VOLUME 11

FINEMAN & BACH, P.C.

FALL 2002

LEGALNOTES

INFORMATION FOR OUR BUSINESS AND CORPORATE CLIENTS

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PROTECT YOURSELF AGAINST TOXIC MOLD–AND THE LAWSUITS IT MAY BRING

The growing number of lawsuits seeking monetary damages as a result of mold infestation should be of concern to all property owners. Recent cases range from the homeowner who is forced to sue his insurance company for failing to pay the cost of mold remediation following a basement water damage claim to multimillion dollar suits against construction companies claiming that entire buildings are unfit due to mold contamination.

News reports of school closures and apartment building evacuations due to mold contamination will surely result in litigation against owners, contractors or landlords. When Ed McMahon sued his homeowners carrier for more than $80 million in damages for injuries allegedly caused by exposure to mold, newspapers carried the story on the front page, especially after he alleged that his dog died from mold-related illness. Public fear of mold and mysterious mold-related ailments coupled with extensive publicity surrounding million dollar lawsuits have resulted in numerous claims against apartment building owners, contractors, architects and real estate sellers and agents.

LAWSUITS STRIKE EVERYWHERE

Apartment building owners in particular have been targeted by tenants claiming both property damage and personal injury stemming from alleged mold contamination in their apartments. Although many mainstream medical doctors dispute the allegations that exposure to mold can cause headaches, inability to concentrate and unexplained weakness and fatigue, there are other "experts" who will testify in court that the moldy closet has resulted in the disability of a tenant occupying the apartment.

Jury verdicts and settlements in such cases have been notable. Last November, a California jury awarded a family over $2 million for personal injuries and damage to their property caused by a moldy apartment. The lawsuit was filed after the property manager refused to reimburse them for their damaged property and moving expenses. A New York City owner of two apartment buildings paid a reported $1.8 million to settle claims of 140 tenants who claimed they became ill and lost property due to mold.

Companies that provide services to residential and commercial businesses have been caught up in the "mold frenzy" as well. There have been claims against roofing contractors who negligently allow water damage to a structure causing the growth of toxic mold, in one case allegedly causing injury to teachers and students in a middle school, as well as claims against HVAC contractors. What sets these cases apart from ordinary negligence cases is the potential for an excessive verdict based upon ill defined and hard to refute claims of personal injury caused by toxic mold.

TAKE PREVENTIVE MEASURES

The key to defending yourself or your business against such claims involves good preventive measures and prompt action if a claim does arise. Since mold requires a moist medium for growth, it is critical to stop any leak or source of water infiltration as quickly as possible. Stopping the source of water will stop the growth of mold. Next, you should seek competent advice concerning removal and remediation of any mold that is found. Unlike hazards such as asbestos or lead paint, mold is often contained in a finite location that is capable of being cleaned and removed or replaced if necessary.

Insurance companies are grappling with the question of whether their homeowner and commercial insurance policies cover mold-related claims. Courts are beginning to interpret language in homeowner's policies,

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FAMILY LIMITED PARTNERSHIPS UNDER FIRE AGAIN

A recent Tax Court case has had a chilling effect on inter-generational gift tax planning. The decision has sent tax planners back to the drawing board to devise new ways to accomplish old objectives of transferring assets from the older generation to the younger generation without the imposition of federal gift tax. All who are considering gifts through family limited partnerships or limited liability companies, or who have already made such gifts, should take heed.

