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ne of the topics I have always wanted to address in this column is procrastination, but every month I managed to put it off until later. It has been suggested that procrastination is sloth in five syllables—just a fancy term for one of the seven deadly sins. My car is getting 2 miles per gallon because I have procrastinated taking it in for service since leasing it in 2004. I have procrastinated writing this column every month until the night before it was due. I have procrastinated filling out the Los Angeles County Bar Association’s questionnaire about my service at Los Angeles Lawyer until I no longer can find the questionnaire at all. To the Association president, I hereby substitute this column for my questionnaire, and here is my response to all inquiries: “Everything is great, thanks for checking.”

According to Irene Leonard, a professional development coach for lawyers, “Procrastination occurs when we are faced with too many decisions and are unable to complete matters of importance.” Maybe, but procrastination also occurs when I know that my TiVo has three new episodes of Family Guy that I can watch on Sunday night instead of writing that set of CEQA findings due Monday morning. Here lies the real danger of procrastination. You can commit malpractice by watching Family Guy when you should be working. A review of 20 years of claims data by the Lawyers’ Professional Indemnity Company (LAWPRO), covering all practice areas, shows that the second biggest cause of malpractice claims is procrastination. It accounts for just over 15 percent of the attorney errors that occurred.

There is ample literature available for overcoming procrastination. One of the briefest and most incisive offerings is an essay, aptly titled “Overcoming Procrastination,” by Steve Pavlina, CEO of Dexterity Software. Pavlina understands that we procrastinators never miss our favorite TV shows. Thus, he concludes, procrastination occurs when the task at hand is not pleasurable or is intimidating. Pavlina wisely suggests that we schedule tasks around the activities we associate with fun. Rather than reward yourself with Family Guy episodes after completing your work-related task, watch Family Guy and then guilt yourself into writing those CEQA findings. It works for me.

Procrastination also may be associated with a pathological familiarity with chaos. Chaos is familiar to the procrastinator because it relates to memories of substance abuse, an unstable household, or some other trauma. The panic associated with functioning amid trauma is subconsciously replicated when we put off our responsibilities to the last minute.

All this relates to a recurring theme in my columns this past year—self-awareness. Practicing law can easily lure us into a state of mindless repetition, wading so deep into the mundane muck that we are blind to who we are, what we do, how we do it, and why. In my columns, I have explored leadership, mentorship, substance abuse, attorney satisfaction, business casual attire, and intimate relations among attorneys. Constant among all these musings was the suggestion that Los Angeles attorneys should examine themselves.

Exploring one’s self is a journey that should never be put off until tomorrow because one can only make decisions today. Many scholars suggest that fear is an underlying cause of procrastination. If that is true, then fear of one’s self may be the impediment of self-exploration. Yet imagine the fearless attorney whose judgment is tempered by a generosity of spirit and a penetrating self-understanding. This is an attorney who does not procrastinate, who mentors wisely, who dresses appropriately, who loves well, and who finds fulfillment in many things related to the practice of law—and many that are not.

R. J. Comer is a partner at Armbruster & Goldsmith LLP, where he specializes in land use law and municipal advocacy. He is the chair of the 2005-06 Los Angeles Lawyer Editorial Board.
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Exemption Rules under the Bankruptcy Reform Statute

**THE BANKRUPTCY Abuse Prevention and Consumer Protection Act** of 2005 made several important changes affecting exemptions. These include 1) domicile requirements, 2) retirement funds, 3) exemptions for retirement funds notwithstanding direct transfers or rollovers, 4) limits on the amounts of exemptions for certain retirement funds, and 5) limits on homestead exemptions. California attorneys should be aware of how these changes may affect their clients who are contemplating bankruptcy.

Regarding domicile, before passage of the act, Bankruptcy Code Section 522(b) provided that domicile exemptions applied to 1) the place in which the debtor’s domicile was located for the first 180 days prior to the petition if the debtor resided in the same state during the entire 180 days, or 2) the place in which the debtor’s domicile was located for the greater portion of the 180-day period than in any other place if the debtor did not reside in the same state during the 180 days. Under the new act, the period is extended to 730 days, thereby making applicable the law of the state in which the debtor was domiciled for 730 days before the date of the filing of the petition if the debtor resided in the same state during the entire 730-day period. Alternatively, if the debtor’s domicile was not located in a single state during the 730-day period, the applicable law is that of 1) the place where the debtor resided for the greater portion of the 180 days before that 730-day period, or 2) the place where the debtor was domiciled for the longer period of such 180-day period than in any other place, if the debtor did not reside in the same state during the 180-day period.

The amendment aims to prevent debtors from taking advantage of favorable state exemptions, such as Florida’s, by moving.

**Retirement Funds**

In the past, a debtor in a state that had not opted out of the federal exemption scheme could exempt retirement funds only under the catch-all exemptions or the exemption for a right to receive social security benefits. If the state had opted out of the federal exemption schedule, state law governed. In California, the exemptions are set forth in Code of Civil Procedure Sections 703 and 704.1

If the debtor chooses to or must use a state exemption scheme, the act nevertheless affords the debtor the retirement fund exemptions by amending Section 522(b) to include them even if a state scheme is otherwise observed. Accordingly, the new retirement fund exemptions are available under the federal and the state exemption schemes.

Not all retirement funds in Sections 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code are exempt. They must meet certain new rules regarding determinations under Section 7805 of the Internal Revenue Code, but they are presumed exempt under Section 522(b)(4) if 1) they are in a retirement fund that has received a favorable determination under Section 7805 of the Internal Revenue Code, and 2) that determination is in effect on the date of the filing of the petition. If there has been no favorable determination, the debtor must demonstrate that 1) no prior determination to the contrary has been made by a court or the IRS, and 2) either the fund is in substantial compliance with the applicable requirements of the Internal Revenue Code or the fund is not in substantial compliance and the debtor is not materially responsible for that failure.

