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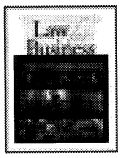

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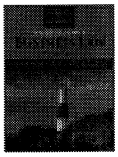

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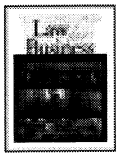

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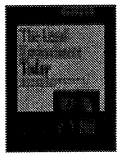

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ARTICLES

PEDAGOGY

THE CONFLICTING RIGHTS OF CREDITORS AND BENEFICIARIES IN A DECEDENT'S ESTATE: AN EXAMINATION OF THE LAWS OF NEW YORK, NEW JERSEY AND CONNECTICUT

by

Elizabeth A. Marcuccio* and Albert B. Kukol**

I. INTRODUCTION

"A man must be just before he is generous."[1] This ancient equitable maxim comes to mind when examining the rights that creditors have in a decedent's estate. Probate assets of a decedent-debtor are generally available to creditors. Probate systems developed to gather the decedent's assets, pay creditors' claims out of these assets, and distribute what is left to the designated beneficiaries. This system is in alignment with one of society's important policies: creditors should be paid. However, this policy sometimes conflicts with an equally important policy: the right of decedents to dispose of their property as they see fit. The purpose of this article is to examine the laws of New York, New Jersey and Connecticut to

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determine what rights creditors have in the assets of a decedent who died a resident of one of these states.

The laws of these three northeastern states make it clear that both the real and personal property of a decedent, if subject to probate, is chargeable with the payment of the decedent's debts.[2] However, more and more people are opting out of the probate system to avoid the delays and expenses of probate administration. Creditors need to be aware of this shift and, more important, know what non-probate assets are available to pay their claims.

II. JOINT ACCOUNTS

Jointly-held stocks, bonds, mutual funds, and bank accounts are very common, and are established for a variety of reasons. When a deposit of cash, securities or other property is made in the name of a depositor and another person in a joint account, it is presumed that the depositor intends to establish a joint tenancy with survivorship rights.[3] So when a father opens a joint account in his name and the name of his daughter, it is prima facie evidence that he intends that his daughter have survivorship rights in that account.[4] But to what extent is this account available for the payment of creditors after the father's death?

The test used by New York Courts to determine creditors' access to non-probate assets is whether the decedent maintained the power to dispose of the asset during his lifetime.[5] In New York, the daughter receives a gift of a moiety, or one-half, of the value of the property on deposit.[6] Although one-half of the value of the account is considered "vested" in the daughter, or gifted to her, at the time the account is opened, the other moiety clearly remains the father's property and is subject to attachment by his creditors during his

lifetime. The father is regarded as its absolute owner until he dies because he had unrestricted power to dispose of his moiety during his lifetime. This allows creditors to reach his one-half interest in the joint account after his death, even though he had named his daughter to succeed to his interest.[7]

Under certain circumstances, creditors of a New York decedent can reach the entire balance of a joint account. This would be the case if the father opened the joint account solely to give his daughter easier access to the funds. If there is clear and convincing evidence that the father did not intend to make a gift to his daughter, but added her as a signatory for his own convenience, the opening of a joint account does not affect title, and the entire account is available to creditors.[8] The total account can also be reached if our depositor was rendered insolvent either when he initially opened the joint account with his daughter, or if upon his death his estate was ultimately rendered insolvent by the establishment of the joint account.[9] Any creditor having a claim against the father's estate can maintain an action to set aside the conveyance as fraudulent, regardless of whether or not the father actually intended to defraud his creditors.[10]

Would the result be different for creditors of a decedent domiciled in either New Jersey or Connecticut? In New Jersey, when a father opens a joint account in his name and the name of his daughter, the inter vivos rights of the parties are not affected.[11] The father can insist that the account remain his sole property during his lifetime, and that his purpose in opening the account was only to achieve a gift to his daughter upon his death. The father's right to control the entire account makes the total account available to the father's creditors both during his lifetime and upon his death, whether or not he actually retains control over the account.[12]

In Connecticut, statutory law requires a surviving account owner to pay from a joint account the following claims against the deceased account owner's estate: funeral expenses, expenses of settling the estate, debts owed for the last illness of the decedent, and any debt due to the state of Connecticut for the aid and care of the decedent.[13] Connecticut case law further expands creditors' rights in joint accounts. Co-holders of a joint account are considered owners of the total account and have access to the entire account balance.[14] When a father adds his daughter's name as a joint owner to his account, either the father or daughter can withdraw all of the funds.[15] As a result, Connecticut Courts have ruled that the entire account is available for the payment of any valid claim against the father, either during his lifetime or upon his death.[16]

III. TOTTEN TRUST ACCOUNTS

When a father opens a savings account "in trust" for his daughter, there really is no trust, but merely a bank account that is payable to the daughter upon the father's death. A tentative trust exists that is revocable at the will of the father until he dies or completes the gift during his lifetime. There is only a presumption that an absolute trust will arise in favor of the daughter upon the father's death. As a result, in all three states when probate assets of the father are insufficient to pay his valid debts, the presumption is rebutted to the extent necessary to make up the deficiency.[17] The estate representative has the authority, and maybe even the duty, to set aside Totten trust accounts to the extent necessary to protect creditors when probate assets are insufficient to pay their claims.[18]

IV. U.S. SAVINGS BONDS

Let's turn to the situation where the father purchases a U.S. savings bond and designates his daughter as either the co-owner or beneficiary of the bond. Can the father's creditors look to the bond for payment of their claims? The passage of title to U.S. savings bonds is governed by the regulations of the Treasury Department, and not by the rules of property law of the individual states.[19] Therefore, the result would be the same whether the father died a resident of New York, New Jersey or Connecticut. Even if the father's probate assets are insufficient to pay his obligations, the bond may not be used to pay the father's creditors.[20] The estate representative is entitled to recover from the daughter only the ratable amount of estate tax imposed as a result of the bond being included in the father's taxable estate. [21] The creditors of this insolvent probate estate can look to the savings bond for payment only if the father purchased the bond with the actual intent to defraud his creditors.[22] Actual fraud cannot be presumed, it must be proven.[23]

V. LIFE INSURANCE

The primary purpose of life insurance is to protect the dependent beneficiaries of an insured by providing them with funds to live on after the insured's death. The insurance laws in New York, New Jersey and Connecticut clearly recognize this purpose, even though life insurance is purchased for many different reasons.[24] If a father names his daughter as the beneficiary of the death benefit payable under his life insurance policy, these proceeds are generally exempt from the claims of the father's creditors in all three states.[25] Only if the father intends to defraud his creditors can his creditors reach these proceeds. In New York, the father must actually intend to defraud his creditors at the time he names his daughter as the

beneficiary.[26] Under New Jersey law, the daughter is entitled to the proceeds against all creditors, but she is not entitled to the amount of premiums her father paid with the intent to defraud his creditors.[27] Pursuant to Connecticut law, the daughter is entitled to the proceeds unless her father intended to defraud his creditors either when he purchased the policy, or when he named her as beneficiary.[28] What if the father does not want the death benefit paid directly to his daughter, but instead wants these proceeds to be poured into a testamentary trust established for her benefit?

In all three states, whether or not the father's creditors can attach these proceeds depends on the specific language used by the father on the beneficiary designation form. If the father names "...my estate..." as the beneficiary, the proceeds are treated like any other probate asset, and are available to pay his creditors' claims.[29] However, in all three states if the father names "...the Trustee of the trust established under Article X of my Last Will and Testament..." as the beneficiary, these proceeds remain exempt from the claims of the father's creditors to the same extent as if the proceeds were payable directly to his daughter.[30] In the alternative, what if the father names the trustee of an inter vivos trust? In all three states, the proceeds remain exempt from the claims of the father's creditors, but in New York there is one very important exception.

When the father names the trustee of his testamentary trust as the beneficiary, it does not matter whether the will containing the trust is executed before or after this designation is made.[31] However, if the beneficiary is the trustee of an inter vivos trust, the trust agreement naming the trustee must be in existence on the date that the beneficiary designation is made and the trust agreement must be identified in the designation.[32]

Otherwise, the proceeds are available to pay the creditors of this New York decedent.[33]

VI. RETIREMENT PLANS (ERISA COVERED PLANS)

Many employers provide retirement and death benefit plans for their employees. Additionally, many employees who do not have employer-provided plans, as well as self-employed individuals, set up their own retirement accounts. The Employee Retirement Income Security Act (ERISA) is the federal law governing most employer sponsored plans.[34] ERISA supersedes all state laws that "relate to any employee benefit plan" governed by ERISA in an effort to provide protection to employees.[35]

The primary purpose of a pension is to ensure that the retired employee will have enough money to live on, free from creditors' claims. Under ERISA, retirement plans must have an "anti-alienation" clause, prohibiting assignment of the interest under the plan.[36] This makes it clear that these plans are protected from creditors while in the hands of the plan administrator, but are the monies protected once they are paid out to the beneficiary?

Let's assume that a retired father names his daughter as the beneficiary of his pension plan. During his lifetime the father receives periodic payments from this plan. It is clear that once these funds reach his hands, they are subject to attachment by his creditors.[37] Both New York and New Jersey courts have specifically looked at ERISA covered plans, holding that ERISA's anti-alienation clause protects funds while in the pension plan, but permits attachment once received by the pensioner.[38]

But can the father's creditors reach the ERISA pension plan proceeds upon his death? What is the status of the benefits when paid to the daughter, since the father designated her as the third-party beneficiary of the plan benefits? As of yet, there is no case which specifically addresses this issue. One can argue that since the plan benefits, when paid to the father, would be available to his creditors, such should be the result here. But should the result be the same when paid to a beneficiary who is not the judgment debtor, like the daughter in our example?

VII. RETIREMENT PLANS (NON-ERISA COVERED PLANS AND ACCOUNTS)

While ERISA covers many employer sponsored plans, many similar pension plans and retirement accounts fall outside of ERISA, such as Individual Retirement Accounts ("IRAs"), Roth IRAs, 403b plans, and state and local government pension plans. Assume that the father had an IRA, again naming the daughter as his beneficiary. Since the IRA is not protected from creditors by ERISA, is there state law which steps in to do the same job? Is the IRA exempted from the claims of the father's creditors? How does each state treat these non-ERISA retirement plans and accounts after the father's death?

In New York, the IRA is exempt from the claims of the father's creditors during his lifetime.[39] It has also been held to be exempt from the claims of his creditors after his death, upon the subsequent payment to his daughter as named beneficiary.[40] It does not matter that the father retained all incidents of ownership and could change the beneficiary at any time during his life. The daughter is entitled to the proceeds.

Thus, in New York, even when ERISA does not apply to certain retirement plans, either statute or case law exempts virtually every type of retirement plan from claims of the decedent's creditors.[41] New York State employees' retirement plans, New York State teachers' retirement plans, Individual Retirement Accounts, Federal Thrift Savings Plans, and 403(b) retirement annuities are all exempt from the claims of the employee's creditors after the employee's death.[42] In addition, because the Federal Thrift Savings Plan is similar to 401k plans offered by private employers, there is no logical reason why 401k plans should not be protected from creditor claims after the employee's death.[43]

What if the father had conveyed assets into his retirement plan with the intent to defraud his creditors? Can his creditors reach the plan benefits when they pass to his daughter upon his death? In New York, EPTL 7-3.1(b) allows creditors to reach fraudulent conveyances into such accounts.[44] Those assets of the account tainted by fraud are no longer exempt from creditors' claims. Creditors can look to these assets for payment when they pass to the daughter upon the father's death.[45]

What if the father is a resident of Connecticut or New Jersey? What is the status of non-ERISA accounts and plans in those states? In both states, statutory and case law similarly exempt non-ERISA accounts and plans from creditors' claims during the father's lifetime.[46] In addition, New Jersey, like New York, allows creditors to attach an IRA that was fraudulently created.[47]

Neither Connecticut nor New Jersey Courts have addressed the issue of whether non-ERISA accounts are exempt when paid to a daughter who was named as the deceased father's beneficiary. While their statutes and their

courts' legal analysis are similar to New York's when reviewing such non-ERISA accounts prior to the father's death, it remains to be seen whether this analysis will carry through after the father's death.

VIII. CONCLUSION

Probate avoidance has increased dramatically in recent years, and the law concerning creditors' rights in nonprobate assets remains fragmented and underdeveloped.[48] Creditors' claims will continue to be examined on a case by case basis because there is no comprehensive statute setting forth the rights of creditors in nonprobate assets.

ENDNOTES

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[1] *Merchants' and Miners' Transp. Co. v. Borland*, 53 N.J. Eq. 282 (1895).

[2] N.Y. Est. Powers & Trusts Law § 13-1.3 (Consol. 2006); N.J. Stat. Ann. § 3B:22-19 (Lexis Nexis 2006); Conn. Gen. Stat. § 45a-428 (2006).

[3] N.Y. Banking Law § 675(a) (Consol. 2006); N.J. Stat. Ann. § 17:16I-5(a) (Lexis Nexis 2006); Conn. Gen. Stat. § 36a-290 (2006).

[4] *Id.*

[5] *In re Trust of Gallet*, 765 N.Y.S.2d 157, 160-61 (Sur. Ct., N.Y. Co. 2003).

[6] *In re Granwell,* 228 N.E.2d 779, 781 (N.Y. 1967).

[7] *Id.* at 782.

[8] *In re Estate of Johnson*, 7 A.D.3d 959, 960 (3d Dept. 2004) *appeal denied* 818 N.E.2d 665 (N.Y. 2004). N.Y. Banking Law § 678 (Consol. 2006) also permits the father to open the joint account jointly with his daughter "for the convenience" of the depositor. Signature cards or account creation

documents with this notation would cause all the monies to be part of the father's probate estate when he died, and thus fully available to creditor's of his estate.

[9] *Granwell*, 228 N.E.2d at 782-83; N.Y. Debt. & Cred. Law § 273 (McKinney 1990) (providing that a conveyance made without fair consideration is fraudulent as to creditors if the transferor is or will be rendered insolvent).

[10] N.Y. Debt. & Cred. Law 273 (McKinney 1990).

[11] *Bauer v. Crummy*, 267 A.2d 16, 56 N.J. 400, 410 (1970).

[12] *Id.*

[13] Conn. Gen. Stat. § 36a-292 (2006).

[14] *Ardito v. Olinger*, 782 A.2d. 698, 65 Conn. App. 295 (2001).

[15] *Fleet Bank Connecticut, N.A. v. Carillo*, 691 A.2d 1068, 240 Conn. 343, 347 (1997).

[16] *Id.*

[17] *In re Estate of Halbauer*, 228 N.Y.S.2d 786, 788 (Sur. Ct., Suffolk Co. 1962), *aff'd* 238 N.Y.S.2d 511 (2d Dept. 1963); N.J. Stat. Ann. § 17:16I-7 (Lexis Nexis 2006); Conn. Gen. Stat. § 45a-368, 369 (2006).

[18] *Halbauer*, 228 N.Y.S.2d at 788; *In re Estate of LaPine*, 1 Misc. 3d 384, 768 N.Y.S.2d 966 (Sur. Ct, Dutchess Co. 2003), *rev'd in part*, 795 N.Y.S. 2d 294 (2nd Dept. 2005); N.J. Stat. Ann. § 17:16I-7 (Lexis Nexis 2006); Conn. Gen Ann. § 45a-368, 369 (2006).

[19] *Franklin Washington Trust Co. v. Beltram*, 29 A.2d 854, 133 N.J. Eq. 11 (1943).

[20] *In re Estate of Satnick*, 537 N.Y.S.2d 464, 465 (Sur. Ct., Bronx Co. 1989).

[21] *Id.*

[22] *Id.*; *Reynolds v. Danko*, 36 A.2d 420, 134 N.J. Eq. 560, 562 (1944).

[23] *Reynolds*, 134 N.J. Eq. at 562.

[24] N.Y. Ins. Law § 3212(b)(1) (McKinney 1985 & Supp. 1997); N.J. Stat. Ann. § 17B:24-6 (Lexis Nexis 2006); Conn. Gen. Stat. § 38a-453 (2006).

[25] *In re Estate of King*, 764 N.Y.S.2d 519, 521 (Sur. Ct., Broome Co. 2003); *Keegan v. Estate of Edward J. Keegan*, 741 A.2d 134, 157 N.J. Super, 279, 292 (1978); N.J. Stat. Ann. § 17B:24-6(a) (Lexis Nexis 2006); Conn. Gen. Stat. § 38a-453(a) (2006).

[26] *Satnick*, 537 N.Y.S.2d at 465.

[27] *U.S. v. Best*, 357 U.S. 51, 78 S. Ct. 1054, 2 L. Ed. 2d 1135 (1958); *Keegan v. Estate of Edward J. Keegan*, 741 A.2d 134, 157 N.J. Super. 279 (1978).

[28] Conn. Gen Stat. § 38a-453(b) (2006).

[29] *In re Will of Knoedler*, 35 N.E. 601, 601-02 (N.Y. 1893).

[30] 7-13 Patrick J. Rohan & R. Mark Davis, New York Civil Practice, at N.Y. Est. Powers & Trusts Law § 13-3.3(c) (2005); *Keegan*, 157 N.J. Super. at 293; Conn. Gen. Stat. § 38a-451 (2006).

[31] Rohan, *supra* at § 13-3.3(a)(2); *Keegan*, 157 N.J. Super. at 293; Conn. Gen. Stat. § 38a-451 (2006).

[32] Rohan, *supra* at § 13-3(a)(1).

[33] *Id.*

[34] See generally 29 U.S.C. § 1002 (2005).

[35] 29 U.S.C. § 1144(a) (2005).

[36] 29 U.S.C. § 1056(d)(1) (2005); *Boggs v. Boggs*, 520 U.S. 833 (1997).

[37] *Robbins v. DeBuono*, 218 F.3d 197, 203 (2d Cir. 2000); *U.S. v Jackson*, 229 F.3d 1223, *as amended* (9th Cir. 2000).

[38] *Lauder v. Jacobs*, 809 N.Y.S.2d 482 (Sur. Ct., Westchester Co. 2005); *State v. Pulasty*, 642 A.2d 1392, 136 N.J. 356, 361, *cert. denied*, 513 U.S. 1017 (1994). In New Jersey, even ERISA covered plan monies that are "rolled over" into a non-ERISA covered IRA lose their former exempt status under the ERISA anti-alienation clause. *Hawxhurst v. Hawxhurst*, 723 A.2d 58, 318 N.J. Super. 72 (1998).

[39] N.Y. C.P.L.R. 5205(c) (McKinney 1997); N.Y. Est. Powers & Trusts Law 7-3.1(b) (Consol. 2006); *Pauk v Pauk*, 648 N.Y.S.2d 134 (2d Dept. 1996).

[40] *In re Estate of King*, 196 Misc.2d 250, 764 N.Y.S.2d 519, 521 (Sur. Ct., Broome Co. 2003); N. Y. Est. Powers & Trusts Law § 13-3.2 (Consol. 2006).

