants can deliver effective presentations and create constructive relationships ahead of time with precisely the agency officials who will determine which organizations receive funding.

In sum, the U.S. government remains an important source of funding for a good share of non-profits for good reason: the expenditures create jobs and provide improved access to many necessary human services.

If you and your clients would like to discuss funding opportunities and how to effectively approach federal agencies and Members of Congress, please contact Kathleen Hatfield khatfield@stewartlaw.com at the Law Offices of Stewart and Stewart, 202-785-4185.

Civility – Professionals, Don't Leave Your Office Without It

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Lawyers are not detached from the world; rather lawyers are a product of their environments. We bring to the profession life experiences and training in the law that is honed by personal attributes that are offered as a service to society. The American Bar Association Model Rules of Professional Conduct capture the complicated fiber of our profession in its Preamble: *"A lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice."*1 The responsibility for the quality of justice, therefore, is placed in the context of the adversarial system and the various functions imposed on the lawyer by the profession. On one hand, when serving as advocates lawyers are required to, "zealously assert the client's position under the rules of the adversary system of justice."2 On the other hand, our adversarial system of justice is a result-oriented system that rewards victors and punishes losers. "Creative and aggressive" structuring of transactions for the benefit of clients is considered excellence by some. However, while aggressiveness and creativity are model attributes for lawyers, these same qualities may disserve clients and the legal profession when left unchecked.3 The economic and financial pressure of the marketplace may nudge lawyers to evade regulatory requirements enacted to protect investors. All of these pressures constrict the moral fiber of lawyers and result in a loss in civility and professionalism. The purpose of this article is to suggest that civility is not a weakness. It is a fundamental requirement imposed upon lawyers as justification for the power that lawyers are granted in our society.

What is Civility? It Is Being a Professional.

Are civility and professionalism the same? Some assert that the cause of the lack of civility and professionalism among lawyers is the absence of a clear definition of the concept of professionalism. The definition of civility is not illusive. A non-lawyer and the "father" of our country, George Washington, provided a clear definition of civility. As a teenager, George Washington copied out by hand, *110 Rules of Civility & Decent Behavior In Company and Conversation.* The rules are based on a set of concepts developed by French Jesuits in 1595. Civility, as defined in Rule No. 1, simply states, *"Every action done in company ought to be with some sign of respect to those that are present."* In other words, *"Treat everyone with respect."* Amazingly, such a laconic definition eludes some in the legal profession. If this standard of conduct was good enough for a sixteenyear- old who sought personal development, certainly it should be good enough for those who are the vanguard of our system of justice. Note that Washington copied these rules and adopted them as his own. He acquired the skill of civility and decent behavior by studying. We should do the same. Civility is an expertise acquired as part of our profession.

Some claim that the definition of professionalism is illusive.4 One of the more succinct definitions of professionalism was developed as the result of the Conference Chief Justices (CCJ). In January 1999, the CCJ, disturbed about the swell in the public's negative perception of lawyer professionalism, adopted the National Action Plan on Lawyer Conduct and Professionalism.5 The National Action Plan defined professionalism as follows:

> *Professionalism is a much broader concept than legal ethics. …professionalism includes not only civility among members of the bench and bar, but also competence, integrity, respect for the rule of law, participation in pro bono and community service, and conduct by members of the legal profession that exceeds minimum ethical requirements. Ethics rules are what a lawyer must obey. Principles of professionalism are what a lawyer should live by in conducting his or her affairs. Unlike disciplinary rules that can be implemented and enforced, professionalism is a personal characteristic. The bench and the bar can create an environment in which professionalism can flourish, and these recommendations are intended to assist in that endeavor. But it is the responsibility of individual judges and lawyers to demonstrate this characteristic in the performance of their professional and personal activities.*6

The CCJ placed the responsibility for acquiring and developing civility and good behavior on the individual lawyers and judges. Self-respect, respect for others, and respect for the law are part of the gene pool of professionalism. Self respect drives the decision not to engage in disrespectful discovery practices. Respect for others, including clients, requires lawyers to exercise judgment with due regard for the meaning of legal norms. In many of the Enron transactions, for instance, an attitude of professionalism may have required lawyers to refuse to issue opinion letters where the transactions violated substantive legal and accounting standards.7 Professionalism and civility, therefore, are skills that are acquired in the same way as one attains proficiency in substantive or procedural law.