Before passage of the act, some courts held that certain retirement plans lost their exempt status when they were rolled over into other plans or accounts. It was also held that exempt funds lost their exempt status when the funds were distributed to a former spouse through a qualified domestic relations order. The act reverses these holdings.

The act adds a subsection to Section 522 to limit the amounts of exemptions in IRAs or Roth IRAs to the sum of $1 million. This rule is subject to certain exclusions and exceptions. The limitation does not apply to a simplified employee pension under Section 408(k) or a simple retirement account under Section 408(p). In addition, “such amount may be increased if the interests of justice so require.”

**Homestead Exemption**

The act contains several amendments affecting homestead exemptions that go beyond the new domicile requirements. These changes 1) reduce the amount of the homestead exemption if the debtor has made fraudulent conveyances or committed criminal or tortious acts, and 2) limit the amount of the homestead exemption if the homestead is purchased, or value to the homestead is added, within a certain period before the date of the filing of the petition. Like the amendments to the domicile requirements, these other amendments apply in all cases and were added to prevent abuses of homestead exemptions.

Under the act, if a debtor has transferred property with the intent to hinder, delay, or defraud a creditor, any homestead exemption can be reduced to the extent of the fraudulent conveyance. Under new Section 522(o), if nonexempt property is converted 10 years before

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the filing date of the petition, the exemption in such property is reduced to the extent that 1) the value of the debtor’s interest in that property was acquired with the intent to hinder, delay, or defraud a creditor, and 2) the debtor could not exempt the property if the debtor held it.

The act adds two sections to limit any amount of “interest” (the term is not defined) in property, including a homestead, to $125,000 under certain circumstances. The first new section is 522(p), which provides that a debtor electing to use state exemptions cannot exempt any amount of interest exceeding $125,000 that was acquired by the debtor in certain property, including a homestead, within 1,125 days of the date of the filing of the petition. This limitation does not apply, however, to any amount that the debtor transferred from a previous principal residence, which was acquired before the 1,215-day period, into the debtor’s current principal residence, if both residences are located in the same state. Nor does it apply to an exemption claimed under Section 522(b)(3)(A) by a family farmer with respect to his or her principal residence.

The new domicile requirements under Section 522(b)(3)(A) are subject to the limitations in Section 522(p). Thus, even if a debtor satisfies the two-year domicile period for claiming a new state’s exemptions, the debtor must still reside in the new home for a period of 1,215 days before the debtor may file a bankruptcy petition and claim the new state’s homestead exemption in excess of $125,000.

Two issues have arisen with respect to Section 522(p) and its applicability. One is whether the section applies to debtors in all states or only those states that have opted out of the federal exemptions. One court has held that the section applies only in states that have not opted out of the federal exemptions. Three other courts have held that Section 522(p) applies to debtors in all states.

A second issue involves the meaning of “interest” and whether an increase in a debtor’s equity in a homestead during the 1,215-day period before the date of the filing of the petition is subject to the $125,000 cap. Noting that the term “interest” is not defined in Section 522(p), one court has held that when the chapter 7 debtors purchased their homesteaded property 1,733 days before the filing of the petition, the increase in the debtors’ equity during the 1,215-day period preceding the filing date was not subject to the homestead cap and that the debtors were entitled to an unlimited homestead exemption. The court explained that the “interest” that the debtors had acquired was the actual purchase of the home. As a result, the $125,000 cap did not apply to the increase in equity.

Another limitation to homestead exemptions is contained in new Section 522(q). It provides that the limitation of $125,000 applies if 1) the debtor has been convicted of a felony, which under the circumstances demonstrates that the filing of the petition was an abuse of the Bankruptcy Code, and 2) the debtor owes a debt arising from violations of securities laws, civil penalties under the Racketeer Influenced and Corrupt Organizations Act, a criminal act, an intentional tort, or willful or reckless misconduct causing serious physical injury or death within the preceding five years.

The figure of $125,000 will be adjusted from time to time under 11 U.S.C. Section 104. In addition, the limitation of $125,000 will be triggered only if the applicable state homestead exemption is in excess of $125,000.

Footnotes:
1 The new federal law amends Bankruptcy Code §522(d) to add express exemptions for retirement funds that are exempt from taxation under §§401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code.
ON SEPTEMBER 20, 2005, the Judicial Conference of the United States—unanimously and without objection—approved proposed amendments to the Federal Rules of Civil Procedure.1 These amendments subsequently were approved this year by the U.S. Supreme Court.2 Absent intervention by Congress, which is not expected, the amendments will become effective on December 1, 2006.3

The amendments—as embodied in Rule 26, and to a lesser extent Rules 16, 34, 37, and 45—will clarify and alter the scope of electronic discovery in federal court. Strictly speaking, these new rules are not so much amendments as they are additions to the existing rules governing pretrial civil discovery. They are intended to fill in gaps in the existing rules so that the task of conducting (and responding to) electronic discovery is less burdensome and more cost-effective.4 Notwithstanding the pending status of the amended rules, practitioners should take the time now to familiarize themselves with the key changes,5 because there is a very strong likelihood that Congress will not object to the amended rules, and they will therefore take effect as scheduled.6

The amendments have introduced basic phraseology to ensure that the Federal Rules of Civil Procedure recognize the import of electronic information. The drafters made a basic definitional change to the rules—namely, introducing the phrase “electronically stored information” into the nomenclature of the rules. By doing so, the drafters have ameliorated a perceived shortcoming in the current version of the rules regarding certain types of electronic information (or data) that may not be rightfully subject to disclosure and discovery. The amendments formalize the overarching principle that all parties involved—the litigants as well as the court—need to make accommodations for the disclosure and discovery of electronically stored information. Most importantly, these accommodations need to be made at an early stage in the litigation so that the parties are spared unnecessary burdens and costs.