[41] *King*, 196 Misc.2d at 255.

[42] *King*, 196 Misc.2d 250, (citing N.Y. Retire. & Soc. Sec. Law § 110 (McKinney 1987); N.Y. Educ. Law § 524 (McKinney 1988); N.Y. C.P.L.R. § 5205(c) (McKinney 1997)); *In re Trust of Gallet*, 765 N.Y.S.2d 157, 163 (Sur. Ct., N.Y. Co. 2003).

[43] *Gallet*, 765 N.Y.S.2d at 163.

[44] *King*, 196 Misc.2d at 254-55.

[45] *Id.*

[46] N.J. Stat. Ann. § 25:2-1 (Lexis Nexis 2006); *C.P. By J.P. v. Township of Piscataway Bd. Of Ed.*, 681 A.2d 105, 293 N.J. Super. 421 (1996); Conn. Gen. Stat. 52-321a, 352b (2006); *Central Bank v. Hickey*, 680 A.2d 298, 238 Conn. 778 (1996); *Sears Roebuck & Co. v. Welker*, 2002 Conn. Super. Lexis 3176 (2002).

[47] *Gilchinsky v. National Westminister Bank N.J.*, 159 N.J. 463 (1999).

[48] McCouch, Will Substitutes Under the Revised Uniform Probate Code, 58 Brook. L. Rev. 1123, 1183 (1993).

ESTATE TAX VALUATION OF A CLOSELY-HELD BUSINESS

By

Martin H. Zern *

I. INTRODUCTION

For federal estate tax purposes, asset valuation is a recurring issue that frequently results in litigation. Often, a dispute arises in determining the fair market value of a closely-held business interest as of the date of death of a stockholder. For a publicly traded corporation, valuation is fairly straightforward; the value of listed stock can readily be ascertained by reference to daily stock market reports. More specifically, Treasury regulations provide that "if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond."[1]

The value of real estate is more problematic due to its unique character. Good practice would seem to dictate that an appraisal be obtained from a qualified real estate appraiser. If the Internal Revenue Service (IRS) does not accept the appraisal, it should at least be a starting point for negotiating a settlement. If the controversy winds up in court, the testimony of the appraiser would be relevant, along with the testimony of the appraiser chosen by the IRS, in assisting the judge or jury

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in determining the value. It may be noted that there is a section in the Internal Revenue Code (IRC) containing special, and quite technical, rules for the valuation of farms and real estate that are part of a closely-held business and that are significant part of an estate.[2]

Apart from the special valuation procedure just mentioned, which has its own complexities and uncertainties, the valuation of a closely-held business presents even more thorny issues than valuing real estate. For a closely-held corporation, technically one is valuing the stock. However, assuming that there are no bid-and-asked prices, the value of the stock must be determined by an analysis of the underlying business. Treasury regulations attempt to give some guidance in this area mentioning some of the factors that should be considered.[3] The basic factors mentioned in the regulations are the company's net worth, prospective earnings power, capability to pay dividends and other relevant factors. In this regard, "other relevant factors" set forth are: goodwill, economic outlook for the industry, position in the industry, management, degree of control represented by the block of stock being valued, and the value of stock in similar businesses for which market quotations are available. The regulations state the weight to be given to any one factor depends on the facts of each case. At perhaps a third level, the regulations state that consideration should be given to non-operating assets, such as, life insurance proceeds paid to the corporation, if not already considered. Complete financial information is required to be submitted with the estate tax return, including reports of accountants, engineers, or any other timely reports of experts.

The IRS provided further guidance regarding factors to be considered in valuing a closely-held business in a Revenue Ruling issued back in 1959.[4] In addition to the factors set forth in the regulations and the ruling, however, the courts over the

years have taken into account numerous other factors that were considered relevant.[5] These factors are described hereafter.

Because there is so much ambiguity in valuing a closely-held business, a stockholder whose estate may be subject to federal, and possibly state, estate taxes obviously has an interest in minimizing the value and avoiding a potential and costly battle with the IRS, which may have an uncertain outcome. Additionally, the stockholders in a closely-held corporation often want control to remain with the surviving stockholders. A commonly employed way to set value and assure that control remains with the survivors is by an agreement among the stockholders providing for a fair payment to the deceased stockholder's estate in exchange for a transfer of the stock of the stockholder to the surviving stockholder(s) or to the corporation. Life insurance on the stockholders is often carried in order to provide the funds necessary to achieve a buyout of the interest of the deceased stockholder. The beneficiary of the policy can be the corporation, which will then have funds to effect a redemption from the estate of the deceased stockholder, or each stockholder can take out a policy on the life of the other stockholder(s) in order to effect a purchase directly by the surviving stockholder(s) of the stock of the deceased stockholder(s).

A key provision in any buyout agreement is the method or methods laid out for valuing the interest of a deceased stockholder. Usually, a method is described for valuing the corporation as a whole. The value of a deceased's stockholder's interest is then calculated by simply multiplying his or her percentage interest in the corporation times the value established for the entire corporation. Some common methods utilized to set the value of the corporation upon a stockholder's death are: by reference to an annual written agreement of the stockholders establishing the value; by referring the matter to

the firm's current accountant; and by referring the matter to a panel of arbitrators. However, the agreement may set the value of the corporation at book value, which may not reflect its actual value. Further, a stockholder's agreement may set the value of the deceased stockholder's interest at the amount of life insurance carried on the stockholder. These are by no means all the methods of valuation, the stockholders being free to adopt any method of valuation they can conjure up. What has been of particular concern to the IRS over the years, however, were stockholder buyout agreements that set the value of a stockholder's interest at less than its actual fair market value.

IRC §2703. It is important to recognize that the basic rule for determining the value of an asset to be included in the gross estate of a decedent is the fair market value at date of death.[6] As noted, the IRS has issued regulations elaborating on this rule in the case of a closely-held business. Over the years, however, courts refined the regulatory guidance to provide an exception in the case of property subject to a valid buyout agreement, provided certain requirements were met.[7] In 1990, Congress enacted IRC §2703 in order to codify and limit the requirements articulated by the courts. This section states that, unless certain exceptions are applicable, as detailed in the next paragraph, the value of any property is to be determined without reference to any right to acquire property or the right to sell or use it. The section was enacted as part of overall legislation to overcome devices utilized to "freeze" the value of an asset.[8]

More specifically, in order for a provision in a buyout agreement setting value to be effective, the agreement must: (1) be a bona fide business arrangement, (2) not be a device to transfer assets to family members for inadequate consideration, and (3) have terms comparable to similar arrangements

negotiated at arm's length. Each of these requirements must be individually met. Further details are provided in Treasury regulations.[9] The section is applicable to all agreements created or substantially modified after October 8, 1990.[10] The applicability of §2703 to a specific fact pattern is illustrated by a recent decision.

II. ESTATE OF GEORGE BLOUNT

In *Blount*,[11] a 2005 decision of the Eleventh Circuit Court of Appeals, the Court considered whether §2703 permitting the value of an interest in a closely-held corporation to be determined by the agreed upon price in a stock buyout agreement was applicable, and whether life insurance proceeds paid to the corporation and used to redeem the stock of a deceased stockholder should be considered an asset of the corporation in determining its value. The Eleventh Circuit agreed with the Tax Court decision concerning the buyout agreement, holding it was inapplicable in determining the value of the corporation. With respect to the life insurance proceeds, which the Tax Court found should be included in valuing the corporation, the Circuit Court disagreed and reversed.

A. Facts

Blount Construction Company (BCC) is a closely-held construction company. It had two stockholders, William C. Blount (Blount) and James M. Jennings (Jennings), who had entered into a stock purchase agreement in 1981 under which stockholder consent was necessary to transfer the stock and the stock of a deceased stockholder had to be redeemed by BBC. The redemption price was set at an amount to be agreed upon or, lacking an agreement, at a price based on book value. In the early 1990s, BCC purchased insurance policies on the

stockholders in the amount of $3 million each in order to provide funds for a stock redemption.

In 1992, BCC instituted an employee stock ownership plan (ESOP). A third party completed annual valuations of BCC to facilitate the ESOP. In early 1995, for example, BCC was valued at about $7.9 million.

Early in 1996, Jennings died owning 46% of BCC, which received about $3 million from insurance proceeds and paid a little less to Jennings' estate to redeem his stock. BCC determined the amount to be paid to the estate based upon the book value of BCC for the previous year.

In October 1996, Blount was diagnosed with cancer and given only a few months to live. Concerned that a buyout of his shares would deprive BCC of liquidity, he ordered studies to determine how much his estate could receive for his shares and still leave BCC in healthy financial condition. Apparently, Blount was not concerned about his family since they were independently wealthy.

In November 1996, Blount amended the buyout agreement binding BCC to purchase his interest from his estate locking the price at $4 million. A recent appraisal, however, valued BCC at $8 million suggesting that his interest was worth about $6.7 million based upon his then approximate 83% interest in BCC, which was his interest when he died in September 1997. On Blount's estate tax return, the value of BCC was declared at $4 million, the price fixed under the buyout agreement. The IRS assessed a deficiency claiming that BCC was worth in excess of $9.5 million and that Blount's interest was worth a little over $7.9 million.

The Tax Court concluded that the 1981 buyout agreement, as amended in 1996, should be disregarded. Further, it held

that the insurance proceeds received by BCC upon Blount's death should be included for purposes of determining the value of the corporation. At the trial, two experts testified for the estate. One expert used a cash flow approach resulting in a value of $4.5 million for BCC and $3.8 million for Blount's interest. The Tax Court completely rejected this valuation on the basis that it ignored non-operating assets, which the regulations require to be considered. The other expert offered by the taxpayer, using a blend of asset and income approaches, valued BCC at $6 million. The IRS expert, using essentially the same method, came up with a value for BCC of $7 million. He then added the insurance proceeds for a combined value of $10 million for the corporation. The estate's expert, however, did not add the insurance proceeds. Taking into account an adjustment for the ESOP, the Tax Court came up with a valuation for BCC in the amount of $6.75 million before taking into account the insurance paid to BCC in the amount of $3.1 million. Accordingly, it held that the value of the corporation was $9.85 million and that Blount's 83% interest was worth $8.2 million. On this basis, it held that there was a tax deficiency of $1.36 million.

B. Court Opinion

The Eleventh Circuit initially noted that it reviews factual determinations of the Tax Court only if clearly erroneous.[12] In this regard, it noted that it did not find clear error in the lower courts determination of a value of $6.75 million. However, the Court disagreed with the Tax Court's holding that the $3.1 million insurance proceeds should be included in determining the value of BCC.

Initially, the Court noted that prior to the enactment of §2703, the courts had carved out an exception to a fair market

value evaluation for property subject to a valid buyout agreement. The court exception, it observed, has three requirements: (1) the offering price must be fixed; (2) the agreement must be binding both before and after the death of the deceased stockholder; and (3) there must be a genuine business reason for the agreement that does not act as a substitute for a testamentary disposition.[13] This court articulated doctrine was codified by IRC § 2307, as previously mentioned. The court doctrine and § 2307 are similar except that the code section requires the buyout agreement to be similar to one negotiated at arm's length.

The Eleventh Circuit then addressed each of the estate's arguments on appeal. First, it considered whether the agreement as modified created a value binding on the IRS. Next, it considered the Tax Court's computation of the value of the BCC shares held by Blount at the time of his death.

The Circuit Court agreed with the Tax Court that the original agreement was substantially modified in 1996 thereby making it subject to IRC §2703. It agreed that the modification was substantial from several perspectives. Pursuant to the 1996 amendment, Blount's interest was frozen at $4 million. Based upon his 83% interest, the value of BCC
was therefore set at $4.8 million. A 1997 appraisal, however, gave a book value of $8.5 million, which would have been the value under the original agreement without the modification. Accordingly, there were substantially different valuation methods before and after the modification. There were other modifications that the Court also agreed were substantial, for example, the ability of BCC to effect the redemption in installments was eliminated.

1. No Binding Agreement:

Finding §2703 applicable, the Court then considered the requirement under Treasury regulations that little weight will be given to an agreement under which the decedent is free to dispose of securities at any price he chooses during his lifetime.[14] Such an agreement is inconsistent with a bona fide business arrangement.[15] After the death of Jennings, Blount owned 83% of BCC and was its president and sole director. Accordingly, the buyout agreement could be changed at any time since the only parties necessary to change it were Blount and BCC, an entity he controlled. The Court found that the ESOP's approval was not necessary to change the agreement disagreeing with the estate's argument to that effect. Thus, it was held that Blount could unilaterally change the agreement during his lifetime, and in fact did modify it. The failure to meet this regulatory requirement meant that the exception to valuing the stock interest at less than fair market value was inapplicable.

2. Comparability:

Although perhaps not necessary, since it had decided that the agreement was not binding during Blount's lifetime, the Circuit Court also reviewed whether the agreement met the test under §2703 that the agreement be comparable to similar arrangements. The Tax Court had concluded that it did not. Under Treasury regulations, similar arrangements are those that "could have been obtained in fair bargain among unrelated parties in the same business dealing with each other at arm's length," where a bargain is one that "conforms with the general practice of unrelated parties under negotiated agreements in the same business."[16] Referring in some detail to the testimony of the experts who testified in the Tax Court, the Circuit Court disagreed with the conclusion of the Tax Court that the agreement did not meet the comparability test was clearly erroneous. Accordingly, it let stand the Tax Court's

determination that the agreement failed the comparability requirement.

3. Fair Market Value:

As noted, the Tax Court had determined that the fair market value of BCC was $9.85 million including $3.1 million proceeds from life insurance payable to the corporation on Blount's death. The Circuit Court, however, held that the Tax Court erred when it included the life insurance proceeds. Accordingly, it held that the value of BCC on Blount's death was $6.75 million excluding the life insurance proceeds. Although Treasury regulations require that non-operating assets be considered in valuing a corporation, as earlier mentioned, the Circuit Court concluded that this regulation did not require the inclusion of the life insurance proceeds.

4. The Life Insurance Proceeds:

Although only a brief segment of the opinion, arguably the most important aspect of *Blount* was the Circuit Court's reversal of that part of the Tax Court's opinion dealing with the $3.1 million of life insurance proceeds that were paid to BCC on Blount's death. The IRS position was that the life insurance proceeds should be included in determining the value of BCC. The Tax Court agreed with the IRS and held that the life insurance proceeds increased the value of the corporation form $6.75 million to $9.85 million.

The underpinning of the Tax Court's holding is a provision in the regulations providing that in valuing corporate stock, consideration should be given to non-operating assets including, life insurance proceeds payable to the corporation.[17] However, the Eleventh Circuit pointed out that this provision is followed by a limiting phrase: "to the extent that such non-

operating assets have not been taken into account ...." In this regard, the Circuit Court concluded that the life insurance proceeds had been taken into account since there was an offsetting, dollar-for-dollar, contractual obligation[18] on the part of the corporation to pay the proceeds to Blount's estate in a stock buyout.[19]

5. Corporate Owned Life Insurance:

The gross estate of a decedent for estate tax purposes includes the proceeds of life insurance on the life of the decedent if the decedent possessed at death any of the incidents of ownership with respect to the policy.[20] Treasury regulations particularize what is meant by "incidents of ownership."[21] In this regard, the regulations provide that incidents of ownership held by a corporation (i.e., a corporate-owned policy) will not be attributed to a sole or controlling stockholder (one with more than 50% of the voting power) to the extent that the proceeds of the policy are payable to the corporation or on behalf of the corporation (such as to liquidate a corporate debt.)[22]

The regulations note, however, that the proceeds of the policy should be considered in determining the value of the decedent's stock.[23] Further, it is provided that if any part of the proceeds are not payable to the corporation and are not taken into account in valuing the corporate stock, any incidents of ownership held by the corporation as to that part of the proceeds will be attributable to the decedent based on stock ownership. For example, if a decedent is the controlling stockholder, and if a corporate-owned policy is paid to the decedent's spouse, the proceeds of the policy will be included in the decedent's gross estate. As a further example, if the proceeds are paid 60% to the corporation and 40% to the

decedent's spouse, only the 40% is includable in the decedent's gross estate.[24]

The IRS and the Tax Court apparently concluded that under the regulations the proceeds of the policy should be considered in determining the value of the gross estate. The Eleventh Circuit did not disagree that the policy should be considered in determining the value of the corporate stock. As noted, however, it concluded that there was an equal and offsetting liability on the part of the corporation to redeem Blount's stock, thus netting out to zero the receipt by BCC of the life insurance proceeds.

In summary, the Eleventh Circuit determined that the buyout agreement was invalid for purposes of determining the value of BCC and that fair market value was the proper basis for determining the value. Furthermore, the Circuit Court held that the Tax Court erred in ignoring the 1996 amended agreement at least to the extent it that it created a contractual obligation to redeem Blount's stock with the insurance proceeds.

III. CONCLUSION

Since buyout agreements are commonplace in closely-held corporations, the *Blount* decision is important for delineating the factors that must be present in order for a redemption price set in a buyout agreement to supercede a fair market value evaluation. It is the author's opinion that §2703 sets the bar quite high in order to meet the requirements of the section. It would seem that if a value set in a buyout agreement is too far removed from a strict fair market value determination, it probably would not meet the requirements of §2703.[25] If §2703 is found to be inapplicable, then the value of the corporation in a court proceeding will be determined by the

judge's evaluation of the testimony of the experts. In this regard, it is not necessarily a case of "splitting the baby in half." It is noteworthy that the Tax Court judge completely disregarded the testimony of one of the experts provided by the estate. Consequently, attorneys retaining an expert must do their due diligence to assure that the expert is knowledgeable about evaluation methods and about what methods are acceptable by a court.

Finally, *Blount* is important for clarifying how life insurance proceeds, which are payable to a corporation and which are required to be used to fund a buyout commitment, are to be treated. It is hoped that the IRS will accept the result in Blount and not litigate this issue further in view of the fact that both the Ninth and Eleventh Circuits disagree with its position. Insofar as the Tax Court is concerned, it is required to follow the "rule of the circuit."[26] Consequently, it could continue to side with the IRS in other circuits. With two circuits against it, however, there is a good chance that it will rule in the taxpayer's favor regardless of the circuit in which the litigation arose, assuming the IRS persists in litigating this issue.

ENDNOTES

[1] Treas. Reg. § 1.20.2031-2(b)(1) (as amended in 1992). The regulation goes on to provide that "[i]f there were no sales on the valuation date, but there were sales on dates within a reasonable period both before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest an lowest sales on the nearest date before and the nearest date after the valuation date." The regulation provides further details and several examples.

[2] *See* IRC § 2032A. Whether reference to this section is advisable depends on the circumstances. In any event, the applicability of this section is beyond the scope of this paper.

[3] *See* Treas. Reg. § 20.2031-2(f)(2).

[4] Revenue Ruling 59-60, 1959-1 CB 237 (1959).