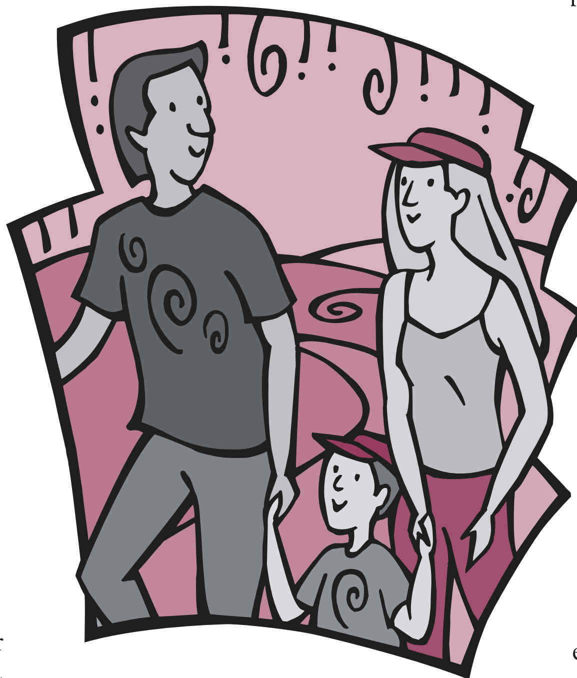
In the Hackl case, the United States Tax Court recently announced an important decision concerning the use of family limited partnerships to accomplish estate planning goals. The Tax Court held that direct gifts of immediately vested ownership interests in a limited liability company (or, for that matter, limited partnership interests) do not constitute gifts of a present interest in property. Accordingly, such gifts will not qualify for the annual exclusion from gift tax. As a result of the Hackl decision, it may be necessary to rethink the manner of current gifting programs and to review the terms of family limited partnership agreements and the operating agreements of limited liability companies.

GIFT TAX REGIME

Under current law, there is an annual gift tax exclusion of $11,000 per year, per donee. In order to qualify for the exclusion, the gift must be an unrestricted right to the immediate use, possession or enjoyment of the property or the income derived from the property. In other words, the IRS requires that the donee has meaningful economic rights, rather than paper rights, in the property transferred. Courts have required that indirect gifts (gifts to trusts or gifts to an entity with pre-existing owners, such as a family limited partnership) must give the donee (the beneficiary of the trust or the entity's owners) "a substantial present economic benefit by reason of use, possession or enjoyment of either the property itself or income from the property." If the donee does not have immediate enjoyment either because of contingencies or future uncertain events, the gifts are taxable. This may not result in the payment of gift tax, but would reduce the donor's lifetime exemption from gift tax (currently $1,000,000).

THE HACKL CASE

In 1995 and 1996, Mr. & Mrs. Hackl gave gifts of membership interests in a limited liability company to their children and grandchildren and claimed annual exclusions for the gifts. Mr. Hackl had previously organized the company to hold and operate tree farming properties. The limited liability company was governed by an operating agreement which set forth the rights of the members and the managers. Mr. Hackl served as the limited liability company's manager.



The Tax Court ruled that the gifted membership interests in 1996 did not give the donees immediate right to the use, possession or enjoyment of the property, as required under the Internal Revenue Code. After reviewing the terms of the operating agreement, the Tax Court determined that various provisions of the entity's operating agreement prevented the donees from having access to any immediate substantial economic or financial benefit in the interests gifted.

The Court suggested that had the terms of the operating agreement been different, the gifts might have qualified for the annual exclusion. Acceptable terms would have included the right of a member to demand and obtain a return of capital; the right of a member to sell the membership interest without the consent of the manager; or the right of a member to effect a dissolution.

PLANNING OPPORTUNITIES

The Hackls' estate planning goals were not unique. They were attempting to (1) reduce their taxable estates through the transfer of property; (2) transfer of interests in the limited liability company prior to the appreciation of the assets; and (3) maintain control of the entity and the cash flow of the entity after the transfer of the interests.

In light of the Hackl decision, the real question becomes how to accomplish these goals without incurring gift tax. A suggested plan would be for a taxpayer to establish an irrevocable grantor trust for the benefit of any children or grandchildren ("children's trust"). The donor would then give cash in an amount equal to the value of the interest to be transferred to the children and/or grandchildren. The trusts would be established as Crummey trusts so that gifts would qualify for the annual exclusion. The children's trust would contain a withdrawal right which would then confer economic value to the member's interest and qualify it for the annual exclusion.

The children and grandchildren could then purchase, at a discounted rate, interests in an LLC from the taxpayer, using the cash which had been gifted. Caution should be exercised when planning the purchase of the interest from the entity. For example, some time should elapse between the gifting of the cash to the children's trusts and the purchase of the interests. Also, there should be no pre-arranged plan or requirement that the interests in the LLC be purchased by the children's trust.