Rule 16(b) represents the starting point for this new dynamic regarding electronic discovery, and it begins with the court’s role. The amendment to Rule 16(b) is “designed to alert the court to the possible need to address the handling of discovery of electronically stored information early in the litigation if such discovery is expected to occur.”9 The drafters were cognizant of the fact that the court’s involvement early in the litigation would “help avoid difficulties that might otherwise arise.”9 The specific language added to Rule 16(b) requires the court to make “provisions for disclosure of electronically stored information.”10 This new language forces the parties to recognize the potential for the discovery of electronic information at the initial stages of pretrial planning and makes it clear that electronically stored information is an appropriate consideration for inclusion in the court’s scheduling order.

Similar changes have been added to Rule 26(f), but they are directed at the parties. The proposed amendment to Rule 26(f) requires the parties to discuss “any issues relating to preserving discoverable information” as well as “any issues relating to disclosure or discovery of electronically stored information, including the form or forms in which it should be produced.”11 This necessarily requires parties to discuss, among other things, the preservation of discoverable information and the formulation of a proposed discovery plan that addresses issues relating to the discovery and production of electronically stored information.

Further, electronically stored information has also been added to Rule 26(a)(1)(B)’s list of items that must be included in a party’s initial disclosures.12 No longer will it be appropriate, or acceptable, to ignore the availability of electronically stored information when exchanging these initial disclosures with opposing counsel.

Reasonably Accessible and Good Cause

While the amendments recognize the propriety and need for discovery of electronically stored information, the drafters were also careful to address the burdens of producing this information. Rule

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26(b)(2)(B), as amended, contains a key provision that introduces a two-tiered approach to the production of electronically stored information. The amendment draws a distinction between information that is "reasonably accessible" and information that is not.

Under the proposed Rule 26(b)(2)(B), a responding party need not produce electronically stored information from sources that it identifies as not reasonably accessible "because of undue burden or cost." If the requesting party seeks discovery of this information, the burden is on the responding party to show that the information is not reasonably accessible. At this stage, the court must decide whether the information needs to be produced. The court may order discovery of the information if the requesting party can show "good cause," taking into consideration the limits imposed by Rule 26(b)(2)(C).

While in theory this two-tiered approach is analytically fair and simple, in practice it may be cumbersome to implement. The proposed amendment itself does not define what "reasonably accessible" and "good cause" mean. This is problematic for a variety of reasons—the most prominent being that the parties are left with little to no guidance on how to prepare for and conduct discovery, while courts are left with no distinct boundaries for deciding what constitutes reasonableness.

The Committee Note for the amendment to Rule 26(b)(2), however, does provide some limited guidance to parties regarding what is reasonably accessible. The drafters appear to have focused on the cost of retrieving electronically stored information as a determining factor of what is reasonably accessible. Thus, for example, the Committee Note explains that "some sources of electronically stored information can be accessed only with substantial burden and cost. In a particular case, these burdens and costs may make the information on such sources not reasonably accessible." Some examples provided by the drafters include backup tapes used for disaster recovery, which are often not indexed or organized; legacy data from obsolete systems; and "deleted" data that only remains in fragmented form. But these are only examples, and the drafters were careful to note, "It is not possible to define in a rule the different types of technological features that may affect the burdens and costs of accessing electronically stored information."

In addressing an appropriate analysis of good cause, the drafters seem to intend for courts to engage in a balancing test to determine whether the burdens and costs can be "justified in the circumstances of the case." According to the drafters, the factors that courts should weigh in the balancing test include:

- The specificity of the discovery request.
- The quantity of information available from other, more easily accessible, sources.
- The failure to produce relevant information that seems likely to have existed but is no longer available.
- The likelihood of finding relevant, responsive information that cannot be obtained from other, more easily accessed sources.
- Predictions as to the importance and usefulness of the information sought.
- The importance of the issues at stake in the litigation.
- The respective resources of the parties.

As part of the balancing test, the Committee Note also instructs that the responding party should bear the burden to show that the identified sources are not reasonably accessible in light of the burdens and costs to retrieve the information. In turn, the requesting party must demonstrate that its need for the information outweighs the burdens and costs of retrieving the information. Notwithstanding this neat and systematic approach (at least on paper), the Committee Note concludes with this caveat:

"The good-cause determination, however, may be complicated because the court and parties may know little about what information the sources identified as not reasonably accessible might contain, whether it is relevant, or how valuable it may be to the litigation."

Under these circumstances, the drafters suggest that the parties and the court engage in limited, focused discovery—such as sampling a limited set of data—to learn what is relevant and the potential burdens and costs involved in full-scale electronic discovery.

The amendments are not clear on whether the requesting party may satisfy the good-cause determination by simply agreeing to bear the costs of production or retrieval. While the proposed amendments appear to preserve the traditional allocation of production (at least initially) to the responding party, the Committee Note takes great care to explain that the court should exercise sound discretion in making this determination:

"The good-cause inquiry and consideration of the Rule 26(b)(2)(C) limitations are coupled with the authority to set conditions for discovery....The conditions...also include payment by the requesting party of part or all of the reasonable costs of obtaining information from sources that are not reasonably accessible. A requesting party's willingness to share or bear the access costs may be weighed by the court in determining whether there is good cause. But the producing party's burden in reviewing the information for relevance and privilege may weigh against permitting the requested discovery."

Thus, whether cost-shifting alone, or a blanket agreement by the requesting party to bear the costs of production, can satisfy the good-cause determination will most likely remain within the province of the court to decide, using factors such as the ones discussed in the oft-cited and seminal Zubulake v. UBS Warburg LLC opinions as guidance.