[5] *See, e.g.*, Estate if Yaeger v. Comm'r, 52 TCM 820 (1986) (effect of loss of services of deceased stockholder); Estate of Luton v. Comm'r, 64 TCM 1044 (1994) (whether the corporation will be liquidated or continue); Estate of Newhouse v. Murphy, 60 TCM 645 (1990) (discount for lack of marketability such as minority interest); and Tally v. United States, 78-1 USTC ¶ 13,228 (Ct.Cl. 1978) (effect of illegal activities).

[6] IRC § 2031(a).

[7] *See generally*, True v. Comm'r, 390 F.3d 1210, 1218 (10th Cir. 2004) (collecting cases).

[8] Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11602(a), 104 Stat. 1388-1, 1388-498.

[9] Treas. Reg. § 20.2073-1 (1992).

[10] *See* Treas. Reg. 20.2073-1(c) regarding what constitutes a substantial modification.

[11] Blount v. Comm'r, 428 F. 3d 1338 (llth Cir. 2005).

[12] This is the general standard for appellate review. *See* Davenport Recycling Assocs. V. Comm'r, 220 F.3rd 1255, 1258 (11th Cir. 2000).

[13] *See generally*, True v. Comm'r, 390 F.3d, 1210, 1219 (10th Cir. 2004) (relevant cases cited therein).

[14] Treas. Reg. § 1.2031-2(h) (as amended in 1992).

[15] *Id.*

[16] Treas. Reg. § 25.2703-1 (b)(4)(i) (1992).

[17] Treas. Reg. § 20.231-2(f)(2) (as amended in 1992).

[18] In this regard, the Court deferred to state law in finding there was a binding contractual obligation to redeem the stock from Blount's estate, despite the fact that the buyout agreement was held invalid for purposes of valuing the corporation for estate tax purposes.

[19] In arriving at this conclusion, the Eleventh Circuit cited as precedent an opinion of the Ninth Circuit and an earlier decision of the Tax Court: Cartwright v. Comm'r, 183 F.3d 1034, 1038 (9th Cir. 1999) and Huntsman v. Comm'r, 66 T.C. 861, 875 (1976).

[20] IRC § 2042.

[21] Treas. Reg. § 20.2042-1(c) (as amended in 1979).

[22] Treas. Reg. § 20.2042-1(c)(6).

[23] Referring to Treas. Reg. § 20.2031-2(f).

[24] Treas. Reg. § 20.2042-1(c)(6).

[25] *See* True v. Comm'r, 390 F.3d 1210, 1239-41 (10th Cir. 2004) (collecting cases that both support and disregard provisions in buyout agreement setting value).

[26] Under the "rule of the circuit," the Tax Court is required to follow the rule of the circuit court in which the litigation arose (i.e., where the taxpayer resides). *See* Golsen v. Comm'r, 54 T.C. 742 (1970). Consequently, the circuit courts could split with respect to a particular issue. In such event, the United States Supreme Court might hear the case in order to resolve the issue.

REGULATING CONSENSUAL RELATIONSHIPS IN THE WORKPLACE—ARE "LOVE CONTRACTS" THE ANSWER?

by
Marlene Barken*
Joanne Barken*

With the entrance of woman into the workplace and the current American trend to spend more time at work, office dating is on the rise. Vault's 2005 Office Romance Survey revealed that fifty-eight percent of employees have been involved in an office romance, up from forty-six percent in 2003.[1] Another survey found that ninety-two percent of over 31,000 men and women questioned admitted to finding a coworker attractive and flirting with him or her.[2]

While the office may be evolving into the hottest singles scene, these statistics give employers plenty of reasons to fear potential lawsuits. Completely prohibiting dating among co-workers has proven impractical and difficult to enforce. One major concern is a sexual harassment claim following a bad breakup between two employees. Legal Assistant, Kramer Levin Naftalis & Frankel LLP, NYC
In light of the inevitability of romance in the workplace, many employers are experimenting with "love contracts" to protect themselves from potential sexual harassment claims.

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Employees wishing to date one another must first sign a written contract that the relationship is in fact consensual, and that they are willing to therefore waive their right to bring a sexual harassment claim in court. This appears to be a safe compromise for employers, offering their workers the freedom to date but preventing possible liability. To date, such contracts have not been tested in court, but they are likely to raise a variety of problems. Invasion of privacy, actual validity as a contract, and exposure to other forms of liability are only a few of the reasons that love contracts are not the best way to handle the rise in office dating.

This paper will first review the background case law on sexual harassment that formed the basis for the Equal Employment Opportunity Commission's (EEOC) guidelines regarding sexual favoritism and consensual relationships in the workplace. Secondly, the authors will discuss recent state and federal cases involving paramours and failed consensual relationships between co-workers. The authors then will explain why love contracts may not be the most effective method by which to address the changing norms of fraternization on the job and will offer management suggestions for a more practical and lawful way to avoid the negative fall-out of consensual relationships in the workplace.

TITLE VII AND SEXUAL HARASSMENT DISCRIMINATION

A. Quid Pro Quo and Hostile Environment Claims

In the 1986 decision, *Meritor Savings Bank v. Vinson,* the Supreme Court provided distinct definitions of the two existing forms of sexual harassment: quid pro quo and hostile work environment.[3] Quid pro quo is the clear situation where plaintiff's submission to or rejection of unwelcome sexual

conduct is the basis for employment decisions affecting the plaintiff. Secondly, the Court held that "a plaintiff may establish a violation of Title VII by proving that discrimination based on sex has created a hostile or abusive work environment... [and that in order for] sexual harassment to be actionable, it must be sufficiently severe or pervasive to alter the conditions of [the victim's] employment and create an abusive working environment.[4]" *Meritor* held that discrimination under Title VII is not limited to a tangible loss. "The phrase 'terms, conditions, or privileges of employment' evinces a congressional intent 'to strike at the entire spectrum of disparate treatment of men and women in employment.[5]" Though the Court did not determine the standard for liability, it agreed with the EEOC that courts should look to agency principles for guidance. The Court explained that while employer liability is not strict, employers are not immune simply because they have policies prohibiting sexual harassment. Rather, liability will depend on the adequacy, timing, and effectiveness of their remedial action.[6]

More recent Supreme Court decisions have increased the need for employers to be proactive in avoiding sexual harassment claims. Both *Faragher v. City of Boca Raton*[7] and *Burlington Industries v. Ellerth*[8] helped to clarify the extent of the employer's liability, which the Court had failed to fully address in *Meritor.* Prior to the holdings in these two later cases, Title VII plaintiffs were encouraged to "state their claims in *quid pro quo* terms, which in turn put expansive pressure on the definition.[9]"

In *Burlington Industries* the plaintiff, Ellerth, was forced to endure remarks and gestures of a sexual nature, as well as threats to deny her tangible job benefits from an employee in a supervisory position. Although those threats were not carried out, and in fact Ellerth was promoted once, she chose to leave

her job, but did not report the abuse until after she had quit.[10] Similarly, Faragher was subjected to physical and verbal harassment by her supervisors. She also chose not to voice her complaints to management.[11]

The Supreme Court sought to impose agency principles of vicarious liability for damages caused by the exploitation of supervisory authority and to encourage employers to prevent instances of sexual harassment. In both cases, the Court found that

> An employer is subject to vicarious liability to a victimized employee for an actionable hostile environment created by a supervisor with immediate (or successively higher) authority over the employee. When no tangible employment action is taken, a defending employer may raise an affirmative defense to liability or damages, subject to proof by a preponderance of the evidence... No affirmative defense is available, however, when the supervisor's harassment culminates in a tangible employment action.[12]

Furthermore, the Court noted that the employer's vicarious liability can be limited if the employer is able to prove that "it acted reasonably in preventing or correcting sexual harassment, or that the employee acted unreasonably in failing to utilize the employer's preventive or corrective opportunities.[13]"

B. Sexual Favoritism

The EEOC has also provided guidance for employers on what claims are cognizable under Title VII, and the Commission's guidelines are accorded deference in sexual

harassment cases.[14] In a 1990 policy document, the EEOC addressed the extent to which employers can be held liable for unlawful sex discrimination by persons who were qualified for but were denied an employment opportunity or benefit because they did not submit to sexual advances or requests.[15] Here the EEOC explored how three different manifestations of "sexual favoritism" in the workplace might adversely affect the employment opportunities of third parties in such a way as to create an actionable charge of either "implicit" quid pro quo harassment and/or hostile work environment harassment.[16] First, the Commission looked at isolated instances of preferential treatment based on consensual romantic relationships. Though perhaps unfair and offensive, such favoritism does not discriminate against men or women in violation of Title VII because both are equally disadvantaged for reasons other than their genders[17]. This principle has come to be known as the "paramour rule" because the non-paramour is disadvantaged simply because of the supervisor's romantic preferences, not because of any illegal discriminatory activity. Second, the Commission dealt with favoritism based on coerced sexual conduct. If the relationship at issue was *not* consensual, then other qualified men and women may be able to establish a Title VII violation by showing that in order to obtain a promotion, it would have been necessary to grant sexual favors. In addition, they would have standing to challenge the favoritism on the basis that they were injured as a result of the discrimination suffered by their co-worker.[18] The third category is widespread favoritism of consensual sexual partners. The EEOC's position is that when such behavior permeates the workplace, those who do not welcome such conduct may have a cause of action based on the creation of a hostile environment.[19]

The memorandum heavily relied on the 1988 case of *Broderick v. Ruder*[20] to further explain how widespread sexual favoritism can violate Title VII. The case involved allegations

by Catherine Broderick, a staff attorney at the Securities and Exchange Commission (SEC), that two male supervisors had engaged in sexual relationships with secretaries who later received promotions, cash awards and other job benefits, and that the plaintiff herself had been subjected to isolated instances of unwanted sexual advances by her supervisor. One supervisor repeatedly pressured her to let him give her a ride home, and when she finally accepted, he barged into her apartment and toured the premises, including her bedroom. Though intrusive, there was no physical contact. The same supervisor regularly made crude jokes in the office and maintained a known and visible liaison with one of the secretaries. A different supervisor, the Regional Administrator, became drunk at an office party and untied the plaintiff's sweater and kissed her and another female employee. Throughout her eight year tenure at the SEC, the plaintiff had demonstrated her capabilities as an attorney, but the friction with her supervisors escalated over the excessive socializing in the office and Broderick's unwillingness to be a "team player." Over time, the plaintiff's performance ratings deteriorated as a result of upper management's growing resentment of her refusal to 'go along, in order to get along'.[21]

The District Court had little trouble finding that the conduct of Broderick's supervisors created a hostile work environment, undermined the plaintiff's motivation and work performance, and deprived her and other female employees of opportunities for job advancement[22]. Any documented deficiencies in her work performance were directly attributable to the general atmosphere in which she worked.[23] The defendant maintained that Broderick's claims were really for quid pro quo harassment and that other than the two isolated situations described above, she was not sexually harassed. Any sexual misconduct by supervisory personnel was not directed at Broderick and was merely part of the "social/sexual interaction

between and among employees.[24]" The defendant argued that Title VII was not intended to regulate sexual morality in the workplace. The court readily dismissed these contentions. While consensual sexual relations in exchange for tangible employment benefits might not create a cause of action for the willing recipient, such advances, for those who do not find them welcome, do create and contribute to a sexually hostile working environment.[25]

The EEOC endorsed the court's theory, but significantly, it noted that "these facts could also support an *implicit* 'quid pro quo' harassment claim (italics added) since the managers, by their conduct, communicated a message to all female employees in the office that job benefits would be awarded to those who participated in sexual conduct.[26]" The Commission went on to state that in a situation where management personnel regularly solicited sexual favors from subordinate employees in return for job benefits, those who did not willingly consent or welcome this conduct might be able to establish that the conduct created a hostile environment, even if they were not directly solicited. Such conduct is actionable because it communicates a message to all employees that job benefits are conditioned on acquiescence to sexual relations.[27] Facts such as those that arose in *Broderick* require an analysis that partially blurs the distinction between quid pro quo and hostile environment sexual harassment.

C. Consensual Relationships Gone Awry

The EEOC's 1990 Policy Guidance has not been revised, and to date, no federal court of appeal has issued an opinion finding that the complained-of consensual favoritism was sufficiently widespread to create a hostile environment.[28] Until this past year, no state supreme court had directly addressed the issue.[29] Then in July of 2005, the California Supreme Court

ruled in *Miller v. Department of Corrections*[30] that non-favored employees could bring such a claim. The conduct revealed in this case goes well beyond the SEC's loose, fraternity party atmosphere under scrutiny in *Broderick.*

The co-plaintiffs in *Miller* were two female corrections employees, Edna Miller and her assistant, Frances Mackey, who claimed sex discrimination, harassment and retaliation by their supervisor, Kuykendall, and his three paramours (Brown, Bibb, and Patrick) who were also employed by the Department of Corrections. In soap opera fashion, the saga went on from 1991 until 1998 and was carried over to a second correctional facility as Kuykendall arranged transfers and promotions for his "women". The three frequently squabbled over him, sometimes in emotional scenes witnessed by other employees, and they openly boasted to the plaintiffs about their ability to influence Kuykendall. Brown, in particular, flaunted her affair, and when vying for a promotion for which Miller was more qualified, Brown announced to Miller that Kuykendall would have to give it to her, otherwise she would "take him down with her knowledge of every scar on his body" (internal quotes omitted).[31] The situation worsened when another female warden, Yamamoto, became close with Brown. It is not clear whether they were engaged in a lesbian relationship, but they teamed up against Miller to make her life miserable. The plaintiffs suffered verbal abuse, demotions, reduced pay, threats, and in one instance Brown physically assaulted Miller and held her captive for two hours. When plaintiff Mackey sought help to release Miller, Yamamoto would not intervene.[32] Kuykendall refused to investigate Miller's complaints of harassment, citing his relationship with Brown, and her relationship with Yamamoto. He told Miller that he should have chosen her, which she took to mean that he should have had an affair with her instead of Brown.[33]

Finally, in 1998, Miller and three other employees filed a confidential complaint with Kuykendall's supervisor, stating that the "institution was out of control.[34]" Brown soon learned of Miller's cooperation with the ensuing internal investigation, and Brown and Yamamoto began a campaign of ostracism against Miller and regularly interfered with her orders. Kuykendall withdrew accommodations that Miller received due to a physical disability. On one occasion, Brown had an angry confrontation with Miller and followed her home. Miller then obtained a restraining order against her,[35] and the plaintiffs brought an action for sexual harassment pursuant to the California Fair Employment and Housing Act.

Despite the sexually charged atmosphere at the state prison and the events unleashed by Kuykendall's multiple affairs, the trial court granted summary judgment in favor of the California Department of Corrections. The trial court and the Court of Appeals reasoned that the supervisor's grant of favorable employment opportunities to the three women with whom he was having concurrent affairs did not constitute sexual harassment of non-favored employees because there had been no attempts to coerce sexual relations from them, and non-favored employees of both genders would be equally disadvantaged. Relying heavily on the EEOC memorandum, the California Supreme Court disagreed. It held instead that the facts of the case indicated that sexual favoritism in this workplace had indeed become so widespread that the message was that employees were sexual "playthings" for the boss. The situation could constitute an actionable hostile environment. The lower courts erred in refusing to let a jury consider the plaintiffs' claims.[36]

Certainly, the rather lurid facts in the *Miller* case are unusual. Nonetheless, it raises new concerns for management. Plaintiffs may now allege (and courts may allow juries to

decide) that consensual sexual behavior and fraternization among colleagues, particularly where there is a supervisor-supervisee relationship, creates a workplace that is permeated with widespread sexual favoritism and hence establishes a hostile environment.[37]

PARAMOURS AND PERSONAL ANIMOSITY

A. The Paramour Rule

In order to put *Miller* into perspective, it is worth returning to the case law that has developed under the well-established paramour rule and a corresponding line of cases that focuses on employment actions that are based on underlying personal animosity resulting from a failed romantic involvement. These cases demonstrate that the employer is generally insulated from liability for sexual harassment, as long as the initial relationship was consensual.

The chief case in point is *Decintio v. Westchester County Medical Center,* where seven male respiratory therapists claimed that they were denied a promotion that went to a woman with whom the Program Administrator was having an affair.[38] The U.S. Court of Appeals for the Second Circuit clearly stated voluntary, romantic relationships cannot form the basis of a sex discrimination suit under either Title VII or the Equal Pay Act.[39] "The proscribed differentiation under Title VII ... must be a distinction based on a person's sex, not on his or her sexual affiliations," and there must be "a causal connection between the gender of the individual or class and the resultant preference or disparity.[40]" For Title VII purposes, the court found no justification for defining "sex" so broadly as to include an ongoing, consensual romantic association. Any other interpretation "...would involve the EEOC and federal courts in the policing of intimate relationships.[41]"

State courts, in construing similar provisions against discrimination, have likewise held that as long as the favoritism is based on personal romantic preference, not coercion, there is no actionable discrimination on the basis of gender. For example, in *Erickson v. Marsh & McLennan Co.*, the plaintiff, an at-will employee, sought relief for reverse sex discrimination under the New Jersey Law Against Discrimination, claiming that fabricated charges of sexual harassment were brought against him and that when he retained an attorney, he was discharged so that his supervisor's paramour could be promoted.[42] The plaintiff was unable to produce any evidence that had he been a woman, he would not have been fired. Moreover, management had the right to fire an at-will employee for a false cause or for any cause, unless it violated public policy, and hiring an attorney is not a "protected activity." The firing may have been unfair, but the court concluded that it was not illegal.[43]

Employers thus may find some comfort in *Decintio* and its progeny because employment decisions that are the result of isolated instances of favoritism will not give rise to successful discrimination charges. Employers should recognize, however, that even isolated acts of favoritism may nonetheless contribute to a general perception of unfairness and may lead to poor morale and distrust. Employers should also be concerned that such preferential treatment does not begin to permeate the workplace in a way that could later be deemed "widespread". Along this spectrum, employers also need to worry about the flip side of romantic relationships in the workplace--those that go sour. Numerous cases address the problems of personal animus dictating employment decisions and/or negatively affecting the work place following a failed relationship. While again, employers are protected from Title VII claims in these cases, the facts are often nasty and disruptive to the workplace.