CONCLUSION

It is believed that the taxpayers intend to appeal the Hackl decision to the Seventh Circuit, and there are some practitioners that believe the decision may be

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RECENT SUPREME COURT DECISION EXTENDS A CREDITOR'S REACH

The protection of one's assets from creditors is a concern of everyone. A recent United States Supreme Court case (the Craft case), significantly expanded the rights of the Internal Revenue Service, and possibly other creditors, to reach assets owned by a debtor as "tenants by the entireties". This is the most common form of property ownership by a husband and wife.

The recent holding runs contrary to most states' interpretation of the law regarding tenants by the entireties. Although Craft is a decision based on Michigan law, Pennsylvania law is very similar.

In Pennsylvania, a tenancy by the entirety is only available to married couples. The tenancy creates a fiction that the property interest is held by the "unity" of the married couple, and not by either spouse, individually. In the past, this distinction has prevented property held by tenants by the entireties from being attached or levied upon by the creditor of only one spouse.

Many people in Pennsylvania use tenants by the entireties property as a form of asset protection against creditors. Although the Craft decision may be limited to only federal tax liens, it should cause all concerned to reconsider whether a creditor, who has a claim against one, but not both spouses, may reach entireties property. It appears from the Craft case, the entireties property is now certainly within the reach of the IRS, however, whether it is within the reach of all other creditors remains to be seen.

Besides tenants by the entireties, there are other vehicles available for achieving asset protection, such as the use of limited liability companies, family limited partnerships, trusts and pension plans. These vehicles may offer greater protection than having an asset owned as tenants by the entireties. With the decision in Craft, one should revisit how much asset protection they are achieving by having property held as tenants by the entireties.

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NEW PA LAW MAY DISCOURAGE LAWSUITS

In June 2002, the Pennsylvania Legislature enacted legislation to restrict the applicability of the so-called tort doctrine of "joint and several liability." This law should address some concerns of the business community, and it may even discourage some lawsuits against "deep pocket" co-defendants.

Over the years, joint and several liability has been the focal point of the unfairness of Pennsylvania Tort Law. The doctrine, which applies when more than one defendant is found liable for plaintiff's injuries, assigns a proportionate share of liability among those defendants. For example, a jury which has made an award in favor of the plaintiff will also assign a percentage of fault among each of the liable defendants.

However, joint and several liability makes each liable defendant responsible to pay the entire judgment to a plaintiff regardless of the defendant's fault. Consequently, a defendant who is found 1% negligent could be responsible to pay an entire verdict if the co-defendant was uninsured, underinsured, insolvent or for any reason unable to pay his or her share.

Joint and several liability was adopted to make certain that the plaintiff was made "whole" by enabling the plaintiff to collect the full amount of any judgment against any of the liable defendants. In reality, the doctrine encouraged plaintiffs to seek a defendant with "deep pockets" and to target that defendant so a jury would at least find the most financially responsible party partially negligent and insure that the entire verdict could be paid. That practice has now changed.

Under the new law, joint and several liability would only apply when a defendant is deemed to be at least 60 % responsible for causing an injury. Before a liable defendant could be required to pay the entire judgment, it must be adjudicated at least 60% responsible. Where a defendant is found less than 60% responsible, it would be responsible to pay only his share of the award.

As you can see, the statute certainly remedies the unjustified scenario where a defendant with "deep pockets" and only very limited liability could not be compelled to pay the full judgment regardless of its level of fault. Joint and several liability would not "kick-in" and make that defendant potentially responsible for the entire judgment until it was found at least 60% responsible.

The Act does create several exceptions. Joint and several liability, as it existed before the new law, would apply where an injury was intentionally caused by the defendant, where an injury was caused due to fraud for violations of the liquor liability law and the Hazardous Sites Cleanup Act.

By passing this law the Pennsylvania Legislature severely curtailed the applicability of joint and several liability. The law, as passed and now in effect, is one of the strictest restrictions on joint and several liability in the United States.

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FAMILY LIMITED PARTNERSHIPS

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reversed. However, until that time, taxpayers must contend with the Tax Court's ruling. Even though the Tax Court has made gifting of noncontrolling interests in a limited liability company and a family limited partnership more complicated, there are still other techniques available to accomplish the same goals. For taxpayers that have already completed Hackl-like transfers, it might be advisable to review the terms of the entity's governing instruments to determine if any amendments are necessary.