The wrinkles to this two-tiered approach have yet to be ironed out. However, this approach—determining whether desired information is reasonably accessible and for good cause—does provide a balanced and fair system for solving the unique problems created by electronic discovery. The responding party is provided the initial opportunity to identify certain sources of information that are not reasonably accessible, which affords it protection from having to search and retrieve information from hard-to-access sources. The requesting party benefits from being notified, at the outset, of the sources from which the responding party does not intend to search and produce information. The requesting party is also provided a means to challenge this designation, if truly warranted, through court intervention (such as a motion to compel or a preservation order).

If amended Rule 26(b)(2)(B) is adopted in its current form, practitioners should be careful at the commencement of a case to identify those sources of electronically stored information that are not reasonably accessible and prepare a proper foundation and explanation as to why producing electronic data or information from those sources would cause undue burden or cost.

**Flexibility and a Safe Harbor**

The proposed amendment to Rule 34(a) formalizes what most practitioners have informally understood to be true—namely, that the current rules for discovery are broad enough to include electronically stored information. Indeed, the term "documents" found in the current version of Rule 34 includes electronic data and other types of nontangible information. To avoid any further ambiguity, the amendment makes this understanding official.

The drafters of the amendment to Rule 34(a) include the term "electronically stored information" as a third category of discoverable information, in addition to the original two categories of "documents" and "things."

Another important change to Rule 34(a) allows the requesting party to "test, or sample" any designated electronically stored information. This is not a matter of right for the requesting party but merely an option that..."
that is available to all parties. As with any other form of discovery, if there are objections to a request to test or sample, the appropriateness of the request is decided by motion practice, in accordance with Rules 26(b)(2) and 26(c). As the Committee Note makes clear, “Courts should guard against undue intrusiveness resulting from inspecting or testing such systems.” Under the proposed amendment, while the requesting party “may specify the form or forms in which electronically stored information is to be produced,” the default form of production is to be “in a form or forms in which it is ordinarily maintained or in a form or forms that are reasonably usable.” Notably, the amendment provides that “a party need not produce the same electronically stored information in more than one form.” If the parties cannot come to an agreement on the form (or forms) of production, then the requesting party can file a motion to compel under Rule 37.

An entirely new subdivision has been added to the current Rule 37:

(f) Electronically Stored Information. Absent exceptional circumstances, a court may not impose sanctions under these rules on a party for failing to provide electronically stored information lost as a result of the routine, good-faith operation of an electronic information system. Rule 37(f) is essentially a safe harbor provision for the responding party. It is a recognition by the drafters that electronically stored information is by nature fluid and dynamic, and may be stored, accessed, or deleted by multiple users simultaneously. With this in mind, the Committee Note to Rule 37(f) explicitly states that the Rule 37(f) safe harbor provision applies to “information lost due to the routine operation of an information system only if the operation was in good faith.” What this means, ostensibly, is that a party may not exploit the routine operation of an information system to thwart discovery, and conversely a party is not necessarily at risk simply because data is lost due to the normal operations of an electronic information system, such as routine backup procedures.

As part of the amendments, the drafters also revised Rule 26(b)(5) to provide a scheme for the retrieval of privileged or work product material that is inadvertently produced. While the amendment to Rule 26(b)(5) does not specifically reference “electronically stored information” in the actual text, the drafters nevertheless had this type of information in mind when making the changes, as they note in their accompanying report: “The volume of electronically stored information responsive to discovery and the varying ways such information is stored and displayed make it more difficult to review for privilege than paper.”

The amendment is silent on whether inadvertent production by the responding party constitutes a waiver (or whether a waiver should be construed). Instead, the amendment merely sets up a specific procedure to allow the responding party to assert a claim of privilege or work product protection after the inadvertent production: “It is a nod to the pressures of litigating with the amount and nature of electronically stored information available in the present age, a procedural device for addressing the increasingly costly and time-consuming efforts to reduce the number of inevitable blunders.”

These are the major changes contemplated by the amendments approved in September 2005 by the Judicial Conference and the Supreme Court and transmitted to Congress. If these amendments take effect as expected, practitioners will have a more fully delineated set of rules on which to rely when conducting electronic discovery. More importantly, the amendments encourage—and to some extent require—the parties to engage in early-stage planning in order to mitigate the burdens and costs of complying with, responding to, and ultimately litigating electronic discovery.

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2 The proposed amendments were transmitted to the Supreme Court on November 29, 2005, with a recommendation that they be approved by May 1, 2006. On Wednesday, April 12, as expected, the Supreme Court approved (without comment or dissent) the amendments and thereafter transmitted them to Congress. See U.S. Courts, Federal Rulemaking, available at http://www.uscourts.gov/rules/index.html#supreme0406 (noting approval of amendments to Rules 16, 26, 34, and 37, among others, by the Supreme Court). A full explanation of the federal rule-making process can be found on the U.S. Courts Web site. See U.S. Courts, Federal Rulemaking, The Rulemaking Process, available at http://www.uscourts.gov/rules/proceduresum.htm and http://www.uscourts.gov/rules/newrules6.html#c0804 (setting forth the amendments as approved by the Supreme Court).

3 The amendments do not contradict the current rules;
rather, they fill a void in them that was created by advances in technology. The vast amount of research, scholarly discourse, and professional compromise that buttress these amendments makes them a rich and powerful resource. Despite the pending status of the amended rules, lawyers (and their clients) should become familiar with their content now.

4 Ken Withers, a senior judicial education attorney at the Federal Judicial Center in Washington, D.C., has provided a succinct synopsis of the early proposed changes to the rules, prior to their publication for public comment. Not all of these early changes were incorporated in the final draft of the proposed amendments, but they do shed light on the underlying principles guiding the drafters. See Ken Withers, Two Tierras and a Safe Harbor, FEDERAL LAWYER, Sept. 2004, available at http://www.kenwithers.com/articles/td904.pdf.