B. Personal Animosity

In *Succar v. Dade County School Board,* the Eleventh Circuit Court of Appeals held that any analysis under a hostile environment theory must focus on whether the complaining employee was targeted because of his or her gender, and that personal feuds cannot be turned into sex discrimination cases.[44] Plaintiff Succar, who was married, had carried on a year long affair with another teacher, Lorenz, when Lorenz began threatening Succar's wife and son. Succar's wife obtained a restraining order against Lorenz, and the extra-marital affair ended soon after. Lorenz was extremely bitter, and she began to verbally and physically harass Succar, publicly embarrassing him in front of colleagues and students. Succar claimed that the school principal took insufficient steps to remedy the situation, and he subsequently filed a complaint alleging hostile work environment sexual harassment. Agreeing with the district court, the Court of Appeals observed that "Title VII prohibits discrimination; it is not a shield against harsh treatment at the work place.[45]" Lorenz's harassment of the plaintiff was not due to his gender, but rather her anger and disappointment at having been jilted.[46]

The following year, the same court applied the reasoning in *Succar* to a claim arising out of a consensual relationship in the quid pro quo context. In *Pipkins v. City of Temple Terrace, Florida,* plaintiff Houldsworth engaged in a consensual relationship with Klein for approximately one year.[47] Klein continued to romantically pursue Houldsworth after she ended the affair. Although Klein had a supervisory position in Houldsworth's department, her immediate supervisor was Florence Lewis-Begin, a friend of Klein's wife. Houldsworth's job evaluations began to deteriorate once she terminated the relationship, and when the City Manager learned of the

problems he commenced an investigation and Klein was ordered to seek other employment. Nonetheless, Houldsworth continued to receive poor evaluations from Lewis-Begin, and Houldsworth ultimately resigned, claiming constructive discharge.[48] Citing *Succar,* the Court ruled that any harassment Houldsworth suffered was attributable to her failed consensual relationship with Klein and the feeling of enmity it engendered in both Klein and Lewis-Begin. She did not meet the Title VII requirement of a showing that the altered terms and conditions of employment were "because of ...sex.[49]"

New York's prohibition against discrimination on the basis of sex pursuant to Executive Law Sect. 296(1)(a) tracks the language of Title VII. The statutory term "sex" has likewise been interpreted to be synonymous with "gender," and does include variants of sexual activity, liaisons, or attractions.[50] Thus, in *Mauro v. Orville,* a legal secretary who had an intimate relationship with her boss, an attorney, could not sustain a claim of discrimination due to her sex when he discharged her in order to reconcile with his wife.[51] A plaintiff would need to demonstrate that there were unwelcome sexual advances after termination of the consensual relationship in order to support a claim that the discharge was motivated by gender.[52]

The foregoing cases establish that employees will not succeed in a Title VII suit when the complained of employment actions were taken to alleviate strained relations following the breakup of a consensual union. They also illustrate, however, how uncomfortable such situations may become, and how they may draw other members of the work force into the fray. Much like any acrimonious divorce, the resulting fall-out is divisive as co-workers take sides, and at a minimum, such intrigue is a distraction most employers would rather avoid.

EMPLOYER COMPLIANCE WITH EEOC GUIDELINES

While case law shows that sexual favoritism as a result of a consensual relationship and allegations of sexual harassment in the form of personal animosity are extremely difficult cases for a plaintiff to make out, sexual harassment suits are still something to be feared by employers. In 2005 the EEOC reported that 12,679 charge receipts were filed and resolved under Title VII claiming sexual harassment discrimination as an issue. Costs are high for businesses fighting these serious allegations, and companies paid a total of $47.9 million in monetary benefits. (This figure does not include damages awarded from litigation.)[53]

What can employers glean from these decisions? It is essential to develop and to uphold a strict sexual harassment policy in the workplace. Without one a company will be unable to defend itself against sexual harassment claims that may arise. Aside from potential financial losses, these statistics prove that sexual harassment continues to be a problem in the workforce, and employers must be proactive in protecting their employees. Furthermore, companies need to be aware of how the national rise in office dating may affect their operation, and they should familiarize themselves with the different options for handling consensual relationships so that they can become equipped to deal with the ramifications of a traumatic break-up in the workplace.

Before employers look for ways to completely eliminate the possibility of a romance budding between two co-workers (instilling a simple non-fraternization policy), they should consider how the relationship will affect the business if it goes well. Depending on the size and nature of a company, office relationships can have a positive influence.

Having a love interest at the office can make employees overall more content in life. Being happy is proven to make people more motivated, productive, and physically healthier than those who are unhappy.[54] Employees may be less likely to rush home at the end of the day if they know that staying late to finish their assignments means that they can take a dinner break in the cafeteria with their significant other. In addition, the couple will share a common interest: their line of work. This could lead to job related brainstorming outside of the office. Couples may also feel the desire to impress each other, and work to their highest ability in order to appear smart and competent in the eyes of their loved one. By allowing people to date each other at work, employers have the potential to gain more hours, enthusiasm, motivation, and productivity from their employees all while making their staff happier in life.

Employers should weigh the costs and benefits of allowing consensual relationships to take place at work, but they cannot ignore the fact that in today's work environment officemates are probably already dating. A more recent approach to handling this challenging situation is the development of the love contract.

REVEALING ALL—LOVE CONTRACTS AND PRIVACY

A. Creation of the Love Contract

Looking for an innovative approach to accommodate office romances and worried employers, the San Francisco firm of Littler Mendelson developed the first love contract in 2000. Since then the firm has completed hundreds of contracts for clients over the past few years.[55] In a 2005 article published by Stephen Tedesco, a partner at Littler, he recommends love

contracts to employers as a means of protecting employers from both sexual harassment claims and sexual favoritism disputes.[56] He states that a love contract "documents that the employee's relationship is consensual, they are aware of the company's sexual harassment policies and agree to maintain proper, professional office behavior and, if the employees are in a supervisor-subordinate working relationship, both parties agree that one will transfer to another department or work group.[57]"

There are several apparent benefits to enforcing the use of these contracts. First, it confirms in writing that the relationship is in fact voluntary. Furthermore, it ensures that the involved parties are aware of the company's policies towards consensual relationships and sexual harassment. Some practitioners recommend holding a separate discussion with each employee to ensure that the relationship is truly consensual, and using this meeting as an opportunity to review the company's sexual harassment policy and complaint procedure. Employees should also be advised that signing the agreement is not a condition of employment and that they may want to consult with counsel before signing. A key component of the contract is that employees should be required to notify the employer if and when the relationship ends and the employer should closely monitor the post-dating situation for problems.[58] Finally, it guarantees that if the relationship falls through, any potential disputes will be handled through mediation or binding arbitration. Advocates of love contracts argue that these methods will be more time and cost effective for all of the involved parties, and will not tie up the court system.[59]

B. Off-hours Dating and Privacy

Perhaps the biggest concern with love contracts is that they have yet to be tested in the courts. Though they borrow concepts from contract and employment law, it is possible that they could lead to claims of invasion of personal privacy.[60] Employees asked to sign such an agreement might feel compelled to reveal an extramarital affair or a homosexual relationship. A few states, including New York, Colorado, North Dakota, and California have privacy protection statutes that afford employees some degree of protection for non-employment related activities.[61]

Though several cases have been filed in New York in both state and federal court questioning whether personal employee relationships are protected "recreational activities," no clear consensus has yet emerged, and love contracts were not at issue.[62] The reasoning in these cases is nonetheless interesting and instructive for employers considering the introduction of the rather intrusive love contract.

In pertinent part, New York Labor Law §201-d states that:

> 2. Unless otherwise provided by law, it shall be unlawful for any employer or employment agency to refuse to hire, employ or license, or to discharge from employment or otherwise discriminate against an individual in compensation, promotion or terms, conditions or privileges of employment because of:
>
> c. an individual's legal recreational activities outside work hours, off of the employer's premises and without use of the employer's equipment or other property.[63]

The statute defines "recreational activities" as:

> any lawful, leisure-time activity, for which the employee receives no compensation and which is generally engaged in for recreational purposes, including but not limited to sports, games, hobbies, exercise, reading and the viewing of television, movies and similar material.[64]

The key case that examined the language and purpose of the statute is *New York v. Wal-Mart Stores*, in which Wal-Mart had discharged two of its employees for violation of its "fraternization" policy that prohibited a "dating relationship" between a married employee and another employee other that his or her own spouse.[65] In a somewhat convoluted opinion, the majority held that "dating" was distinct from a "recreational activity" because its key component was "amorous interest," and as such, it could not be included in the statute's clearly delineated categories of leisure-time activities.[66] Since the indispensable element of dating, "in fact its raison d'etre, is romance, either pursued or realized," it could not be counted as an activity within the purview of the statute.[67] Judge Yesawitch, in a strong dissent, argued that the statute encompasses all social activities, whether or not they have a romantic element, "for it includes *any* lawful activity pursued for recreational purposes and undertaken during leisure time.[68]" The majority's holding gave no protection to social relationships that might contain a romantic aspect, regardless of the participants marital status, or the impact of their relationship on their capacity to perform their jobs.[69] Judge Yesawitch urged instead that the statute be read broadly to effect its remedial purpose:

> ...given the fact that the Legislature's primary intent in enacting Labor Law Sec. 201-d was to curtail employers' ability to discriminate on the basis of activities that are pursued outside of work hours, and that have no bearing on one's ability to perform one's job, and concomitantly to guarantee employees a certain degree of freedom to conduct their lives as they please during non-working hours, the narrow interpretation adopted by the majority is indefensible.[70]

The New York Court of Appeals has never addressed the issue, and the Wal-Mart decision has been followed in numerous cases. For example, in *Bilquin v. Roman Catholic Church*, the plaintiff, a Pastoral Associate for Faith Formation, had no cause of action under Labor Law § 201-d(1)(b) for wrongful termination when she was not renewed for employment due to her cohabitation with the husband of a parishioner.[71] Likewise, in *Hudson v. Goldman Sachs & Co.,* plaintiff had no cause of action when he was dismissed for having an extramarital affair with a co-employee.[72] Nor did he have a cause of action for any form of discrimination on the basis of sex or marital status, because his female paramour was single, and she was also terminated.[73]

The only federal case to date, however, may be most predictive of the future of privacy claims that arise out of consensual office romances. In *McCavitt v. Swiss Reinsurance America Corp.,* the plaintiff, an officer of the company, was romantically involved with another officer. Despite the fact that the company had no written anti-fraternization policy, the plaintiff was passed over for promotion and ultimately fired because of their dating.[74] The U.S. Court of Appeals for the Second Circuit reluctantly agreed with the district court that its

decision was governed by the Third Department's decision in Wal-Mart, and thus it dismissed McCavitt's complaint on the grounds that dating is not a protected recreational activity. Absent persuasive evidence that the New York Court of Appeals would reach a different conclusion regarding the scope of "recreational activity" under the statute, the Court felt bound to apply the interpretation of New York's intermediate appellate court.[75] Circuit Judge McLaughlin, in his concurring opinion, urged that the New York Court of Appeals, if given the chance, should reach the opposite conclusion. Endorsing Judge Yesawich's reasoning quoted above, Judge McLaughlin added a common sense, reality check: "Romance has a distinctly distinguished history of originating in office contacts. It is one of the most clichéd of movie plots... (and quoting Justice Frankfurter), 'There comes a point where this Court should not be ignorant as judges of what we know as men.'"[76]

CONCLUSIONS AND RECOMMENDATIONS TO EMPLOYERS

A. Avoid Using Love Contracts

The rise in office dating is clearly a sticky situation for employers to handle. Trying to find a balance between turning a blind eye and ruling the office romance scene with an iron fist is more difficult than it sounds. It is not surprising that the safety net love contracts appear to cast for employers has become so popular. However, it is unlikely that these contracts will be of any real use to the employer, and they are not worth the attorney fees it would cost to have them drafted.

Forcing employees to sign one of these so-called "love" contracts places them in a very awkward and unnatural position. It's doubtful that two people will decide to consult with the Human Resources department before they even go out

to dinner with one another. Signing an agreement turns the casual date into a big commitment, and couples are far more likely to simply hide their relationship.[77] Furthermore, since these contracts have yet to be tested in court, their validity may not hold up. Employees who feel pressured to sign such agreements could later argue that the circumstances were coercive in that the employer gave the tacit message that signing (and waiving certain rights to sue) was an implied condition of continued employment. Thus love contracts may "poison the waters" and leave the employer wide open to other potential forms of liability. Once the employees have signed the agreement, there is a written record that the employer is aware of the relationship. It is likely that such admissions will reveal relations between employees that may be homosexual, inter-racial, mixed religions, extramarital, etc. If one or both members of the couple later suffer a tangible employment loss, they may be able to make out a discrimination case against the employer on the basis of grounds other than sex. Finally, love contracts send the negative message to the employees of the firm that their employer is limiting their rights to their own privacy, as well as limiting their protection from sexual harassment if that situation does arise.

B. Protecting Employees While Protecting the Company

To create the most productive work atmosphere, employers should be focusing on making their employees feel safe and content. Instead of limiting the rights of their workers, companies should focus their efforts and legal resources on drafting strong policies against sexual harassment, should educate their employees on how to follow them, and should regularly monitor and consistently enforce such policies. Statistically it is inevitable that consensual relationships will occur at most operations. Employers need to achieve a balance between decorum in the work place and the

extremely offensive behavior exhibited in *Miller*, and to a lesser extent, in *Broderick*. Employment law practitioners have offered the following advice to navigate this terrain:

> Employers should keep in mind the key factors behind the *Miller* court's decision (and the EEOC's policy) in order to evaluate the legal risk to the company including, (1) the number of employees with whom the supervisor had sexual relationships, (2) the number of supervisors engaged in sexual relationships with subordinates, (3) how public the relationships are in the office and the interaction between the employees who are the supervisor's paramours and the supervisor. (4) whether the employees having these relationships are receiving benefits that other employees are not receiving and which are not justified by performance or other merit-based reasons; (5) whether the employees that are having these relationships with supervisors wield power over the employees who are not in such relationships; and (6) whether the overall feeling in the workplace is that in order to be promoted or receive equal treatment, an employee must have sexual relations with the supervisor.[78]

To date, the case law indicates that it is extremely difficult for employees to successfully claim discrimination on the basis of sex if they are discharged because of either an ongoing consensual union or because of strained relations following a breakup. Nonetheless, employers who insert themselves in their workers' private lives by either imposing unrealistic non-fraternization policies or requiring workers to

voluntarily come forward and to sign love contracts, may ultimately find themselves sued in privacy actions. Given these multiple constraints, an employer's best option is to emphasize a strict sexual harassment policy and to require a professional atmosphere in the work place. This method will provide support for employers in court, but more importantly, it will send a positive message to employees that management wants to protect their rights, not to restrict them.

ENDNOTES

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[2] Reinhold, "Office Dating, A Hot Affair Could Put Your Career on Ice" http://diversity.monster.com/wo/articles/dating/ (last visited Dec. 30, 2006).

[3] 477 U.S. 57, 106 S.Ct. 2399, 91 L.Ed.2d 49 (1986)

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[9] 118 S.Ct. at 2260

[10] Ellerth *supra*, 118 S.Ct. at 2257

[11] Faragher, *supra*, 118 S.Ct. at 2280.

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[13] *Id.*

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[16] 1990 WL 1104702 (E.E.O.C. Guidance)

[17] *Id.*

[18] 1990 WL 1104701 at 8 (E.E.O.C. Guidance)

[19] 1990 WL 1104702 at 2. (E.E.O.C. Guidance)

[20] 685 F. Supp. 1269 (D.D.C. 1988).

[21] *Id.* at 1272.

[22] *Id.* at 1278.

[23] *Id.* at 1280.

[24] *Id.*

[25] *Id.*

[26] 1990 WL 1104702 (E.E.O.C. Guidance)

[27] *Id.*

[28] Douglas, John, *Consensual Office Affairs*, National Law Journal, October 31, 2005.

[29] *Id.* noting Erickson v. Marsh & Mclennan Co. Inc., 569 A.2d 793 (1990).

[30] 30 Cal. Rptr. 3d 797, 36 Cal. 4th 446 (Cal.2005).

[31] *Id.* at 453.

[32] *Id* at 456.

[33] *Id.*

[34] *Id.* at 457.

[35] *Id.*

[36] *Id.* at 468-469. *But also see Drinkwater*, *supra* note 14, finding that plaintiff's allegations of an open sexual relationship between her supervisor and one of her co-workers was insufficient to establish an oppressive, hostile work environment, and plaintiff could not survive a motion for summary judgment on that count.

[37] *Douglas*, *supra* note 28.

[38] 807 F.2d 304 (2nd Cir. 1986).

[39] *Id.* at 308.

[40] *Id.* at 307.

[41] *Id* at 561.

[42] *Erickson*, *supra* note 29.

[43] *Id* at 561.

[44] 229 F.3d 1343 (11th Cir. 2000).

[45] *Id* at 1345.

[46] *Id.*

[47] 267 F.3d 1197 (11th Cir. 2001).

[48] *Id.* at 1199.

[49] *Id.* at 1200.

[50] *Mauro v. Orville*, 259 A.D. 2d 89, 697 N.Y.S. 2d 704 (1999).

[51] *Id.* at 90. *See also Kahn v. Objective Solutions, Intl.*, 86 F. Supp. 2d 377 (2000) dismissing plaintiff's complaint wherein she alleged that she had engaged in consensual sexual relations with her employer and was fired at the insistence of the latter's wife.

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[61] *Id.*

[62] Sneirson, *supra* note 58.

[63] N.Y.Labor Law § 201-d (McKinney's Supp. 2002)

[64] *Id.*

[65] 207 A.D. 2d 150, 621 N.Y.S. 2d 158 (Third Dep't. 1995).

[66] *Id.* at 152.

[67] *Id.*

[68] *Id.* at 153.

[69] *Id.*

[70] *Id.*

[71] 286 A.D.2d 409, 729 N.Y.S.2d 519 (2nd Dep't 2001).

[72] 283 A.D. 2d 246, 725 N.Y.S. 2d 318 (First Dep't 2001).

[73] *Id.*

[74] 237 F.3d 166 (2nd. Cir. 2001).

[75] *Id.* at 168.

[76] *Id.* at 169.

[77] Sneirson, *supra* note 58.

[78] Leblang, Kevin and Manne, Rachel. *Playing Favorites in the Workplace.* The Metropolitan Corporate Counsel. (November 2005) *available at* http://

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EMINENT DOMAIN AFTER *KELO V. NEW LONDON*: IS CHANGE IMMINENT?

By

Dennis D. DiMarzio*, Glenna Summer**, and Lonnie Jackson***

I. INTRODUCTION

The United States Supreme Court has historically played the critical role of hearing and deciding cases that ultimately define our society as one of law. Many of the Court's decisions have been handed down with little fanfare, and any national publicity and debate faded soon thereafter. Sometimes, however, the Court renders a landmark decision which involves such a fundamental right and has such immediate and long term implications that a firestorm of national publicity and debate continue long after the decision date. One June 23, 2005, the Supreme Court decided such a case, *Kelo v. New London*,[1] an eminent domain decision, and the firestorm of publicity and debate continues. In *Kelo*,[2] the Court dramatically expanded the eminent domain power of government to take private property for "public purposes" rather than "public use." The Court reasoned that a Connecticut city could constitutionally take private property in the name of economic development by a private developer.

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The purpose of this paper shall be to analyze the controversial case of *Kelo v. New London*[3] and to evaluate its clear implications. A brief historical overview of the law of eminent domain will be presented in order to gain a proper perspective of the *Kelo* decision. The *Kelo* decision will then be discussed. Finally, the implications of this decision will be evaluated.