The Adversarial System: The System Made Me Do It?

We often blame our incivility on the adversarial nature of our judicial system. The goal of our adversary system is to obtain the truth. Sometimes the quest for the truth is bitter and laborious. When this intense quest produces intangible or even mediocre results, the use of the adversarial system may become an end in and of itself. When this occurs, truth is supplanted by advocacy and the outcome is all that matters. "Just win, baby," was the mantra for a successful Oakland Raiders NFL Football team of a past era. This mantra describes the attitude of advocates or negotiators whose goal is simply to win at all cost. The attitude of winning at all cost is the mother of uncivil and unprofessional conduct.

In an adversary system, the rights of the individual are protected. Those rights are often protected against society. When individual rights clash with society, or when society forces the surrender of individual rights, the individual is given the dignity of fighting for his or her rights.

In this way the adversarial system has intrinsic value because rights are not curtailed without justification. However, because it is the result that is the primary concern of the judicial system the system becomes an end *per se*. The United States of America is the land of the free and the home of the "Bottom Line." While we claim to cherish the individual rights on which our system is based, we seem to cherish even more the result – the judgment, who won and who lost. *"To the victors belong the spoils"* could be the motto for our adversary system of justice. This result-oriented system necessarily places advocacy, rather than civility and professionalism, as the ground rules for success.

While lawyers must zealously assert the client's position under the rules of the adversary system, because of the nature of the adversary system of justice, lawyers typically respond to client pressure to think "outside the box." Many clients desire aggressive and creative lawyers who are willing to walk up to the line of legality and illegality and cross it if necessary. Lawyers must use their abilities honestly and morally.

Civility and professionalism are therefore skills, which develop from the moral and personal qualities of each member of the profession. Consequently, it becomes the duty of each member of the legal profession to hone and develop these skills. Note that the Model Rules do not state how the Rules are to be observed. As such, The Model Rules rely on the personal qualities and moral character of each member of the profession to protect the judicial system with the skills of professionalism and civility.

Zealous Advocacy: A Skill Acquired Through the Exercise of Civility.

First, zealous advocacy does not envision illegal, immoral or unprofessional conduct. However, the pressures of the result-oriented judicial system and the demands of clients thrust lawyers closer to the edge of professionalism and civility and encourage the adoption of the mantra, "Just win baby." In other words, the end justifies the means.8 Unrestrained advocacy erodes the purpose of the system itself. Yet "result-oriented" litigation is the cornerstone of our system and is responsible for breathing life into our individual rights granted by the United States Constitution.9 The result orientation of the law permits jurists and lawyers to improve the quality of life in society. Conversely, zealous advocacy cannot always be assumed to be a force for positive change. Zeal is warranted so long as it does not undermine the system of justice. This system of justice was derived as a method of resolving disputes without physical violence. Zeal, aggression and creativity should not be exercised to the point that justice ends and injustice begins. The Model Rules impose a duty to advocate substantive issues in good faith.10 "Good faith" is defined in the Uniform Commercial Code as, "honesty in fact."11 Honesty in advocacy is as much a skill as it is a character trait. If our system of justice is to survive as a means of improving the quality of life in society, and not become a mere form of verbal combat, honesty, civility and professionalism must be maintained.

Civility is Not a Weakness.

Civility is a necessary skill for lawyers. The skill is honed and developed by the rigors of our adversarial system. An effective lawyer does not have to use deception to win cases. Rather, effective lawyers most often win cases through preparation and knowledge of the facts and law. Lawyers must be creative and often aggressive. Lawyers must represent their clients with the proper level of zeal. Not to do so would be unprofessional. However, when advocacy becomes an end in and of itself, civility suffers, the profession suffers and clients are illserved. Civility is treating everyone with respect. Lawyers must endeavor to treat each other better, least we demean our profession and ultimately disserve our clients.