5 Aside from the major changes embodied in the amendments to Rules 16, 26, 34, and 37, the proposed amendments also address the scope of production regarding interrogatories pursuant to Rule 33 and under the subpoena powers as outlined in Rule 45. Most of these changes are analogous to the significant revisions found in Rule 26.


8 Id. at Rules App. C-27.

9 Id.

10 Id. at Rules App. C-26.

11 Id. at Rules App. C-31 to Rules App. C-32. According to the Committee Note accompanying the proposed amendment to Rule 26(f), “When a case involves discovery of electronically stored information, the issues to be addressed during the Rule 26(f) conference depend on the nature and extent of the contemplated discovery and of the parties’ information system.” Id. at Rules App. C-33.


13 The two-tiered approach adopted by the drafters is consistent with the Sedona Production Principles, which support the approach that a party, over an objection, need not produce information if it was not purposely stored for business use or is otherwise inaccessible due to its special characteristics. See Tom Allman, The Sedona Production Principles and the Proposed Federal Rules Addressing E-Discovery (memorandum to the Sedona Conference Working Group on Electronic Document Retention and Production) (Oct. 6, 2004), available at http://www.kenwithers.com/articles/allman100604.doc.


17 Id. at Rules App. C-47 (Committee Note).

18 Id. at Rules App. C-42 (Introduction).

19 Id. at Rules App. C-47 (Committee Note).

20 Id. at Rules App. C-49 (Committee Note).

21 Id.

22 Id.

23 Id. at Rules App. C-49 to Rules App. C-50 (Committee Note); see also Martha K. Gooding, Electronic Discovery: Change Is in the Wind (Apr. 2006) (“The court may order discovery of the inaccessible data for good cause shown, and it also may impose conditions on such discovery, including the familiar condition of allocating the costs of the discovery between the parties.”), available at http://howrey.com/docs/E-discovery.pdf.
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Advanced Asset Protection and Tax Planning with LLCs

HISTORICALLY, CORPORATIONS HAVE BEEN the favored choice of entity for businesses, but that is no longer true today. The shift began in 1977 when Wyoming introduced the limited liability company into the United States. In 1994, California followed suit. LLCs quickly soared in popularity, primarily because they combine the best elements of a corporation (limited liability for all owners, centralized management, and potentially unlimited duration) and a limited partnership (economic flexibility and pass-through taxation). However, in addition to these clear benefits, LLCs offer other critical advantages—in particular, the charging order protection and flexibility in business asset protection—that practitioners should not overlook.

LLCs, like corporations, generally shield their owners from entity-level liabilities. Corporate shareholders are protected from personal liability by the common law principle that a corporation is a separate legal person (and one person is not liable for the obligations of another person), and LLC members are similarly protected by the California LLC statutes (which are derived from the same common law principle). As an example, if either a corporation or an LLC owns an apartment building and a tenant slips, falls, and sues, the lawsuit is directed against the corporation or the LLC (absent piercing-the-veil arguments) and not against the individual owners of the entity.

The difference between the liability protection of a corporation and an LLC arises in the context of lawsuits and claims directed against the owners of these entities. The shares of stock of a corporation are a personal asset that is not exempt from claims of creditors under California statutes and case law. This means that a creditor holding a judgment against a corporation may be able to seize the shareholder’s shares of stock, and, given a sufficient ownership interest, liquidate the corporation and gain access to its assets. Consequently, while a corporation generally protects shareholders from lawsuits directed against the corporation, it does not necessarily protect corporate assets from lawsuits directed against the shareholders.

In a limited partnership context, the creditor can never receive less than an economic interest, whereas in an LLC setting, the creditor may not even get that much.

To determine whether a membership interest is assignable, one must look to the statute or to the LLC’s operating agreement, if there is one. Most operating agreements drafted to override the default statutory provision of assignability of interests in the operating agreement.2 

Charged interest, make any management decisions, or gain access to the LLC books and records. This is consistent with the historical framework of charging orders. Also, the creditor has no ability to transfer the underlying membership interest unless the creditor forecloses on the interest.

Because the charging order is a lien, until there is a foreclosure of the membership interest of the debtor-member, the only value that the creditor can obtain from the LLC is the interception of the distributions of property from the LLC to the debtor-member. Assume that a LLC generates $1 million of cash flow for the year, and 20 percent of that is distributed to the debtor-member. If a creditor has a charging order, the $200,000 goes to the creditor.

To determine whether a membership interest is assignable, one must turn to the statute or to the LLC’s operating agreement, if there is one. By default, the statute provides that a membership interest may be assign able only if the majority of the members not transferring their interest consent to the assignment. This would mean that in a two-person LLC (with equal interests), the nondebtor-member would have to consent to the assignment. If the other member is a spouse, a friend, or a family member, the charging order, as a creditor’s remedy, may lose all its viability.

The presence of an operating agreement can greatly enhance the charging order protection, because the LLC statutes allow members to override the default statutory provision of assignability of interests in the operating agreement. Most operating agreements drafted to override the default statutory provision of assignability of interests in the operating agreement.

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today provide that only the economic interest in the LLC may be assigned but not the entire membership interest. The economic interest component grants its holder the right to receive distributions of cash and property from the LLC and the right to receive allocations of gain, loss, income, and deductions. This means that voting and management rights, as well the right to access the LLC’s books and records, are nonassignable. This also means that if the debtor-member controls the LLC (because of sufficient voting power or by virtue of being the manager), he or she may take the simple expedient of ceasing to make distributions from the LLC, and the creditor will not be able to get any assets out of the LLC.

Taking the term “assignable” a step further, if the operating agreement provides that the membership interests in the LLC are nonassignable, the charging order remedy becomes meaningless. In drafting the LLC charging order statute, the California legislature departed significantly from the limited partnership charging order statute (the progenitor of the LLC statute). The limited partnership statute charges the entire limited partnership interest, but then makes the creditor an assignee (i.e., an economic interest holder).