II. BRIEF HISTORICAL OVERVIEW OF THE LAW OF EMINENT DOMAIN

The "Takings Clause" located in the Constitution's Fifth Amendment reads: "...Nor shall private property be taken for public use, without just compensation."[4] That Clause has been applied to the States through the Court's incorporation of the Takings Clause into the Fourteenth Amendment's Due Process Clause.[5] This Constitutional basis for the Government's eminent domain power is fundamentally important. But even before these Constitutional provisions were penned, the Founders embraced property ownership as a fundamental right of liberty. Philosopher John Locke believed that the right to property was a natural right to man. That "...governments were formed to protect the natural rights of man..."[6] was "most influential"[7] for the Founders. James Madison, Thomas Jefferson and John Adams embraced the Lockean view of property[8] and by the late eighteenth century the "Lockean" view was widely accepted in America.[9]

A. Early Decisions Protecting Private Property

Two Supreme Court decisions highlight the Court's primary concern with protecting private property interests. *Vanhorne's Lessee v. Dorrance*,[10] declared in 1795 a Pennsylvania statute unconstitutional that would have resolved a land dispute by taking property away from certain Pennsylvania citizens and transferring it to a group of

subsequent settlers.[11] The Court found it repugnant to seize the property of one citizen to give it to another citizen.[12] In the 1798 *Calder v. Bull* decision,[13] the Court again refused to support a decision that "...takes property from A and gives it to B."[14]

B. Clear Public Use Approach

Government, however, could take property and transfer title to itself for some public use such as a military facility, a public road or a park.[15] Furthermore, that public use interpretation was stretched to include condemnations and transfers of title from one private party to another when the subsequent use would be available to the public at large. Common examples include common carriers like railroads, a public utility, or a stadium.[16]

C. Public Benefit or Public Purpose Approach

Two landmark Supreme Court decisions dramatically expanded the meaning of "public use" to include "public benefit" or "public purpose" in eminent domain takings. In *Berman v. Parker*,[17] congress identified a blighted neighborhood in Washington D.C. and determined that it had become "injurious to the public health, safety, morals, and welfare" and that it was necessary to "eliminate all such injurious conditions by employing all means necessary and appropriate for the purpose," including eminent domain.[18] The case involved the wholesale taking of hundreds of urban dwellings, razing them, and then turning their sites over to private developers who would then build new improvements for their private, profit-making purposes. Mr. Berman objected to the taking of hi non-blighted department store. However, the Court allowed the taking of the neighborhood as a whole. In *Hawaii housing Authority v. Midkiff*,[19] the Court approved

an eminent domain taking of real property from lessors and transferring it to lessees on the Hawaiian island of Oahu, where it was said there was oligopolistic state of freehold title that was "skewing the State's residential fee simple market, inflating land prices, and injuring the public tranquility and welfare."[20] The Court had expanded its view of "public use."

In 1981, the Michigan Supreme Court allowed the City of Detroit to accomplish a pervasive eminent domain taking in the name of "economic development." In *Poletown Neighborhood Council v. City of Detroit*,[21] the City of Detroit sought to prevent a pending unemployment crisis and to spur "economic development." The City was allowed to condemn and take the entire residential community of *Poletown* and then sell the property at a dramatically reduced price to General Motors. The purpose of the sale was to guarantee that General Motors would not close operations in the area. the taking included churches, school, hospitals, and displaced over thirty-four hundred residents.[22]

In 2004, however, the Michigan Supreme court effectively overturned its *Poletown* decision in the case of *County of Wayne v. Hathcock.*[23] The County of Wayne started a project for the development of business and technology near its new Metropolitan Airport terminal and jet runway. The county commenced a series of condemnation proceedings to acquire the property for developers. The County claimed not blight removal but rather improvement of the local economy with projected new jobs and substantial additional tax revenue.

The Michigan Supreme Court rejected the condemnation claims and thus narrowed its interpretation of "public use." The Court established three tests, and of which would be sufficient to justify a condemnation under Michigan law. First, the Court announced a "Public Necessity Test."

Eminent domain must be limited to enterprises that generate public benefit, and whose very existence depends on land that can only be provided by the central government.[24] Second, the Court stated its "Public Accountability Test." When the private entity remains accountable to the public in its use of the property, a public use exists.[25] Finally, the Court identified its "Public Concern Test." A public use exists when the selection of the condemned land for a private interest is based on immediate public concerns and facts of independent public significance.[26] The Decision was in sharp contrast to the expanded *Poletown* construction of "public use" for an eminent domain taking. Instead, The *Hathcock* Court required that in order to justify an eminent domain taking of property near the new Metropolitan Airport runway, it would apply the three tests and require that at least one of them be satisfied.

III. KELO V. NEW LONDON

Should there be a broad definition of "public use" as opposed to applying tests and imposing greater scrutiny for an eminent domain taking of private property? The expanding and diverse case law involving eminent domain proceedings clearly showed that lower courts were struggling with this question. In *Kelo v. New London*,[27] the Supreme Court granted certiorari and seized the opportunity to answer this question in an eminent domain case from Connecticut. The Court would offer its modern day definition for an appropriate taking under the Fifth Amendment's Takings Clause applied to the States through the Fourteenth Amendment. The City of New London, Connecticut approved an integrated development plan designed to revitalize its ailing economy. Through its development agent, the City purchased most of the property targeted for the project from willing sellers, but initiated condemnation proceedings against certain unwilling sellers. Invoking a state statute that specifically authorized eminent domain to promote

economic development, and arguing that Supreme Court precedent and its expanded definition of "public use" should justify its condemnation claims, the City of New London prevailed before the Supreme Court of Connecticut.[28]

The City of New London intended the development plan to capitalize on the Pfizer Company building a major facility. It was expected to create jobs, increase tax and other revenues, and to revitalize an economically distressed city, including its downtown and waterfront areas. Suzette Kelo had lived in the area since 1997 and had made extensive improvements to her water view home. In all, there were nine parties including Ms. Kelo who contested the condemnation claims. While the Connecticut Supreme Court ultimately approved the taking, the dissenting justices would have imposed a "heightened" standard of judicial review for takings justified by economic development. They would have found the takings unconstitutional because the City failed to establish by "clear and convincing evidence" that the economic benefits of the plan would have been realized."[29]

In affirming the *Kelo*[30]case, the Supreme Court not only embraced the broad definition of "public use" to include public purpose, but it also clearly rejected any "heightened" review for takings justified by economic development. Writing for the majority, Justice Stevens noted that a rational basis review was appropriate because, "there is...no principled way of distinguishing economic development from other public purposes we have recognized."[31] Furthermore, he noted that the Court has a "longstanding policy of deference to legislative judgments in the field."[32] He also emphasized "...that nothing in our opinion precludes any state from placing further restrictions on its exercise of the takings power."[33]

Justice Stevens delivered the opinion of a divided court. In a five to four decision, Justices Souter, Ginsburg, Breyer and Kennedy joined Justice Stevens. Justice Kennedy filed a concurring opinion. Justice Kennedy suggested that in certain cases a heightened standard of review should be used. In "...cases in which the transfers are so suspicious, or the procedures employed so prone to abuse, or the benefits are so trivial or implausible, that courts should presume an impermissible private purpose."[34] He emphasized that *Kelo* was not such a case. The Chief Justice, Justice Scalia, Justice O'Connor, and Justice Thomas dissented. Justice O'Connor and Justice Thomas wrote separate dissenting opinions. Those dissenting opinions serve as a foundation of the next section of this paper, where the implications of the *Kelo* decision will be evaluated.

IV. IMPLICATIONS OF *KELO*

A. The Kelo Dissenting Opinions

There is no better place to begin the evaluation of the implications of the *Kelo* decision than to examine the separate dissenting opinions written in the case by Justice O'Connor and Justice Thomas. Justice O'Connor expressed her concerns about the decision in two remarkable observations:

> The spector of condemnation hangs over all property. Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory.... The beneficiaries are likely to be those citizens with disproportionate influence and power in the political process including large corporations and development firms.[35]

Justice O'Connor clearly felt the Court too broadly defined "public use" under the Takings Clause and that it abdicated its responsibility to properly enforce the Constitution when it suggested that the States could choose appropriate limits on economic development takings.

Justice Thomas warned that the *Kelo* decision was "far reaching, and dangerous."[36] He traced the law of government takings and reasoned that the Court had gone too far in defining "public use".[37] Furthermore, he referred to earlier urban renewal projects that some described as 'Negro removal.' He observed that a disproportionate percentage of lower income, elderly, and non-white people would likely be impacted by the Court's decision.[38]

Justice Thomas argued that "There is no justification...for affording almost insurmountable deference to legislative conclusions that a use serves a public purpose."[39] He stated that the Court has long had an "... overriding respect for the sanctity of the home ..."[40] and that the Court "... would not defer to a legislature's determination of the various circumstances that establish ... when a search of a home would be reasonable."[41] Yet, the Court cannot "... second-guess ... whether the government may take the infinitely more intrusive step of tearing down ... homes."[42] He poignantly observes, "Though citizens are safe from the government in their homes, the homes themselves are not."[43]

No less than two Supreme Court Justices then warned of the pending problems resulting from the *Kelo* decision. They were joined in their dissents by two additional justices, Chief Justice Rhenquist and Justice Scalia. Since the *Kelo* decision, Justice Roberts and Justice Alito have replaced Chief Justice Rhenquist and Justice O'Connor, but if left the *Kelo* majority intact. That being true, it is therefore highly unlikely

that the newly composed Court would agree to hear a new case testing the Takings Clause or that they would do anything other than affirm the *Kelo* decision.

While the ultimate *Kelo* decision and the strong dissenting opinions that were a part of it will long be remembered, perhaps the most significant aspect of the case was justice Stevens' statements in the opinion that the Court would defer to legislative judgments in the field and "... that nothing in our opinion precludes any state from placing further restrictions on its exercise of the takings power."[44] These are telling statements that leave the door wide open for state legislatures and state supreme courts to tailor their own state takings power. When the Supreme Court rendered a decision in the *Kelo* case, they essentially decided not to ultimately resolve the takings question, but rather to leave it to the states.

B. New Takings, Public Opinion, and State Governments

It is much too soon to properly gauge the ultimate impact of the *Kelo* decision. However, certain early observations suggest where things might be headed. Prior to the *Kelo* decision, there was an increase in the number of eminent domain claims. "According to the Institute for Justice, more than 10,000 properties were threatened or taken by eminent domain between 1998 and 2002."[45] Based on the Court's broader interpretation for "public use" and the number of communities who are interested in economic development to attract new business and expand tax revenue, the number of takings claims is likely to rise dramatically.

Another clear early observation is that the public generally reacted negatively to the *Kelo* decision and to the use of eminent domain takings to further economic development. According to Dana Berliner of the Institute for Justice, "Polls

show public opposition has ranged from 70 percent to more than 90 percent of respondents."[46] This would point toward people lobbying their state legislators for laws to restrict such takings and to fight legal claims in the area if their property is targeted.

Based on this overwhelming public opposition and the *Kelo* Court's ruling that states could choose appropriate limits on takings connected with economic development, it seems likely that state governments will address this issue with new legislation. In fact, according to Larry Morandi, who tracks eminent domain issues for the National Conference for State Legislators, that is precisely what is happening. "Lawmakers in 44 states have drawn up more than 320 eminent domain bills."[47] Alabama, Michigan and Ohio took steps to limit or place a moratorium on the use of eminent domain for economic development purposes. South Dakota sought to block takings for any private person or nongovernment entity. Pennsylvania proposed a ban on private development takings bu the measure would exempt Philadelphia and Pittsburgh for seven years. The early state bills are very restrictive.[48] Even the Federal Government has been considering bills that would restrict the use of federal funds to support condemnation that "primarily benefits private entities."[49]

C. First State Post Kelo Decision: Norwood v. Horney

On July 26, 2006, the Ohio State Supreme Court became the first state high court to decide a case involving eminent domain issues since the *Kelo* decision. In the case of *Norwood v. Horney*,[50] a development project in Norwood Ohio gave rise to the property owners' challenge. Norwood was a community near Cincinnati that had undergone changes that "... eroded its industrial base, diminished its financial strength, shifted its nature from residential to commercial and increased noise,

pollution, and traffic."[51] The City entered into an agreement with a private firm to plan economic development. The plan called for construction of apartments and condominiums, commercial office space and parking with substantial revenue earmarked for the city. The firm was able to purchase most of the affected property, but the City commenced eminent domain proceedings against owners who refused to sell. The City relied on a consultant's conclusion that the neighborhood was a "deteriorating area" in danger of becoming a blighted area and proceeded under the Norwood Code to take the property. A state trial court upheld the taking and an appeals court denied a stay of that judgment. The Ohio Supreme Court reversed those lower court decisions.

The Ohio Supreme Court steered away from the *Kelo* decision and instead cited the *Kelo* dissent and the *Hathcock*[52] Michigan Supreme Court decision to use a heightened scrutiny test in reviewing the eminent domain powers. The Court ruled that the fact the appropriation would provide an economic benefit to the government and community, standing alone, did not satisfy the public use requirement of the Ohio Constitution. Furthermore, the Court ruled that the use of "deteriorating area" as a standard for determining whether private property is subject to appropriation was unconstitutionally void for vagueness. Finally, the Court ruled that that part of the City of Norwood Code which permitted the taking and using of appropriated property after the compensation had been deposited but prior to appellate review was also unconstitutional in violation of the separation of powers doctrine.[53] This case clearly shows that the *Kelo* decision potentially might not signal a change in how state courts handle eminent domain cases.

V. CONCLUSION

The sharply divided Supreme Court *Kelo* decision, the public's generally negative reaction to that decision, and numerous states enacting new "takings" legislation are all factors that suggest that more litigation will continue. The Court's dramatic expansion of the interpretation of "public use" to include "public purpose" under the Fifth Amendment's Takings Clause in the name of economic development, and the common "blight" problems in America's larger cities invite such litigation. Furthermore, politicians and those in state and local governments will have difficult decisions in navigating a path to protect private property interests on the one hand and to promote economically healthy cities on the other hand. Wealthy developers and major corporations seeking government inducements to stay in one city or to relocate to another city will only add to the difficulty of those decisions.

The Court's decision in *Kelo* not to use a heightened scrutiny test in "Takings" cases involving economic development, its announced deference to state and local governments' decision in those cases, and its general abdication to state governments to pass more restrictive laws in this area has ultimately served to make a gray and cloudy area of law even more gray and cloudy. Indeed, the new state legislation, and likely increased litigation in numerous states suggests we have storm clouds forming and new decisions from the various states will be raining down on us soon.

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[1] *Kelo v. New London*, 126 S. Ct. 24, 162 L. Ed. 2nd 922, 2005 U.S. LEXIS 5331 (2005).

[2] Id.

[3] Id.

[4] U.S. Const., amend. V.

[5] U.S. Const., amend. XIV, §1. See *Chicago, B. & Q.R. Co. V. Chicago*, 166 U.S. 226, 41 L. Ed. 979, 175.

[6] John Lock, *Second Treatise of Government* 19, at 15 (C.B. Macpherson ed., Hackett Publ'g Co. 1980) (1960)

[7] Joshua E. Baker, *Quieting the Clang: Hatcock as a Model of the State-Based Protection of Property Which Kelo Demands*, 14 Wm. & Mary Bill of rts. J. 351 at 354. (2005)

[8] Id.

[9] Id.

[10] *Vanhorne's Lessee v. Dorrance*, 2 U.S. 304, 311 (1795).

[11] Id. at 304.

[12] Id. at 311.

[13] *Calder v. Bull*, 3 U.S. 386 (1798).

[14] Id at 388.

[15] *Old Dominion Land Co. V. United States*, 269 U.S. 55 (1925).

[16] *National Railroad Passenger Corporation v. Boston & Maine Corp.*, 503 U.S. 407 (1992).

[17] *Berman v. Parker*, 348 U.S. 26 (1954).

[18] Id. at 28.

[19] *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984).

[20] Id. at 232.

[21] *Poletown Neighborhood Council v. City of Detroit*, 304 N.W. 2d 455 (Mich. 1981).

[22] Stephen J. Jones, *Trumping Eminent Domain Law: An Argument for Strict Scrutiny Analysis Under the Public Use Requirement of the Fifth Amendment*, 50 Syracuse L. Rev. 285, 295 (2000).

[23] *County of Wayne v. Hathcock*, 684 N.W. 2d 765 (Mich. 2004).

[24] Id. at 781.

[25] Id. at 782.

[26] Id. at 783.

[27] *Kelo v. New London*, 125 S. Ct. 2655 (2005).

[28] *Kelo v. New London*, 843 A. 2d 500 (2004).

[29] Id. at 587, 588.

[30] *Kelo v. New London*, 125 S. Ct. 2655 (2005).

[31] Id. at 2662.

[32] Id. at 2660.

[33] Id. at 2665.

[34] Id. at 2667.

[35] Id. at 2670,2671.

[36] Id. at 2687.

[37] Id. at 2678.

[38] Id. at 2687.

[39] Id. at 2684.

[40] Id. at 2685

[41] Id. at 2684.

[42] Id. at 2685.

[43] Id.

[44] Id. at 2668.

[45] Tresa Baldas, *States Ride Post-"Kelo" Wave of Legislation*, The NAT'L. L.J. 46 (Aug. 1, 2005) at http://web.lexis-nexis.com.

[46] Warren Ritchey, *Fracas Over Home Seizures Moves to States*, CH. SCI. MONT., (Dec. 15, 2005) at http://web.lexis-nexis.com.

[47] David Loos, *Legislatures Moving to Boost Property Rights in Kelo Wake*, 10 ENV"T & ENERGY PUB 9. (Mar. 2, 2006) at http://web.lexis-nexis.com.

[48] Id.

[49] Terry Pristin, *Developers Can't Imagine a World Without Eminent Domain*, N.Y. Times, January 18, 2006 at C8.

[50] *Norwood v. Horney*, 853 N.E. 2d 1115 (Oh. 2006).

[51] *In Ohio, 'Economic Benefit' Alone Does Not Justify Use of Eminent Domain*, Vol. 75, No. 6, The U.S. Law Week, (Aug. 15, 2006) at 1099 at http://pubs.bna.com.

[52] *County of Wayne v. Hathcock*, 684 N.W. 2d 765 (Mich. 2004).

[53] Norwood v. Horney, 853N.E. 2d 1115 (Oh. 2006).