Endnotes

1 ABA Model Rules of Professional Conduct, Preamble, A Lawyer's Responsibilities, ¶ 1.

2 Id. at ¶ 2. Rule 1.3 of the Louisiana Rules of Professional Conduct (and the current corresponding version of Model Rule 1.3), however, departs from the oft-cited "zealous representation" requirement and provides just that a lawyer "shall act with reasonable diligence and promptness in representing a client." Although the Louisiana Supreme Court did not adopt the official comments to the ABA Model Rules when it adopted the current version of Rule 1.3, said official comments to Rule 1.3 state that a lawyer should act with "commitment and dedication to the interests of the client and with zeal in advocacy on the client's behalf." Thus, as Professor Dane Ciolino has recognized, "while the duty of 'zealous representation,' per se, does not appear in the current Louisiana Rules of Professional Conduct, it is a phrase often used by Louisiana lawyers. (Unfortunately, some lawyers invoke the refrain of 'zealous representation' in an effort to justify unprofessional and uncivil conduct.)" LA. PROF. RESPONSIBILITY LAW & PRACTICE (2007).

3 W. Bradley Wendel, Professionalism as Interpretation, 99 NW. U.L. REV. 1168-1170 (2004).

4 Dane S. Ciolino, Redefining Professionalism as Seeking, 49 LOY. L. REV. 229, 231-232 (2003).

5 National Action Plan on Lawyer Conduct and Professionalism (adopted January 21, 1999 by the Conference of Chief Justices. The definition of professionalism is concise enough to identify civility and professionalism as an acquired skill.)

6 Id. at 2 (emphasis added).

7 See generally William W. Bratton, ENRON, SARBANESOXLEY AND ACCOUNTING: RULES VERSUS PRINCIPLES VERSUS RENTS, 48 VILL. L. REV. 1023, 1044 (2003).

8 See Nicolò Machiavelli, THE PRINCE (1515).

9 Shelly v. Kramer, 334 U.S. 1 (1948); Brown v. Board of Educ., 347 U.S. 483 (1954).

10 ABA Model Rules of Professional Conduct 8.2(a) (5th ed., ABA Ctr. for Prof. Responsibility 2003).

11 UCC § 1-201(19).

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The recession has had a profound effect on the purchase of legal services by corporate counsel. In many companies, the paradigm has shifted from using the largest firms, because that is the safe harbor option, to engaging smaller and/or boutique firms. In some instances, this is occurring because large firm partners are leaving and joining or starting smaller firms, and clients are following their lawyers. In other instances, clients are presenting unprecedented opportunities for high-quality small firms to compete for their business, precipitated by budgetary and economic constraints. While many law firms have had to lay off highly skilled and trained lawyers, many small firms including my firm, Krevolin & Horst in Atlanta, have actually added lawyers because of increased demand from in-house lawyers. Many small firms can provide highly credentialed lawyers with relevant substantive experience on a more cost-effective basis. Here's why:

Lower associate billable rates. At Krevolin & Horst, we recently hired two lawyers who each had over eight years' experience and were on partnership track at very large, prominent firms with principal offices based in Atlanta and Washington, D.C. We reduced their hourly rates by over $200 per hour. Same lawyers, same credentials, same quality, for a lot less money.

Lower partner billable rates. Many small firms like ours are formed by lawyers who previously were partners in large firms. Typically, once moving to a smaller firm, partners are able to reduce their hourly rates substantially. This presents a wonderful opportunity for in-house counsel to engage partners with the substantive knowledge and experience they desire while saving money under their outside counsel budget.

No billing gimmicks. Small firms typically offer reasonable rates from the inception of the relationship. On the other hand, many large firms recently have tried to preserve client relationships by offering discounts of 5 to 25 percent. That begs the question, why were the rates so high initially? We recently won a beauty contest defending a complex trade secrets case where several large national firms decreased their quoted billing rates by about a third in 48 hours to try to win the business. Ultimately, with the substantial discounts, the large firm rates were fairly comparable to our rates, but the client engaged us because we had been straightforward from the beginning about what our rates would be and because of the lawyers with trade secrets experience who would staff the case. The client felt we would not overstaff or overwork the case to make up for the discounted rates.