Thus, in a limited partnership context, the creditor can never receive less than an economic interest, whereas in an LLC setting, the creditor may not even get that much. It is unclear why the legislature created this apparent loophole for debtor-members but not for debtor-partners. One possible reason is that LLC members are allowed to actively participate in the management of the entity, and limited partners are not allowed any active participation.

In most business dealings it would not be possible for practitioners to make LLC interests entirely nonassignable. Clients want to retain flexibility and ability to dispose of their LLC interests. However, in family settings or for LLCs established solely for liability protection purposes, it may be possible either to prevent assignability altogether or to so limit it as to make the charging order remedy of little value to the creditor.

The charging order statute allows the creditor to foreclose on the debtor-member’s membership interest “subject to the charging order.” The section further provides that the buyer at a foreclosure sale has the rights of an assignee. An assignee is limited to being an economic interest holder, without any voting or management rights. Because only an assignable interest is subject to the charging order, it appears that the foreclosure remedy is severely limited if 1) there is a well-drafted operating agreement that restricts assignability of interests, or 2) there is no operating agreement but the majority of the nondebtor members do not consent to the assignment. Even without either of these features, by granting the buyer of the foreclosed interest the rights of assignee, the debtor-member is able to retain all voting and management rights, and, consequently, control over the LLC.

Prior to the foreclosure, a debtor-member may redeem his or her membership interest. The statute does not specify that the interest must be redeemed at fair market value. This leaves room for drafters to insert various favorable redemption provisions into the operating agreement, such as a poison pill.

Once a creditor forecloses on the membership interest, the charging order lien is converted into an actual interest in the LLC. When that happens, the cash flow of the LLC on account of the economic interest now owned by the creditor becomes distributable to the creditor. If the cash flow is distributable to the creditor, then all the tax consequences of the ownership of that economic interest are properly allocable to the creditor.

It is possible that the LLC will generate taxable income and pass it through to the creditor, even if the creditor receives no distributions. Given these adverse income tax consequences, foreclosure may often be disadvantageous to the creditor or to a buyer of an economic interest in an LLC at a foreclosure sale.

Single-member LLCs deserve special attention in the charging order analysis. It may be argued that given the historical framework of charging orders, their protection should not extend to single-member LLCs (there are no other “partners” to protect from the creditor). One bankruptcy court has so held in a well-reasoned opinion. However, the California charging order statutes make no distinction between single-member and multimember LLCs. Further, the California Supreme Court held that the charging order protection would apply in a case in which all the partners of a limited partnership were the debtors of a single creditor.

The creditor had argued to no avail that because there were no “innocent” (nondebtor) partners to protect, the charging order protection should not apply.

To date, there are no California cases analyzing the efficacy of charging orders on single-member LLCs. Attorneys should caution their clients that if they are seeking to maximize their charging order protection, they should form multimember LLCs or add new members to existing LLCs. These new members would need to have some membership interest in the LLC. This allows for some flexibility because of the somewhat loose definition of the membership interest in the statutes. For example, the additional member may have only a capital or a profits interest in the LLC, but not necessarily both.

If an LLC has two spouses as the only members, and the interests in the LLC are community property of the spouses, the LLC would probably not enjoy the protection of a multimember LLC. Under the community property laws, if either spouse is a debtor, the creditor will be able to charge the LLC interests of both spouses. This would mean that there would be no nondebtor members to protect with the charging order.

In sum, regardless of the assignability of interests or whether or not the creditor forecloses, in the event of a charging order, a debtor-member stands to lose only his or her economic interests in the LLC, but never voting, management, or access-to-information rights. The charging order protection is critical for businesses with valuable assets (for example, real estate, significant accounts receivable, contracts, or intellectual property). However, it is less critical for service businesses, such as consulting firms, that generally have no assets to protect.

The Operating Agreement

Attorneys can further enhance the liability protection afforded by LLCs by properly drafting the operating agreement. There are two important planning points. First, if the LLC agreement provides that the manager must make all distributions to members on a pro-rata basis, then distributions have to be made either to all members or none. This means that if one member is pursued by a creditor holding a charging order, protecting that member would mean withholding distributions from all members of that LLC. Consequently, LLC agreements should be drafted to deal with this potential problem.

One possible solution is to allow the manager to make distributions to all other members, and not the debtor-member. A second potential solution is to include a poison-pill provision in the LLC agreement. A poison-pill provision usually gives either the LLC itself or the nondebtor members the right to buy out the debtor-member for a nominal amount of money. The poison pill has the effect of substituting the debtor-member’s membership interest with a nominal amount of cash, which limits the assets that a creditor can collect against. In some cases the poison-pill provision eliminates the need for charging order protection, and that is particularly effective when the LLC is holding depreciable real estate and passing through losses. The poison pill should be implemented only for family-setting LLCs in which the family members are on good terms with each other.

Practitioners should note that while these tactics are consistent with the LLC statutes,
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California courts have not ruled on any challenges to them. Clients should be informed about this lingering uncertainty.

**Series LLCs**

Similar to corporations, LLCs generally protect owners from lawsuits directed against the entity. However, the assets within the entity are not protected from these lawsuits, and the creditor of the LLC may be able to reach the entity’s assets. Accordingly, instead of placing all assets in one LLC, practitioners advise clients to form multiple LLCs, placing a single asset in each LLC. At times, lenders also require borrowers to hold collateral in so-called special purpose (bankruptcy remote) entities, with each entity holding a separate piece of collateral. For a client who owns only a few real estate (or other business) assets this structure works well. However, for a client with a multitude of assets, the fees (such as the minimum franchise tax imposed on each entity) and costs of setting up dozens of entities add up quickly.