NOT-FOR-PROFIT ENTITY ACTIVITIES AND INCOME: CHALLENGES TO CONTINUING TAX- EXEMPT STATUS

by
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INTRODUCTION

Many places of worship and other community organizations today wish to continue the purposes for which they were founded. But they lack contribution income sufficient to continue their religious, literary, educational, artistic or charitable purposes. These not-for-profit entities must find methods of using resources available to them for the maintenance of their missions without creating threats to their tax-exempt status.[1]

Not-for-profit corporations and other entities organize and market themselves, as do for-profit businesses. Not-for-profit organizations, however, seek to serve a public or mutual benefit purpose other than the pursuit of accumulated profit. The United States Congress and state legislatures recognize the fact that certain traditionally charitable or religious enterprises are tax exempt because of the public purposes they pursue. [2]

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A not-for-profit enterprise is not prohibited from obtaining funds by contribution or even by sale or rental of personal or real property.[3] Legislatures, of course, describe the purposes for which these funds may be used. If a not-for-profit organization engages in fund producing activities, unrelated to its purposes, the entity's tax-exempt status may be revoked. [4]

This article proposes to describe the formation of not-for-profit entities for tax-exempt purposes, cautions concerning the activities of those organizations and some methods for keeping the tax-exempt status of a not-for-profit despite the existence of unrelated business income and even substantial related income.

FORMATION OF THE TAX-EXEMPT ENTITY: PLANNING AND ACTING WITH CAUTION

The Formation Articles

The Internal Revenue Code clearly states that a not-for-profit organization may submit an IRS Form 1023 and organizational articles stating its not-for-profit purpose and structure. The organizational articles will describe the particular entity by articles of incorporation, articles of association or trust agreement.[5]

The organizational articles of the not-for-profit will describe how the organization is not created for profit and that no part of its earnings will yield benefit to any private shareholder or other interested person. The articles will indicate that the organization is formed for religious, scientific, literary, educational, artistic or charitable purposes that benefit the public at large. No substantial portion of the not-for-profit's activities may be used to influence legislation. The organization may not participate in political campaigns

whether by active endorsement or by substantial donations. Illegality and violations of fundamental public policy cannot occur. [6]

In October 1975, Aid to Artisans, Inc., for example, organized itself as a not-for-profit Massachusetts organization.[7] The organizers wanted to promote and sell the handicraft output of disadvantaged artisans in developing societies of the world, so as to improve and expand that output. Its Articles of Organization were part of its completed Form 1023 "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code". These Articles, as amended, used language from the Code in listing its purposes:

> The prosecution of charitable, scientific and educational purposes, with no part of the net earnings of the Corporation to inure to the benefit of any private individual, nor any substantial part of the activities of the Corporation to be the carrying on of propaganda, or otherwise attempting, to influence legislation, and with no participation in, or intervention in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office, and, in particular, the promotion, improvement and expansion of the handicraft output of disadvantaged artisans in developing societies of the world by providing assistance and support in the areas of marketing, quality control standards, financing and related areas.[8]

The organization described a number of types of assistance to the artisans. The corporation would market the handicrafts to museums and other not-for-profit agencies for sale to interested buyers. United States exhibitions and newsletters concerning the work would solicit need for support.

If the corporation began to experience any profit, that money would be used to provide technical and material support to the artisans.

The Internal Revenue Service refused to grant the organization tax exempt status because it was not satisfied with the organization's definition of "disadvantaged artisan" nor that the artisans themselves were in fact members of this category. Aid to Artisans contended that its activities served public rather than private interests, were undertaken for charitable purposes and, therefore, qualified it as a tax exempt organization.

The United States Tax Court agreed with Aid to Artisans. The Court reasoned that the operational test applied to the entity indicated that the organization's primary activities and purposes were tax exempt and further one or more tax exempt purposes; that a substantial part of the organization's activities do not further non-exempt purposes nor do they serve private interests. The court indicated rather that the organization sought alleviation of economic distress, artistic and cultural education, preservation of authentic handicraft and economic stability in disadvantaged communities. Aid to Artisans, therefore, was entitled to an exemption from income tax pursuant to IRC 501(a).[9]

Aid to Artisans cautions any legal or tax advisor. An exhaustive review of Section 501(c)(3) of the Internal Revenue Code with the client will help the practitioner determine the exact organizational purposes that benefit the public. The application for tax-exempt status will then be clear and concise. The practitioner will select the correct type of tax exempt entity. [10]

A considerable number of entities are treated as not-for-profit organizations; the Code treats these organizations as tax-exempt because of that designation. Those entities most ordinarily associated with the not-for-profit status are religious, charitable, scientific, literary, educational, artistic, healthcare and animal cruelty prevention organizations. Civic leagues operated for social welfare purposes, agricultural organizations, chambers of commerce, boards of trade, fraternal clubs and veterans associations, credit unions operated for mutual purposes and without profit, legal services and trusts for public benefit are also tax-exempt. Social philanthropy, expressed through care for culture and others, forms the framework in which such organizations are treated as operating on a not-for-profit basis and through which tax-exempt status is offered to them[11].

It is also important to advise the client to keep the not-for-profit purpose of the organization continually in mind. Clients should minimize activities that would impair the not-for-profit tax exempt status. For example, the organization's compensation and private benefit policies require close scrutiny; substantial lobbying efforts and political campaign contributions must be avoided.

Caution Concerning Salaries and Benefits to Insiders

The IRS will scrutinize excessive salaries which do not reflect a difference between a not-for-profit entity's salaries and those in the for-profit sector. The Service may revoke the tax-exempt status of the organization for this violation[12]. In addition, excessive benefits to inside individuals may result not only in a loss of tax-exempt status, but also in the imposition of considerable excise taxes ranging from five to one hundred percent. The Service will scrutinize transactions in which the value of the benefit given to an insider exceeds the value of the

consideration which the not-for-profit receives from that insider or others. It will also penalize dealings in which the revenues of the not-for-profit determine the insider's economic benefit as if a partnership existed between the insider and the entity[13]

Forbidden Private Benefits

Not only can the entity's activities not benefit an insider; the private interests of any individual or organization may not be served. The organization must benefit individuals recognized as objects of charity (for example, the poor or distressed) or the entity may promote religion, science, literature, education, health, art or fellowship for the benefit of the public at large. Private benefit to a non-insider, however, is not forbidden in all cases[14]. The private benefit must be a substantial part of the entity's business in order to jeopardize its tax-exempt status.

Penalized Substantial Lobbying Efforts

The substantiality test applies to the entity's lobbying attempts – such a portion of the organization's activities may not be to influence legislation. Legislation includes any action by the Congress and any state or local governing bodies to pass bills or resolutions. It does not include attempts to influence decisions by executive, judicial or administrative bodies. The entity may not contact, or urge the public to contact, members of a legislative body for the purpose of proposing or opposing legislation. The organization itself may not advocate the adoption or rejection of legislation. An organization, however, may conduct educational meetings and prepare materials in an educational manner without jeopardizing its tax-exempt status. If the organization violates this prohibition, the IRS may levy an excise tax against the entity, equal to five (5%) percent of its

lobbying expenses for the year in which it ceases to qualify for exempt status. In addition, organization managers may be liable for an additional five (5%) percent of those expenditures[15].

The Service also makes available an option under IRC Section 501(c) to use the expenditure test. The organization may lobby without jeopardizing its tax exempt status provided the expenditures do not exceed a proportionate amount of its income not to exceed one million ($1,000,000) dollars. An organization which engages in excessive lobbying must pay an excise tax equal to twenty-five (25%) percent of the excess expended in its lobbying efforts[16]. Cases continued to examine the meaning of "proportionate amount". In any event, caution should be practiced in this area.

Dangerous Political Campaign Activity

The Internal Revenue Code absolutely forbids not-for-profit organizations from directly or indirectly participating in any political campaign through private contributions or public statements. The organization may, however, engage in educational and voter registration campaigns, so long as it neither favors nor opposes any candidate. An individual member of the organization is free to endorse any candidate as long as it is clear that the endorsement is not that of the organization. The entity must afford equal opportunity for all candidates to participate in any public forum sponsored by the organization. Any participation in a political campaign jeopardizes the tax-exempt status of the entity. Any political expenditures are subject to an excise tax of ten (10%) percent in regard to the organization and two and a half (2.5%) percent against its managers. If the expenditures are not corrected through their recovery to the extent possible, the Service may levy an additional tax equal to one hundred (100%) percent of

the expenditures against the organization and fifty (50%) percent of the expenditures against its managers[17].

The practitioner must advise the client to file the required documents in order to form the proper type of organization. The client must not engage in the explicitly forbidden activities described above. But if contributions begin to dwindle, the continued existence of the enterprise may be in jeopardy. Many tax-exempt organizations have already begun to tap unrelated business income sources in order to maintain themselves. The next section of this paper explores the Code regulation and taxation of unrelated business income. The tax-exempt organization may also be exempt from tax upon funds obtained from these sources.

METHODS FOR KEEPING THE TAX-EXEMPT STATUS OF A NOT-FOR-PROFIT DESPITE THE EXISTENCE OF UNRELATED BUSINESS INCOME AND SUBSTANTIAL RELATED INCOME

Unrelated Business Income

UBIT Regulation:

The Internal Revenue Code and the Tax Regulations permit tax-exempt organizations to engage in income producing activities unrelated to their tax-exempt purposes. These activities, however, are subject to income tax liability if the following three conditions are met: the activity constitutes a trade or business; the trade or business regularly occurs; the trade or business is not substantially related to the entity's tax-exempt purposes. The entity, furthermore, may lose its tax-exempt status if the unrelated activities are a substantial part of the organization's activities[18].

In 1947, New York University acquired the Mueller Noodle Company in order to obtain income which would assist its tax-exempt educational purposes. The pasta manufacturing business was certainly a regular business and bore no relationship to the educational purposes. Its income, therefore, is taxable and not exempt, at least under present law. NYU could even have lost its tax-exempt status if it operated the Company, and the business was a substantial part of its activities[19]. If NYU however, operated a student cafeteria, its income would be substantially related to its purpose and would be tax exempt. Mueller Company dividends, as passive income from an NYU investment, would also be tax-exempt. Donations from the Company to the University to create an endowed tax chair would not qualify as taxable because such gifts are always exempt[20].

Many other forms of business activity are subject to the unrelated business income tax if the business activity is not substantially related to the exempt purpose of the organization. Income from the sale of advertising constitutes unrelated trade or business income[21]. Most forms of gaming are considered unrelated trade or business. Bingo games, however, have a special tax-exempt exception, as long as the bingo game (1) is conducted in its traditional form and not as an instant lottery, (2)does not compete with for-profit organizations in the area, and (3)does not violate any local law. The sale of merchandise and publications may be considered an unrelated business, but only if the items do not have a substantial relationship with the exempt purposes of the entity[22].

The practitioner may recommend that unrelated business activities be conducted by a separate for-profit organization by way of contract, parent-subsidiary relation or joint venture so as to not dilute the not-for-profit purposes of an entity. No control over the business activity resides in the

exempt organization. Arrangements between the parties must emphasize the business activity's exempt benefits to the exempt entity's mission[23]. The business corporation or other enterprise may then be able to contribute its net income to the not-for-profit organization. New York University and other charitable entities have chosen this path. Most contemporary social entrepreneurs, however, have not chosen this alternative, but have instead framed their enterprises to fit within the exceptions listed by the Code and Regulations concerning the unrelated business income tax (UBIT).

Exceptions to UBIT Regulation:

The Code and the Tax Regulations allow that income from the activities of a not-for-profit entity may escape income tax liability if the income production meets one of the following exceptions: the work is performed by volunteers; the activity primarily assists its own members; the sale of donated merchandise occurs[24]. The law also permits rents from real property, royalties, capital gains and interest and dividends to be exempt from the unrelated business income tax unless any of these activities are financed with borrowed money[25]. Such a financing arrangement is commercial in nature and will be taxed because the income from the rentals or other activities must be used to repay the outstanding loan.

The rental fees must constitute actual rentals from passive real estate, rather than payment for services provided to outsiders. The Internal Revenue Service has ruled that a University communications tower permanently affixed to its property could rent excess capacity on its satellite dish to a paging company without being subject to income tax on unrelated business[26]. An exempt organization may rent out its meeting hall, providing utilities and janitorial services, without tax liability[27]. An entity may lease parking lot space for

customary parking service in relation to the tax exempt purpose, but not rent to tenants[28]. The Service has also indicated that rental charges to maintain the real property such as attendance, security, and clean-up are not subject to tax, whereas services for the renters' benefit such as set-up of chairs, tables and public address systems are not exempt[29].

Related Business Income

Court and IRS rulings have indicated that certain not-for-profit activities will be exempt from tax and will not affect the tax-exempt status of the organization if the activity is substantially related to the exempt purposes of the organization. As already noted above, an organization which sold artifacts produced by poor artisans from other countries was permitted to keep its tax-exempt status and its tax-exemption because its profits were used for the entity's charitable purposes[30].

A religious publisher has been permitted, furthermore, to continue its work as a tax-exempt and not-for-profit organization despite the significant profits earned by the religious press[31].

In 1931 three Presbyterian ministers obtained a corporate charter for the Presbyterian and Reformed Publishing Company in order to

> ...state, defend and disseminate (through every proper means connected with or incidental to the printing and publishing business) the system of belief and practice taught in the Bible, as in that system is now set forth in the Confession of Faith and Catechisms of the Presbyterian Church in the United States of America...[32]

The corporate charter required than any income was to be used to improve its publications, to extend its influence and to support Presbyterian institutions. In 1939, the Internal Revenue Service granted the publishing Company tax-exempt status indicating that the corporation's works were religious in nature and that its activities, therefore, were exempt from income tax

From 1931 through 1969, Samuel, Charles and Bryce Craig, operated the Company without any compensation for themselves. Two of the three brothers made loans to the Company in order to keep it functioning. Editing, packing and shipping tasks and clerical work were done by volunteers. In 1969, the business experienced an increase in financial activity because of a series of best sellers written by a minister and published by the Company. This increased economic success enabled the company to pay its workers, repair its equipment and to make contributions to affiliated religious organizations. In accord with disclosure requirements, the Company filed annual reports. In 1980, the Internal Revenue Service revoked the Company's tax-exempt status. The Service reasoned that the Company was not now "operating exclusively for purposes set forth in 501(c)(3)" and was "engaged in a business activity which is carried on similar to a commercial enterprise."[33] The Service applied the revocation retroactively to January 1, 1969.

The publishing company appealed the revocation to the United States Tax Court which upheld the IRS decision but ruled that the retroactivity portion of the decision was an abuse of discretion[34]. The Tax Court did, however, set a revocation date at 1979. The Company's substantial commercial activities since that date, evidenced by greatly increased profits, undermined the exempt purpose of the organization. The Company additionally was distributing its books in part through a commercial publishing house, thereby competing with commercial publishers. The Company had in effect

converted itself to a commercial enterprise by marketing its books to obtain more readers, by paying workers, by its substantial royalties, by its formal contracts with authors and by its failure to formally affiliate itself with any church organization[35].

In 1984, the United States Court of Appeals for the Third Circuit reversed the Tax Court decision; it decided that the successful operation of a tax-exempt organization does not transform its business into a commercial enterprise[36]. The Court of Appeals reasoned that increased economic activity should not automatically forfeit the tax-exempt status of an enterprise. The Publishing Company continued to operate for tax-exempt purposes and the benefit from the company's operation did not inure to the benefit of any private shareholder or individual.

The Court indicated that the Company certainly continued to operate for tax-exempt purposes. The Court noted the legislative history of the tax exemption Code provisions. The original sponsor of Section 501(c)(3) in the United States Senate described the religious publishing house as a primary example of a tax-exempt organization:

> The corporation which I had particularly in mind as an illustration at the time I drew this amendment is the Methodist Book Concern, which has its headquarters in Nashville, which is a very large printing establishment, and in which there must necessarily be profit made, and there is a profit made exclusively for religious, benevolent, charitable, and educational purposes, in which no man receives a scintilla of individual profit. Of course if that were the only one, it might not be a matter that you would say we would be justified in changing these provisions of law to meet a

> particular case, but there are in greater or less degree such institutions scattered all over this country. If Senators will mark the words, the amendment is very carefully guarded, so as not to include any institution where there is any individual profit, and further than that, where any of the funds are devoted to any purpose other than those which are religious, benevolent, charitable, and educational.[37]

The company was organized exclusively for the exempt purpose because it had no commercial motive but sought, through its activities and its management decisions, to remain closely affiliated with the Orthodox Presbyterian Church. The company used its substantial profits for a religious purpose. This religious purpose was not diluted by the accumulation of funds to purchase or build an office or warehouse so that the mission of the company might even be expanded[38].

The company's profits did not inure to the benefit of any private individual or shareholder. No person was to receive a ten (10%) percent portion of the Company's gross income instead of a salary, as occurred in the case of L. Ron Hubbard, the founder of the Church of Scientology[39]. The Company paid salaries which rose from $550 in 1972 to about $57,600 in 1979, but no one person received a salary greater than $15,350 and five individuals were paid under $6,250. The Court observed that, in the circumstances, the salaries "were relatively modest."[40]

The practitioner then may rely on the *Presbyterian and Reformed Publishing Company* decision to advise a client concerning business activities substantially connected to the client's charitable purpose. A Service General Counsel's memorandum which antedates the decision reinforces this conclusion: a not-for-profit organization should be able to

operate a business if that business is substantially connected to its charitable purpose.

> For some time now it has been increasingly apparent that our earlier approach to the problem of permissibility or non-permissibility of business activities of charities has been based on misconception that somehow in the enactment of the provisions for exemptions of charities from income tax, Congress intended an implied restriction on the extent of their engagement in business activities. In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classifications of exempt charities to those charities not engaged to any substantial extent in commercial endeavors[41].

The Internal Revenue Service and Court decisions, however, continue to scrutinize the substantiality test in both of its applications: the income, whether from an unrelated or substantially related business, must be exclusively used for a charitable purpose and may not inure to the benefit of any private individual; if the income stems from unrelated business activity, the income should not be a substantial part of the charity's operation. Court decisions seem to permit substantial operations to be tax-exempt and not to affect an entity's tax-exempt status so long as the income is exclusively used for charitable purposes, but the Service continues to examine any substantial business activities in which an exempt organization engages.

CONCLUSION

The Internal Revenue Code and its court and Service interpretations require that the practitioner exercise considerable caution in advising not-for-profit clients. Clients must follow the Internal Revenue Code formation articles strictly. The charitable organization must be organized for charitable purposes and not improperly compensate its employees or board members through salaries or private benefits; substantial lobbying efforts and political campaign contributions need to be avoided. Clients must understand the definition of unrelated business income and exceptions to the rule of UBIT regulation such as the sale of donated merchandise, real property rentals, royalties, capital gains, interest and dividends. Finally, the practitioner needs to clearly describe related business income and the present controversy concerning its taxability in accord with the substantiality test. The formation of separate for-profit entities which contribute business profits to the tax-exempt entity may be the most acceptable alternative at this time to the related business income problem addressed by the *Presbyterian* decision but still resurrected by the Internal Revenue Service.

ENDNOTES

[1] Places of worship and other community organizations in New York City, for example, possess land and even buildings. Many of these entities, however, lack the liquid assets necessary to the continuation of their missions.

[2] See, for example, the acknowledgement of this fact in the discussion of charitable exemption problems held before the Senate Finance Committee and the House Ways and Means Committee in early 2005, available at http://waysandmeans.house.gov/hearings.asp? and at http://finance.senate.gov/sitepages/hearing0305.htm.