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BEWARE OF SECURITIES INDUSTRY ABUSES; MAKE SURE YOUR BROKER SERVES YOU

It seems that one securities brokerage house did make money "the old fashioned way" - by taking advantage of its smaller customers while pandering to those mega-corporations that paid consulting fees in the millions and tens of millions of dollars. The New York Attorney General conducted an in-depth investigation of the broker-dealer and hit the jackpot when emails were discovered in which analysts disparaged some of those investment banking clients. Saying that a client's business is "crap" may seem to be only indiscrete or bad business but, in this case, those same analysts were telling you and me to buy the client's stock. And that is a blatant conflict of interest which earned a $100 million fine.

INDUSTRY ABUSES HAVE BEEN PREVALENT

Brokerage houses also have been known to recommend that you buy a particular stock and then, when you do, sell it to you from its own inventory. Why exactly are they recommending that you buy while they are selling? Also, favored clients were given advance information of changes in the broker's recommendation. If for example the change is from "hold" to "buy", the favored clients will have bought before you get the same information - and after the price started to rise. Or suppose that you instruct your broker to buy XYZ stock at market and discover that your broker immediately bought XYZ at 25 and sold it to you for 251/4. This is not the "best execution" to which you are entitled.

It is not surprising that some brokerage houses routinely engaged in these practices. For quite some time, these abuses were considered acceptable and small investors were considered fair game. Friendly regulatory agencies were not concerned with these practices and overprotective courts bent over backward to protect the huge securities industry and maintain New York as the financial capital of the world. One mechanism for protecting brokerage firms arose was a natural outgrowth of separating the selling and administrative functions, that is, separating the "introducing broker" from the "clearing broker." The selling or introducing broker might be guilty of the most flagrant misrepresentations or bucket shop practices, but when called to account by the swindled investor, there are no assets to be found and there is no fund from which restitution can be made.

Some investors sued the clearing broker without whom the transactions could not have taken place in the hopes of finding a responsible party which still had assets.. But, courts were reluctant to hold the clearing brokers responsible under any circumstances. Some courts went so far as to declare that the clearing broker had no responsibility to the customer even if it had actual knowledge of fraud and continued to clear the fraudulent transactions. No only was the clearing broker relieved of any legal duty to alert the customer to the fraud, it remained free to process transactions knowing that they were fraudulent.

THINGS ARE CHANGING

It has only been during the past few years that courts and arbitrators have been taking a different view, primarily due to the unholy alliance between the broker, A. H. Robbins, and Bear Stearns, which was Robbins' clearing broker. Bear Stearns officials actively and knowingly took steps which enabled A. H. Robbins to stay in the business of selling worthless stock and violate a myriad of SEC rules and regulations. Robbins and Bear Stearns both became the target of lawsuits. Arbitrators and courts were unable to ignore the evidence or exonerate Bear Stearns. Chinks soon began to appear in the armor that the courts had crafted. There have been other cases and other decisions. The recent revelations about corporate America and the broker-dealers cannot help but accelerate the trend.

It is important to recognize, however, that these problems are the result of industry practices, rather than necessarily reflecting upon the integrity or competence of your broker and it is not our intention to condemn all stock brokers. As in any profession, the majority are honest, competent and interested in their clients' interests but there are some rotten apples as reflected by the SEC and NASD disciplinary actions. If you are an active investor, your best protections are to know your broker, keep abreast of the market and business news and watch transactions in your portfolio carefully.

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TOXIC MOLD

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which may or may not cover the cost of mold remediation in your home if you suffer a water damage claim. Similarly, a Commercial General Liability policy may contain language that the insurer believes excludes coverage for mold-related claims. If you feel that you have even potential exposure to a claim involving mold, you may want to consult an attorney experienced in the area of mold litigation and related insurance issues. The law in this area is developing in response to the number and variety of cases filed, and your counsel may be able to guide you through any pitfalls you may be facing now or in the future.

Although mold has been around since the dawn of time, it is making its presence known in courtrooms around the country as never before. Advance knowledge of its dangers and proper preventive action can help reduce your chance of getting caught up in the frenzy.

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