Series LLCs are a creative solution. The concept of the series LLCs has been adopted from the offshore mutual fund industry, where segregated portfolio companies and protected cell companies have existed for quite some time. These concepts exist in countries such as Guernsey, British Virgin Islands, Bermuda, the Cayman Islands, Mauritius, and Belize.

In the United States, the concept of a series LLC exists in Delaware, Oklahoma, Iowa, Illinois, and, most recently, in Nevada. Delaware is the most frequently used jurisdiction for creation of domestic series LLCs. In Delaware, a single LLC can have assets placed within separate series (akin to compartments). An asset placed in one series is protected against the liabilities arising in a different series (provided separate books and records are kept for each series and the assets of each series are accounted for separately). Delaware also allows each series the added flexibility of having different managers and members.

For federal (and California) income tax purposes, practitioners can usually choose whether to file one tax return for all series or a separate one for each. In practice, a single return is filed, and series are tracked solely to a bookkeeping standpoint. Under California law, a foreign LLC that registers to do business in California will continue to be governed by the laws of the foreign jurisdiction where it is organized. This means that Delaware law will continue to apply to a Delaware series LLC that is registered in California.

To understand the value of a series LLC, consider a client who has 40 parcels of real estate in California. If each parcel is owned by the client through a separate LLC, the client would be forced to pay $32,000 a year in California minimum franchise taxes ($800 per entity), varying legal fees to establish each entity, and tax return preparation fees for 40 partnership returns. Instead, the client may form a single series LLC and then register it with the California secretary of state. Although the LLC has 40 series with each one holding a separate real property parcel (and each separate from the rest for liability purposes), only one LLC is actually registered in California. This will reduce the California franchise tax from $32,000 to $800. Only one LLC agreement is drafted, and only one tax return is filed. Each parcel of real property is then titled into a specific series of the LLC. Separate books and bank accounts are maintained for each series. If the client acquires additional properties in the future, no changes need to be made to the LLC operating agreement. He or she would simply need to title the new properties into new series and create new books and records for the new series.

In addition, series LLCs arguably offer even more protection than multiple LLCs. Whereas multiple LLCs owned by the same members may be treated as alter egos, the Delaware series LLC statute specifically prohibits treating series as alter egos. It should be noted that treatment of series LLCs in bankruptcy is uncertain, as a bankruptcy court would not be bound by the Delaware series LLC statute and could order substantive consolidation.

Another caveat is that the Franchise Tax Board has issued revised instructions for Form 568 (the form filed for LLCs) to provide that “each series in a Delaware series LLC is considered a separate LLC.” However, the position of the FTB finds no support under the California statutes. (It is also not clear why the instructions are limited to only Delaware series LLCs.) California statutes define a “limited liability company” as an entity that is organized under the California Limited Liability Company Act, and a “foreign limited liability company” is defined as an entity organized under the laws of a foreign state or country. The statutes provide, further, that in order to form a limited liability company, articles of organization shall be filed with the secretary of state. An LLC simply cannot be created without the consent of a secretary of state of some state. Because no articles of organization are ever filed for a series of a limited liability company—the series are simply a bookkeeping concept—a series of an LLC should never be a limited liability company under California law.

Further, California statutes provide that a foreign limited liability company registering to do business in California will continue to be governed by the laws of the jurisdiction in which the LLC is organized, even if California laws are at odds with the foreign jurisdiction. Delaware and, similarly, in other states that allow for the creation of series treats the series LLC as one limited liability company, not as multiple limited liability companies. Consequently, the FTB’s position that each series is a separate LLC appears to be in conflict with the California statutes.

Moreover, the concept of series exists solely to segregate liabilities among the various assets of an LLC. Series exist only on the LLCs’ books and records, and a series LLC can be identical to a regular LLC, except for the segregation of liabilities. The fact that a state allows one to segregate liabilities within one LLC should not mean that each series is treated as a separate legal entity. For minimum franchise tax purposes, California can impose the annual $800 tax only on an LLC itself, and not on the separate series of a single LLC.

Consider this fact pattern: A regular Delaware LLC owns properties in California and is registered in California for several years. The Delaware certificate of formation is amended to allow the creation of series. Assume no other changes are made to the LLC. The only difference between the LLC before and following the amendment of the certificate of formation is liability segregation. Based solely on that distinction, the FTB would now assess against this LLC multiple franchise taxes. That appears to be an untenable argument.

California law specifically provides that a foreign LLC registered to do business in California will continue to be governed by the laws of the foreign jurisdiction in which it is organized. Therefore, a series LLC should work in California—noting, however, that a California court has yet to opine on series LLCs.

Jurisdiction shopping for LLCs is relatively simple if one knows the client’s objectives. For tax purposes, its state of formation is irrelevant to a member residing in California if the LLC is taxed as a partnership or a subchapter S corporation. California would tax any resident member on its allocable income. If the LLC is taxed as a subchapter C corporation, jurisdictions such as Nevada or South Dakota (or even some foreign countries that do not impose an income tax) may be good choices because there are usually no corporate income taxes in these jurisdictions. However, this will work only if the business is either located in that jurisdiction or has no easily ascertainable physical location (such as Internet-based business).

For liability protection, many look to jurisdictions such as Delaware and Nevada, domestically, and such foreign jurisdictions as the Island of Nevis or St. Vincent and the
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In practice, single-member LLCs are usually disregarded, whereas multimember LLCs may be treated as corporations (if they have multiple members), or disregarded (if one or more members), partnerships (if they have an established history of making it difficult for creditors to pierce the corporate veil of an LLC).

**Protection of Business Assets**

Another way LLCs may be used to limit liability exposure is to form multiple (or series) LLCs to own separate, distinct portions of a business. If the business is held in one entity, all the assets of the business are exposed to risks and liabilities arising out of all the various business assets and operations.