Experienced partners. Small firm lawyers typically are capable of handling the entire transaction or litigation from start to finish. The transactional lawyers are familiar with all aspects of a deal as opposed to one component. They also know how to get deals closed and contracts signed without endless negotiating over minor issues. Small firm litigators typically will have more trial experience than their large firm counterparts simply because of the mix of cases. We were recently selected over several large firms to defend the senior executive officers of a large financial institution who had been sued in a shareholder derivative case. We were brought in two months before trial to try the case. We have trial lawyers who had corporate governance expertise, substantial trial experience and rates that were far below our competitors. Fortunately, we won a defense verdict after a seven day jury trial.

Partnering with other lawyers/firms. Small firms tend to focus on a limited number of practice areas and handle those matters competently and efficiently. On the other hand, there are some matters which only large firms have the unique, specialized knowledge to handle. For those matters outside our area of expertise, we assist our clients by referring them to the lawyers we know are the most capable to handle the matter for the client. Rather than just getting stuck with a "guy down the hall who does that stuff" like clients sometimes get at large firms, since our only objective is to best satisfy the client's needs, we recommend the person we believe will do the job.

Direct access to partners. Small firms emphasize personalized attention. Clients typically get the benefit of direct access to partners who, because of their experience, many times can answer a question either on the telephone or by email. Matters get handled right the first time and in less time.

Availability of alternative fee arrangements. Small firms tend to be more entrepreneurial and have lower overhead, giving them the flexibility and willingness to be creative in fee arrangements. Those arrangements include flat or fixed fees for a certain type of case or business transaction, hybrid arrangements of reduced hourly rates with a contingency component that provides the law firm and client a shared risk/reward platform, or a contingency arrangement which is sometimes used for business litigation.

Substantially lower overhead. This includes everything from elimination of law libraries (everything is available electronically), summer associate programs, mock court rooms (we prefer real ones) to fewer administrative staffers, less expensive office space, and lower partner and associate incomes.

No billable hour requirements for associates. At Krevolin & Horst, we have never had a formal billable hours requirement. Our belief is that an hours quota simply emphasizes number of hours over quality of the hours. If we hire responsible attorneys, they will work as hard as necessary to get the work out the door in a timely, competent manner. Artificial hour requirements simply provide an incentive for associates to spend more time on a matter than may be necessary.

No first-year associates. It has been our experience as former hiring, training and billing partners at large firms, that much, if not most, work done by first-year associates provides little client value. At Krevolin & Horst, we only hire lawyers who have either clerked for a federal judge and/or worked for a large firm for at least two years. This allows us to take advantage of the training provided by others and hire associates better prepared to hit the ground running.

Compensation for partners and associates is tied to overall firm performance. This eliminates internal file hoarding by lawyers seeking higher compensation through higher billable hours and instead causes the work to be done by the lawyers with the most relevant skills and experience.

Thinner staffing on both transactional and litigation matters. The practical reality of small firms is that they simply don't have the bodies to put layers of lawyers on each matter. The organizational structure is much flatter as opposed to a giant pyramid. Do you really need five layers of associates, senior associates, junior partners and senior partners reviewing and revising a brief before it goes out the door? At Krevolin & Horst, our largest litigation cases (involving eight-figure damage claims and hundreds of thousands of documents) have three lawyers. Most cases are handled by two lawyers, and some by one with minimal supervision or assistance provided by one other lawyer. The same applies to transactional matters. Most corporate or commercial real estate deals are handled by two lawyers. Work is performed by the lawyer who can do it most cost effectively whether they are a partner or an associate.

The Primerus advantage. By joining Primerus, Krevolin & Horst now has the ability to offer clients a network of highly competent, small firms who approach the business of practicing law like we do. This helps us compete against much larger firms.

Jeff Horst is a business litigator and has handled a wide variety of business related disputes in the areas of accountant liability, business torts, contracts, corporate governance, covenants not to compete, employment, entertainment, franchise, insurance coverage, intellectual property, officer and director liability, securities litigation, shareholder disputes and trade secrets.

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