[3] See the discussion of charitable tax exemptions for income obtained not only from contributions but also from investment income which follows.

[4] The Internal Revenue Service continually confronts situations in which not-for-profit organizations obtain profits from business, but the business purports to use income for charitable purposes. See, for example, *Presbyterian & Reformed Publishing Company v. Commissioner*, discussed infra.

[5] IRC 501(c)(3), 26 U.S.C. Section 501(c)(3).

[6] Id.

[7] See *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202 (1978).

[8] Loc. Cit. at 203.

[9] Loc. Cit. at 215.

[10] U.S.C. Section 501(c)(3) lists organizations eligible for tax-exempt status: Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in, (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

[11] This description merely amplifies by example the organizations already listed in Section 501(c)(3).

[12] Id.

[13] Id.

[14] Id.

[15] 26 U.S.C. Section 503.

[16] Id.

[17] Id.

[18] See Treasury Regulation 1.501(c)(3)-1(e)(1).

[19] See Law School to Get Company's Profits, N.Y. Times, Oct. 3, 1947 at 27 quoted in the article of Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 Emory Law Journal 1475 at 1556.

[20] Loc. Cit. at 1482.

[21] See Treasury Regulation 1.501(c)(3)-1(e)(1).

[22] Id.

[23] See Plunkett and Christianson, *Exempt Organization Law: The Quest for Cash: Exempt Organizations, Joint Ventures, Taxable Subsidiaries and Unrelated Business Income*, 31 WILLIAM MITCHELL 1 (2004).

[24] Id.

[25] Id.

[26] Private Letter Ruling 98-16027.

[27] Revenue Ruling 69-178.

[28] Private Letter Ruling 93-11024.

[29] Private Letter Ruling 98-35001.

[30] See *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202 (1978).

[31] See *Presbyterian & Reformed Publishing Company v. Commissioner*, 743 F. 2d 148 (3d Circuit, 1984).

[32] Loc. Cit. at 150.

[33] Loc. Cit. at 151.

[34] See *Presbyterian & Reformed Publishing Company v. Commissioner*, 79 T.C. 1070 (1982).

[35] Loc. Cit. at 1078.

[36] See *Presbyterian & Reformed Publishing Company v. Commissioner*, at 152 ff.

[37] Loc. Cit. at 153.

[38] Loc. Cit. at 156-157.

[39] See *Founding Church of Scientology v. United States*, 397 U.S. 1009 (1969).

[40] See *Presbyterian & Reformed Publishing Company v. Commissioner*, at 154.

[41] General Counsel Memorandum 34,682 (Nov. 17, 1971).

An Effect of the Revision to the New York Mental Hygiene Law on General Contract Law

by

Winston Spencer Waters*

INTRODUCTION

This article examines the common law doctrine of contracts involving persons deemed to be adjudicated and non-adjudicated mentally incompetent. It reviews the current case law in New York as it relates to contracts of persons deemed to be "incapacitated" pursuant to Article 81 of the Mental Hygiene Law. The article attempts to outline the similarities and differences between general contract law and the Mental Hygiene Law as they relate to contracts of the "incompetent person" and the "incapacitated person." The burden of proof required to establish "incapacity" pursuant to the Mental Hygiene Law and mental capacity required to enter into a contract is also discussed.

I. TRADITIONAL CONTRACT LAW

Early New York Court of Appeals cases clearly established the contract rules regarding adjudicated and non-adjudicated incompetents. A contract made with a person duly adjudged incompetent and for whom a committee has been appointed is void[1] and a contract of a non-adjudicated

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incompetent is voidable.[2] In an early decision, the New York Court of Appeals held in *Blinn v. Schwartz,* that a deed of a person actually insane, but never so adjudged, is not void, in the sense of being a nullity. It is voidable at his election upon recovering his reason, and may then be ratified or avoided at his pleasure. The deed has force and effect until the option to declare it void is exercised.[3] This privilege is denied to the party with whom the mental incompetent contracted.[4]

There are different tests to determine if the requisite mental capacity to contract existed.

Test 1

In New York State, the requisite mental capacity to enter a contract has been measured by what is largely a cognitive test.[5] This test examines whether the contracting party was capable of understanding and appreciating the nature and consequences of the particular transaction. The level of "insanity" to avoid the contract must be an absolute incapacity to understand the effect of the act. Therefore, mere weakness of mind, or partial insanity or monomania, unconnected with the subject matter of the contract, is not sufficient. A moderate degree of incapacity may be sufficient where the transaction is accompanied by fraud, imposition or duress.[6] Persons suffering from a disease such as Alzheimer's are not presumed incompetent.[7]

Test 2

The second test is the motivational test. This test does not examine whether or not the contractual party understood the transaction. It focuses on whether the act of entering into the agreement was the result of mental illness. The motivational test is subjective. It applies when there is

evidence that, even though understanding was complete, the nature of a particular mental disease was such that the capacity of a contracting party to control his acts was eliminated and he was induced to enter the contract. This test recognizes the ability of mental disease such as manic depressive psychosis to control a person's actions despite the individual having an understanding of the transaction. In *Ortelere v. Teachers Retirement Bd.,*[8] the New York Court of Appeals, held that a modern understanding of mental illness, suggests that incapacity to contract or exercise contractual rights may exist, because of volitional and affective impediments or disruptions in the personality, despite the intellectual or cognitive ability to understand.[9] Grace Ortelere, an elementary school teacher since 1924, suffered a "nervous breakdown" in March, 1964 and went on a leave of absence which expired on February 5, 1965. She was then 60 years old. On July 1, 1964, she came under the care of Dr. D'Angelo, a psychiatrist who diagnosed her breakdown as involutional psychosis, melancholia type. Dr. D'Angelo prescribed six weeks of tranquilizers and shock therapy. Dr. D'Angelo continued to see her monthly until March, 1965. On March 28, 1965, she was hospitalized after collapsing at home from an aneurysm and died ten days later.

As a teacher she had been a member of the Teachers' Retirement System of the City of New York. This entitled her to certain annuity and pension rights, pre-retirement death benefits, and allowed her to exercise various options concerning the payment of her retirement allowance. On June 28, 1958, she had executed a 'Selection of Benefits under Option One' naming her husband as beneficiary of the unexhausted reserve. Under this option, upon retirement her allowance would be lower retirement allowances, but if she died before receipt of her full reserve, the balance would be payable to her husband. On June 16, 1960, she designated her husband as beneficiary of her service death benefits in the

event she died prior to retirement. On February 11, 1965, when her leave of absence had just expired and while she was still being treated, she executed a retirement application, selecting the maximum retirement allowance payable during her lifetime with nothing payable on or after death. Three days earlier she had written the Teacher's Retirement Board of the City of New York, stating that she intended to retire on February 12 or 15 or as soon as she received "the information I need in order to decide whether to take an option or maximum allowance." She asked eight specific questions, which demonstrated an understanding of the retirement system concerning the various alternatives available. An extremely detailed reply was sent, by letter of February 15, 1965, although by that date it was technically impossible for her to change her selection of how retirement benefits would be paid. The board's chief clerk, before whom Mrs. Ortelere executed the application, testified that the questions were answered verbally on February 11, 1965. Her retirement reserve totaled $62,165. Following her leave of absence, Mrs. Ortelere became very depressed and was unable to care for herself. Her husband brought an action to set aside his wife's retirement application by reason of her mental incompetency. The Supreme Court entered judgment declaring that the retirement application of decedent was null and void. Her husband recovered judgment for full amount of the reserve credited to her at the time of her death and the Retirement Board appealed. The Supreme Court, Appellate Division reversed and dismissed the complaint and the husband appealed. The New York Court of Appeals held that the Retirement Board of the Teacher's Retirement System of the City of New York was, or should have been, fully aware of Mrs. Ortelere's condition. They, or the Board of Education, knew of her leave of absence for medical reasons and her use of staff psychiatrists. "The avoidance of duties under an agreement entered into by those who have done so by reason of mental illness, but who have

understanding, depends on balancing competing policy considerations. There must be stability in contractual relations and protection of the expectations of parties who bargain in good faith. On the other hand, it is also desirable to protect persons who may understand the nature of the transaction but who, due to mental illness, cannot control their conduct."[10] Incompetency to contract may exist, despite the presence of cognition, when a contract is made under the compulsion of manic depressive psychosis.[11]

The law presumes the competence of a contractual party. In the case of an adjudicated incompetent, all that is necessary is the production of a certified copy of the judgment declaring the person to be "incompetent." In the case of a non-adjudicated incompetent, the burden of proving one's incompetence is on the party alleging it.[12] The later must demonstrate that, because of the affliction, the person was incompetent at the time of the transaction.[13] In *Ortelere,* the court held that a showing of medically classified psychosis is required otherwise few contracts would be invulnerable to a psychological attack.[14] According to the court, it was apparent the plaintiff's evidence was sufficient to sustain a finding that, when she acted on February 11, she did so as a result of serious mental illness, namely, psychosis.[15] Grace Ortelere's psychiatrist testified that, as an involutional melancholiac in depression, she was incapable of making a voluntary "rational" decision.[16] Lay witnesses cannot properly give an opinion as to party's mental capacity as to rationality or irrationality, even when such opinion might be based upon specific acts and conversations, or personal observations.[17] The lay witness could state the acts and conversations of which he had personal knowledge, and then be permitted to say whether, in his judgment, such acts and conversations were rational or irrational.[18]

II. THE MENTAL HYGIENE LAW

Article 81 of the Mental Hygiene Law was enacted in 1992 after an extensive study of the statutes governing fiduciary appointments for incapacitated persons by the New York State Law Revision Commission. Although its initial purpose was to revise former Article 77 (conservatorship) and former Article 78 (committeeship) of the Mental Hygiene Law, the Commission ultimately found it necessary to establish a new statutory system to provide for the needs of disabled persons. The Commission concluded that former Articles 77 and 78 of the Mental Hygiene Law failed to provide relief sufficient to meet the needs of persons who, while neither incompetent nor substantially impaired are functionally limited in providing for the activities of daily.[19] Rather than amending the existing committeeship and conservatorship statutes, the Commission proposed the adoption of a new statutory system of guardianship to be set forth in Article 81 of the Mental Hygiene Law. In 1992, the Legislature complied by repealing former Articles 77 and 78 and enacting the proposed guardianship statute as Article 81 of the Mental Hygiene Law. The primary objective of Article 81 is to provide a system of fiduciary appointments for persons who are unable to provide for the activities of daily living.[20] In a proceeding brought pursuant to Article 81, however, the court is not called upon to determine whether an individual is competent or incompetent.[21] A finding of incapacity by the court conducting the hearing does not establish that a person is incompetent.[22] Article 81 specifically provides that the appointment of a guardian shall not be conclusive evidence that the person lacks capacity for any other purpose, including the capacity to dispose of property by will except those powers and rights which the guardian is granted.[23]

The protocol for the proceedings are defined by the statute.[24] Any party has the right to (1) present evidence; (2) call witnesses, including expert witnesses; (3) cross examine witnesses, including witnesses called by the court; (4) be represented by counsel of his or her choice. The hearing must be conducted in the presence of the person alleged to be incapacitated, either at the courthouse or where the person resides, to permit the court to obtain its own impression of the person's capacity. If the person alleged to be incapacitated physically cannot come or be brought to the courthouse, the hearing must be conducted where the person resides unless: (1) the person is not present in the state; or (2) all the information before the court clearly establishes that (i) the person alleged to be incapacitated is completely unable to participate in the hearing or (ii) no meaningful participation will result from the person's presence at the hearing.[25]

Article 81 defines the required burden and quantum of proof necessary in a guardianship proceeding.[26] The standard of proof must demonstrate that a person is incapacitated based upon clear and convincing evidence.[27] The statute permits a court for "good cause shown" to waive the rules of evidence.[28] It permits hearsay evidence to be admitted into the proceedings through the testimony of a court evaluator[29] and allows a court evaluator to testify about his report which usually contains hearsay evidence if the court deems such information to be reliable.[30] The law requires a hearing with witnesses.[31] There is no requirement expert witnesses, such as a psychiatrist, psychologist be called. The court can take testimony from a nurse or social worker. In some cases, the court has ruled that testimony of lay witnesses is suffice for a finding of a person being "incapacitated."[32]

The finding of a "substantial impairment" under former Article 77 concerning conservatorships did not establish incompetence allowing a court to declare a contract "void." In an Article 77 proceeding, a psychiatrist was required to testify concerning the ability or inability of the alleged conservatee to manage business matters only. The determination that a person was in need of a "committee" under former article 78 concerning committteeships did establish imcompetence allowing a court to declare a contract "void." In an Article 78 proceeding, a psychiatrist was required to testify concerning the ability or inability of the alleged incompetent to manage both person and property. The finding of "incapacity" pursuant to article 81 gives the court the power to declare contracts of the "incapacitated" to be void. The Article 81 court is given the power, if it determines that the person is incapacitated and appoints a guardian: to modify, amend, or revoke any previously executed appointment, power, or delegation or any contract, conveyance, or disposition during lifetime or to take effect upon death, made by the incapacitated person prior to the appointment of the guardian.[33] Article 81 courts have held that (1) a marriage contract constitutes a contract within the meaning of the Mental Hygiene Law.[34] As such, it is subject to revocation by the court on the ground that a party thereto for whom a guardian has been appointed was "incapacitated" at the time it was contracted rendering such party incapable of consenting thereto by reason of want of understanding.[35] Health care proxies, durable powers of attorney, amended and restated certificates of trusts, and Last Will and Testaments have also been invalidated.[36] The Appellate Division in affirming the Surrogate Court held that mental incapacity invalidated an individual's durable powers of attorney, health care proxy, and amended and restated certificate of trust, executed prior to appointment of guardian upon a showing of clear and convincing evidence the incapacitated person executed the documents at a time when she was

incapacitated.[37] Moreover, in modifying the Surrogate's decision, the Appellate Division stated the Last Will and Testament that was signed and witnessed at approximately the same time should have also been declared void.[38]

CONCLUSION

It is the view of the author that the repealed Articles 77 and 78 worked well. The standard for a conservatorship proceeding pursuant to Article 77 of the Mental Hygiene Law required an evaluation and testimony from a psychiatrist that the alleged conservatee was unable to manage his business affairs. The standard for a committeeship proceeding pursuant to Article 78 of the Mental Hygiene Law required an evaluation and testimony from a psychiatrist that the alleged incompetent could not manage both his financial affairs and person necessitating the appointment of a committee. The burden of proof was similar to that required in a breach of contract action seeking to have a contract rescinded on the basis of mental incompetence. In such proceedings there is a requirement that a psychiatrist testify.

Article 81 does not require testimony from a psychiatrist to have a person declared "incapacitated." Moreover, in a special proceeding, contracts can be declared voidable without the need for an actual finding of a mental illness. The burden of proof in an Article 81 proceeding have been relaxed. A contract can easily be avoided by filing an Order to Show Cause, attending a hearing within thirty days and having a nurse, social worker, psychologist, or doctor testify about behavior of the alleged incapacitated person. This type of testimonial evidence is dramatically different than that required previously pursuant to the repealed Articles 77 and 78 respectively and in an action in Supreme Court to have a contract avoided due to mental incapacity.

Endnotes

[1]Blinn v. Schwarz, 177 N.Y. 252, 262 (1904); Matter of Deimer, 85 N.Y.S.2d 506, 509 (4th Dep't 1948).

[2]Matter of Gebauer, 361 N.Y.S.2d 539, 544 (Surrogate Court, Cattaraugus County 1974), aff'd, 378 N.Y.S.2d 653 (4th Dep't 1976).

[3]Blinn, 177 N.Y. at 263.

[4]*Id.*, at 262.

[5]*See* Aldrich v. Bailey, 132 N.Y. 85 (1892).

[6]Blinn, 177 N.Y. at 262.

[7]Feiden v. Feiden, 542 N.Y.S.2d 860, 862 (3d Dep't 1989).

[8]25 N.Y. 2d 196 (1969).

[9]Ortelere v. Teachers' Retirement Bd., 25 N.Y. 2d 196, 199 (1969).

[10]*Id.*, 25 N.Y. 2d at 205.

[11]Fingerhut v. Kralyn Industries, Inc., 337 N.Y.S.2d 394, 399 (Supreme Court, New York County 1971).

[12]Feiden, 542 N.Y.S.2d at 862; Matter of Gebauer, 361 N.Y.S.2d at 544.

[13]Feiden, 542 N.Y.S.2d at 862.

[14]Ortelere, 25 N.Y. 2d at 206.

[15]*Id.*

[16]*Id.*

[17]Paine v. Aldrich, 133 N.Y. 544, 547 (1892).

[18] *Id.*

[19] *See*, Recommendation of the Law Revision Commission to the 1992 Legislature; McKinney's 1993 Session Laws of N.Y., p. 2025.

[20] N.Y. Mental Hyg. Law§ 81.01(McKinney 2007).
Legislative findings and purpose.
The legislature hereby finds that the needs of persons with incapacities are as diverse and complex as they are unique to the individual. The current system of conservatorship and committee does not provide the necessary flexibility to meet these needs. Conservatorship which traditionally compromises a person's rights only with respect to property frequently is insufficient to provide necessary relief. On the other hand, a committee, with its judicial finding of incompetence and the accompanying stigma and loss of civil rights, traditionally involves a deprivation that is often excessive and unnecessary. Moreover, certain persons require some form of assistance in meeting their personal and property management needs but do not require either of these drastic remedies. The legislature finds that it is desirable for and beneficial to persons with incapacities to make available to them the least restrictive form of intervention which assists them in meeting their needs but, at the same time, permits them to exercise the independence and self-determination of which they are capable. The legislature declares that it is the purpose of this act to promote the public welfare by establishing a guardianship system which is appropriate to satisfy either personal or property management needs of an incapacitated person in a manner tailored to the individual needs of that person, which takes in account the personal wishes, preferences and desires of the person, and which affords the person the greatest amount of independence and self-determination and participation in all the decisions affecting such person's life.

[21]N.Y. Mental Hyg. Law § 81.01(McKinney 2007).

[22]N.Y. Mental Hyg. Law § 81.29(b)(McKinney 2007).

[23]N.Y. Mental Hyg. Law § 81.29 (McKinney 2007). Effect of the appointment on the incapacitated person
(a) An incapacitated person for whom a guardian has been appointed retains all powers and rights except those powers and rights which the guardian is granted.
(b) Subject to subdivision (a) of this section, the appointment of a guardian shall not be conclusive evidence that the person lacks capacity for any other

purpose, including the capacity to dispose of property by will.
(c) The title to all property of the incapacitated person shall be in such person and not in the guardian. The property shall be subject to the possession of the guardian and to the control of the court for the purposes of administration, sale or other disposition only to the extent directed by the court order appointing the guardian.
(d) If the court determines that the person is incapacitated and appoints a guardian, the court may modify, amend, or revoke any previously executed appointment, power, or delegation under section 5-1501, [fig 1] 5-1505, or 5-1506 of the general obligations law or section two thousand nine hundred sixty-five of the public health law, or section two thousand nine hundred eighty-one of the public health law notwithstanding section two thousand nine hundred ninety-two of the public health law, or any contract, conveyance, or disposition during lifetime or to take effect upon death, made by the incapacitated person prior to the appointment of the guardian if the court finds that the previously executed appointment, power, delegation, contract, conveyance, or disposition during lifetime or to take effect upon death, was made while the person was incapacitated or if the court determines that there has been a breach of fiduciary duty by the previously appointed agent. In such event, the court shall require that the agent account to the guardian.
(e) Nothing in this article shall be construed either to prohibit a court from granting, or to authorize a court to grant, to any person the power to give consent for the withholding or withdrawal of life sustaining treatment, including artificial nutrition and hydration. When used in this article, life sustaining treatment means medical treatment which is sustaining life functions and without which, according to reasonable medical judgment, that patient will die within a relatively short time period.

[24]N.Y. Mental Hyg. Law § 81.11(McKinney 2007).

[25]*Id.*

[26]N.Y. Mental Hyg. Law§ 81.12(McKinney 2007).

Burden and quantum of proof
(a) A determination that a person is incapacitated under the provisions of this article must be based on clear and convincing evidence. The burden of proof shall be on the petitioner.
(b) The court may, for good cause shown, waive the rules of evidence. The report of the court evaluator may be admitted in evidence if the court

evaluator testifies and is subject to cross examination; provided, however, that if the court determines that information contained in the report is, in the particular circumstance of the case, not sufficiently reliable, the court shall require that the person who provided the information testify and be subject to cross examination.

[27]N.Y. Mental Hyg. Law § 81.12 (a) (McKinney 2007).

[28]*Id.*

[29]N.Y. Mental Hyg. Law § 81.12 (b) (McKinney 2007).

[30]*Id.*

[31]N.Y. Mental Hyg. Law § 81.11(McKinney 2007).

[32]This is not the same standard required to declare a contractual party incapacitated within the meaning general contract law. In *Paine v. Aldrich, supra*, the Court of Appeals held in an action to set aside a deed on the ground that the grantor was at the time of its execution, *non compos mentis,* that the opinion of a witness not an expert was inadmissable evidence.

[33]N.Y. Mental Hyg. Law §81.29 (d) (McKinney 2007).

[34]Matter of Jayne Johnson, 658 N.Y.S.2d 780, 785 (Supreme Court, Suffolk County 1997).

[35]*Id.*

[36]Matter of Rita R, 811 N.Y.S.2d 89 (2d Dep't 2006).

[37]*Id.*

[38]*Id.*

THE USE OF FACTUAL, NOT FICTIONAL, HYPOTHETICALS

by

Peter M. Edelstein*

Abstract

For as long as this author can remember, principals of law have been illustrated and explained by the use of hypotheticals in the form of statements or questions composed of contrived scenarios and the use of alphabet letters instead of actual events and persons.

This author proposes that traditional hypotheticals trade off short term insight for long term understanding and retention. Hypotheticals based on recognizable people and facts gleaned from actual events result in a more effective teaching technique.

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I. Introduction.

The author's premise was derived, not from sudden realization of the blandness and small profit in the use of antiseptic hypotheticals using "A's" and "B's" and simplistic fact patterns, but as the result of a dismaying epiphany that one cannot buy a newspaper without seeing a breach of law related article on the front page.

In law school students heard (and now we perpetuate) questions and statements like:

> Assume A says to B: "I will sell you my car for $1,000." Does an offer exist?" or "A says to B: "I will sell you my house for $500,000." B says, "O.K. it's a deal." Is the Statute of Frauds applicable?

How dull, unimaginative, uninteresting and forgettable. Events constantly occurring around us furnish a rich and fascinating mine of living material to supplement and replace traditional hypotheticals with meaningful facts to which the students' can readily relate. This writer proposes that traditional hypotheticals trade off short-term insight for long-term understanding.

The word "hypothetical" has evolved to serve two functions as a teaching technique: first, to illustrate an example of a legal doctrine, theory or other "rule;" and second, to elicit a response that demonstrates the students' understanding of the substantive material. The author urges both usages can make more effective educators and better students by supplementing the fictional hypothetical with the factual one.

II. Practice.

Assume (for purposes of this paper) that instructors' objectives are:

(i) getting the students' attention,
(ii) creating an interest in the subject matter,
(iii) generating a desire to learn.

While it is beyond the scope of this article to delve into the "psychology of education," probably all instructors have had the experience of illustrating a rule based on "real life" experience, especially one in which the instructor may have been involved. Students always seem more attentive and interested in these examples. There is a sense that the students' tend to retain the point because of their emotional identification with the instructor. This emotional involvement converts into a motivation to understand and more easily learn the subject matter.

When teaching the concept of consideration, disputed debts and past consideration, the following "true" hypothetical is the platform:

> I live in a house that faces a beautiful view of a large lake. When I bought the house twenty-six years ago there was a magnificent tree in the yard between the house and the lake. Each successive year I noticed that the tree lost its leaves earlier in the summer. Knowing nothing

> about trees, I diagnosed that the tree was sick. I called a tree company for a second opinion. The arborist confirmed that the tree was sick and had to be removed. We entered a **contract** to have a tree removed from my property for $1,000.00. After the arborist and his crew climbed the tree, they came down and the arborist told me he could not do the job because the tree had Dutch Elm disease and the limbs were brittle and therefore may crack and cause his workers to fall. I was really ticked off and told the arborist so, he said he would speak to his men. Upon his return he said that the men told him they would do it for more money, so the arborist and I **agreed** that the amount for the tree removal would now be $2,000. Before the bill was received, I felt that the arborist had scammed me as to the additional $1,000.00 and this was his way of getting another $1,000. I disputed the bill in good faith.

Almost without fail, the students seem to learn the rules related to consideration, (that there was no consideration for the second promise based on pre-existing duty and the genuineness of the disputed debt). Students easily relate to this

type of anecdote. Because of an identification with the author's legal problem, the students become interested in the facts, and as a result are motivated to remember the rules being taught.

"Personal" hypotheticals are easy to convey and make for lively discourse. Hypotheticals that are adapted from current affairs seem to be even more beneficial. Additionally, they expand the students' universe beyond I-pods, beer and sex, to include world events.

III. Methodology and Illustrations.

Where do we find the bases for such hypotheticals (other than our personal experiences)? To plant seeds that may flourish this author believes that newspapers (*The New York Times* is the author's choice because of its comprehensive coverage) may be the most fruitful source.

Some random examples:

1. Subjects for possible hypotheticals in the areas of: *contracts, offer, acceptance, consideration, restrictive covenants, interference with contractual relationships*:

> "A CBS DEAL WITH COURIC MAY BE NEAR
>
> CBS's long courtship of Katie Couric has moved close to a conclusion. A deal to recruit her away from NBC's "Today" show and into the nightly anchor chair at CBS News may be completed as early as this week, people close to the negotiations said yesterday.

> While Ms. Couric is under contract to NBC through the end of May and, under the terms of her current deal, cannot have any formal talks with CBS or another network until the beginning of that month, NBC executives decided in recent days to permit Ms. Couric's representatives to discuss outside offers for her future services."
> (*New York Times*, April 4, 2006, by Bill Carter)

This writer suggests that there is not a student in class who cannot identify with Katie and her horrible problems in deciding which billion-dollar offer to accept.

2. Subjects for possible hypotheticals in the areas of: *negligence, fraud, elements of a trial, concept of a class-action, settlement, federal drug regulation, rules of evidence, damages:*

> "JURY TO START DELIBERATION IN TWO VIOXX INJURY CASES
>
> After a month of testimony, the fourth Vioxx-related personal injury trial ended Monday with well-worn closing arguments from lawyers for Merck and for two men who say the company's

> drug Vioxx caused their heart attacks.
> Less than two years after Merck withdrew Vioxx from the market, and eight months after the first Vioxx case reached a verdict, litigation over the drug has settled into something of a groove.
>
> In this case, as in the earlier suits, lawyers for Merck insisted that the company fully disclosed Vioxx's potential dangers to regulators and the public. Lawyers for the plaintiffs pointed to documents and e-mail messages showing that company scientists were concerned about Vioxx's risks long before Merck withdrew the drug from the market in September 2004."
> (*New York Time*, April 4, 2006, by Alex Berenson)

While college students are too young to enjoy the thrills of arthritis, they can relate to the potential damage of a "bad" medicine on the market.

3. Subjects for possible hypotheticals in the areas of: *the FAA, contract law, breach of contact, labor unions, power of labor unions, arbitration, negotiation, and settlement:*

> "6,000 PILOTS AT DELTA AIR VOTE TO STRIKE
>
> The nearly 6,000 pilots at Delta Air Lines, proving resistant to a second round of concessions, voted overwhelmingly to approve a strike should their contract be voided by an arbitration panel, the pilot's union said yesterday. The panel is expected to issue a ruling by April 15."
> (*New York Times*, April 5, 2006, by Jeff Bailey and Christopher Elliot)

Any student planning travel for a spring break or home at the end of the semester wants to know about this subject.

4. Subjects for possible hypotheticals in the areas of: *ethics, criminal law, fraud, trials, witnesses, evidence and the relative weight thereof, politics and the law:*

> "IN ENRON TRIAL, A CALCULATED RISK - TWO FORMER CHIEFS PREPARE TO TAKE THE STAND IN THEIR OWN DEFENSE
>
> Two of the country's best corporate salesmen are about to make the most important pitches of their lives.

> After 32 days of testimony from 22 witnesses, prosecutors rested their case last week in the criminal trial of Enron's former chief executives, setting the stage for the defense to take over as of Monday.
>
> Now the trial has moved to what may be the make-or-break moment for both sides: the testimony of Jeffrey K. Skilling and Kenneth L. Lay. Mr. Skilling could take the stand as early as Wednesday."
> (*New York Times*, April 4, 2006, by Alexei Barrioneuvo and Kurt Eichenwald) (Author's note: Lay is now dead; Skilling in jail)

Cases of possible massive wrongdoing and possible absence of all ethical considerations captivate everyone.

5. Subjects for possible hypotheticals in the areas of: *ethics, taxes, contracts. illegal bargains, and sex.*

> "AN OLD PROFESSION THAT'S NEW TO DOING TAXES
>
> At 22, Sarah Patterson has already spent several years in the working world, but she has yet to

> report her income to the government.
>
> For one thing, Ms. Patterson, of Manhattan, works in a cash business, with no withholding tax. But she is also worried about how to list her profession on a 1040 form – she is a foot fetish model."
> (*New York Times*, April 5, 2006, by Corey Kilgannon)

Everybody loves this.

6. Subjects for possible hypotheticals in the areas of: *start-up of small businesses, financing a small business; entrepreneurship:*

> "FOR START-UPS, WEB SUCCESS ON THE CHEAP
>
> When Seth J. Sternberg and two colleagues started Meebo, a Web-based instant messaging service, they didn't go looking for venture capitalists. Using their credit cards, they financed the company themselves to the tune of $2,000 apiece. It was enough to cover their biggest expense – leasing a few computer servers at $120 a month each.

> Within a month of its introduction in September 2005, Meebo was getting as many as 50,000 log-ins a day, and it needed more servers. It decided to take a modest $100,000 from three angel investors, wealthy individuals who typically contribute small amounts but do not get involved in management decisions."
> (*New York Times*, November 9, 2006, by Miguel Helft)

Students dream of becoming wealthy from an internet scheme.

7. Subjects for possible hypotheticals in the areas of: *contracts, insurance, causes of action:*

> "INSURER SUED FOR
> REFUSING TO PAY COSTS
> OF ANOREXIA
>
> A New Jersey couple filed suit against Aetna, Inc., the Hartford-based insurance company, on Wednesday, claiming that it refused to fully cover their daughter's treatment for anorexia.
>
> The suit was filed in United States District Court here. The couple, Cliff and Maria DeAnna

> of Mountainside, N.J., said Aetna refused to pay for nearly 10 weeks of their daughter's inpatient treatment, saying her eating disorder was not "biologically based." Insurers have balked at covering mental illnesses that they say do not have a proven physiological basis."
> (*New York Times*, November 9, 2006, by Tina Kelly)

Who can resist an anorexia case?

8. Subjects for possible hypotheticals in the areas of: *contracts, mistake of fact, mistake of value, title to personal property, remedies, consideration, difference between sufficiency of consideration and adequacy of consideration:*

> "COULD BE A POLLOCK; MUST BE A YARN
>
> After retiring from truck driving in 1987, Teri Horton devoted much of her time to bargain hunting around the Los Angeles area. Sometimes the bargains were discovered on Salvation Army shelves and sometimes, she willingly admits, at the bottom of Dumpsters.
>
> Even the most stubborn deal scrounger probably would have

> been satisfied with the rate of return recently offered to her for a curiosity she snagged for $5 in San Bernardino thrift shop in the early 1990s. A buyer, said to be from Saudi Arabia, was willing to pay $9 million for it, just under an 180 million percent increase on her original investment. Ms. Horton, a sandpaper voiced woman with a hard-shell perm who lives in a mobile home in Costa Mesa and depends on her Social Security checks, turned him down without a second thought."
> (*New York Times*, November 9, 2006, by Randy Kennedy)

Doesn't everyone wish for a find like this?

9. Subjects for possible hypotheticals in the areas of: *environmental law, remedies, rights of owners of real property versus interests of public, federal law, jurisdiction*:

> "IN CAPE COD'S DUNES,
> SOMETHING'S GROWING
> BESIDES SCRUB PINE
> Seen from the top of a sand-strewn bluff, the Atlantic, flecked with white caps, stretches out for miles along a deserted beach. Shrubs with tiny leaves, turning red in autumn, rustle in the wind.

On a dune not far away, two freshly built, very large houses interrupt this near-primeval landscape in the midst of the Cape Cod National Seashore, a federally protected are established in 1961 to limit exactly that kind of development.

Nearby, a Modernist beach house built around the time of the park's founding is almost hidden in the dunes. Small and brown, it sits lightly over the land, on stilts. But while new houses, some still covered in Tyvek insulation, sprout on privately owned land in the midst of the national seashore, this one, like dozens of others from the same era, has been taken over by the National Park Service, which administers the seashore, and it is now rapidly decaying.

Local environmental and preservation groups, as well as some town officials and residents, worry about the scale of the new houses, additions and outbuildings that are being built – or may one day be built – on 600 private plots in the fragile 27,000-acre seashore, as wealthy owners push the limits of Park

> Service guidelines, or ignore them altogether. Although just a handful of mansions have gone up so far, preservationists are concerned that market forces, combined with the increasing recognition by landowners that the guidelines are not legally binding, will lead to the kind of over-building they moved to Cape Cod to avoid."
> (*New York Times*, November 11, 2006, by Tracie Rozhon)

This case illustrates the risks involved when sufficient prior research is not done or there is a failure to recognize the myriad of jurisdictional issues.

10. Subjects for possible hypotheticals in the areas of: *criminal law, sentencing, pleas, evidence, or jurisdiction:*

> "YOUNG SNIPER IS SENTENCED TO 6 LIFE TERMS
>
> Lee Malvo was sentenced Wednesday to life in prison without chance of parole for six murders here in Montgomery County, shootings that were among a three-week series of sniper attacks that terrorized the Washington area four years ago.

In a brief statement, Mr. Malvo, now 21, told the court that he knew he could never be forgiven.

"I'm truly sorry, grieved and ashamed for what I've done," he said.

Mr. Malvo pleaded guilty in October to the six killings here, where the series of 13 shootings began and ended in October 2002.

He testified here in May against his accomplice and onetime mentor, John A. Muhammad, providing a chilling account of their attacks around Washington and elsewhere across the country.

But despite the contrition he voiced Wednesday and his cooperation with the authorities in their case against Mr. Muhammad, he was sentenced by Judge James L. Ryan of Montgomery County Circuit Court to six consecutive life terms without the possibility of parole, the most severe penalty possible.

It is unlikely, however, that he will ever serve time in Maryland.

> He has already been sentenced to life in prison in Virginia for shootings there and was sent to Maryland on the condition that he be returned after the case against him here was resolved."
> (*New York Times*, November 9, 2006, AP, author not identified)

This event captivated the entire nation for its sheer brutality.

IV. An Endorsement for the Premise Supporting the Use of Meaningful Hypotheticals.

The author is not the first to propose that actual events be used as teaching techniques.

When Jesus wanted to teach his disciples, he did not use hypotheticals involving "Mr. A" and "Ms. B." Rather, he used parables, with thought-provoking and meaningful themes (and references to possible legal topics for class discussion).

> From Luke, Chapter 10, Verses 30-35:
> Just then a lawyer stood up to test Jesus. "Teacher," he said, "what must I do to inherit eternal life?" Jesus said to him, "What is written in the law? What do you read there? The lawyer answered, "You shall love the Lord your God with all your heart, and with all your soul, and with all your strength, and with all your mind; and your neighbor as yourself." And Jesus said to

him, "You have given the right answer; do this, and you will live." But wanting to justify himself, the lawyer asked Jesus, "And who is my neighbor?"

Jesus replied, "A man was going down from Jerusalem to Jericho, and fell into the hands of robbers, who stripped him, beat him, and went away, leaving him half dead (criminal law?). Now by chance a priest was going down that road; and when he saw him, he passed by on the other side (jaywalking and ethics?). So likewise a Levite, when he came to the place and saw him, passed by on the other side (more jaywalking and ethics?). But a Samaritan while traveling came near him; and when he saw him, he was moved with pity. He went to him and bandaged his wounds (assault?), having poured oil and wine (contractual capacity?) on them. Then he put him on his own animal, brought him to an inn (the law of innkeepers, bailments?), and took care of him (ethics?). The next day he took out two denarii, gave them to the innkeeper (consideration, hospitality law?), and said, "Take care of him

> (contract?); and when I come back, I will repay you whatever more you spend (debt?)."
>
> Jesus asked: "Which of these three, do you think, was a neighbor to the man who fell into the hands of the robbers?" The lawyer said, "The one who showed him mercy." Jesus said to him, "Go and do likewise."

Of course, the question that begs to be asked is why did Jesus use parables. Matthew, Chapter 13, Verses 10 and 11, provides the answer:

> Then the disciples came and asked Jesus, "Why do you speak to them in parables?" He answered, "To you it has been given to know the secrets of the kingdom of heaven, but to *them* it has not been given..." (In Aramaic the word *them* has been loosely translated to mean "college students").

While the quoted biblical references are lengthy, they are easily paraphrased and emphasize the author's premise.

V. Conclusion.

Instructors desire to have the students' attention, create an interest in the material and generate a desire to learn. All this can be more easily and gracefully effectuated by creating an emotional connection with our students and the subject

matter, thereby producing a more positive motivation to learn. This writer proposes that real-world illustrations are more effective tools to achieve these results than simplistic, abstract or fictional hypotheticals.