For example, assume that a corporation owns a patent for an automobile tire and also manufactures and sells the tire. If a tire becomes defective and results in damage, the lawsuit will be filed against the corporation as the manufacturer and seller of the tire. The lawsuit, assuming it is successful and exceeds the insurance coverage, would reach the corporation's assets—including the very valuable patent—and possibly place it in bankruptcy.

The solution is for the corporation to continue to manufacture and sell the tires but to form a separate LLC to own the patent, with a nonassignable licensing agreement between the two entities. If a lawsuit is filed against the corporation, the creditor would not be able to reach the patent. Note, however, that this protection may be undone by a successful alter ego challenge or substantive consolidation in a bankruptcy proceeding.

Any business with significant assets should consider forming a separate LLC for each distinct segment of its business or to hold valuable assets. Taken a step further, each significant asset of a business can be insulated using a series LLC, with a separate licensing agreement (if appropriate) running from each series to the operating entity.

In addition to liability protection, LLCs are wonderful tax planning vehicles. They may be treated as corporations (if they have one or more members), partnerships (if they have multiple members), or disregarded (if they have a single member) for tax purposes. In practice, single-member LLCs are usually disregarded, whereas multimember LLCs are generally treated as tax partnerships. Because LLCs are usually tax partnerships, contributions and distributions are generally tax-free, and partnership tax planning opportunities abound. Members are allocated nonrecourse liabilities for basis purposes, allowing them to absorb more losses (one of the primary tax reasons why real estate is never owned through corporate entities). There are no restrictions as to the ownership of LLCs (S corporations are restricted as to the number and type of shareholders), and no restrictions as to their economic structures (S corporation can only have one class of economic interests). In short, LLCs taxed as partnerships offer all the income tax advantages of limited partnerships, no general partner exposure, and none of the corporate tax disadvantages.

In California, spouses who own LLC interests as community property and are the only members can pick and choose whether the LLC will be treated as a partnership or as a disregarded entity for income tax purposes. This makes it easier for spouses who own real estate through a disregarded LLC to complete Section 1031 exchanges, since there is no risk that the real estate interests will be reclassified as partnership interests.

Some clients have existing businesses that are organized as corporations and are looking for the charging order protection of the LLC. If the corporate exit tax is too high, the corporation may be kept in place and an LLC (preferably a multimember LLC) substituted as the sole corporate shareholder. While tax problems remain, at least the client has liability protection.

If the corporation has made an S election, the top-tier LLC should be a disregarded entity (otherwise the LLC would be a prohibited shareholder, destroying the S election). However, if an LLC is a disregarded entity it means that it either has only one member or a husband and wife are holding membership interests as community property. Either structure minimizes the effectiveness of the charging order protection. In that case, an LLC formed in a foreign jurisdiction and elected to be treated as a disregarded entity would offer the client tax neutrality and a much higher degree of asset protection.

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become the default entity of choice for many practitioners, from tax planning to estate planning to asset protection.

1 See Wyoming Stat. Ann., tit. 17, art. 15; Corp. Code §§17000 et seq. Limited liability companies have been around for over 100 years. In 1892, Germany enacted a law authorizing an entity known as Gesellschaft mit beschränkter Haftung (GmbH), an act that was quickly copied by many countries in Europe and Latin America. This law was also the basis for the limited liability company statute adopted by the state of Wyoming.

2 According to the California secretary of state, there were twice as many corporations formed in California in 2004 as LLCs (116,210 versus 58,097), but in 2005, there were almost as many LLCs as corporations formed.

3 Maxwell Cafe v. Department of Alcoholic Control, 142 Cal. App. 2d 73, 78 (1956) (“Generally a corporation is a distinct legal entity separate from its stockholders and from its officers.”).

4 Corp. Code §17301(a).

5 Corp. Code §17302(e).

6 Corp. Code §17302(a).


8 See Corp. Code §15673 (A creditor of a limited partner has the right to receive a distribution of cash and property. The court may even appoint a receiver to collect the distributions for the benefit of the creditor. Corp. Code §17302(a).

9 Corp. Code §17301(a).

10 Id.

11 Corp. Code §17301(a).

12 Id.

13 Corp. Code §17001(n).

14 Corp. Code §§15673 and 15672(a).

15 Corp. Code §17302(b).

16 Corp. Code §17301(a)(3).

17 Corp. Code §17302(c).

18 “Distributable” means that the creditor has the right to receive a distribution of cash and property. See Delaware Limited Liability Company Act §18-215; Oklahoma Limited Liability Company Act §18-2054.4; Iowa Statutes tit. XII, subtit. 2, ch. 490A, 305; Illinois Compiled Statutes ch. 505, §37-46; Nevada Revised Statutes §86.291.


20 Even if separate capital accounts are maintained for each member’s interest in each series. Corp. Code §17450(a).

21 Delaware Limited Liability Company Act §18-215. Even if separate capital accounts are maintained for each member’s interest in each series.

22 Corp. Code §17450(a).

23 Because all 40 properties are now aggregated on one tax return, the LLC may become subject to the California gross receipts tax imposed on LLCs. To avoid this, a Delaware series limited partnership may be used instead of a series LLC. If the client already has multiple LLCs each paying the maximum gross receipts tax, converting the existing LLCs to one series LLC will result in one gross receipts tax. (Note however, that one trial court held, in a proposed statement of decision, that the gross receipts fee under Rev. & Tax. Code §17942 is unconstitutional. See Northwest Energetic Servs., LLC v. Franchise Tax Bd, No. CFC-05-437721, San Francisco Super. Ct. (Mar. 3, 2006)).

24 Providing that the debtor-member vests in the distribution (i.e., cash and assets are distributable to the debtor-member) but instructing the manager to withhold the distribution while the charging order is pending, allows the LLC to allocate taxable income to the creditor (following a foreclosure) without distributing cash.


26 Delaware Limited Liability Company Act §18-215. If an entity is organized in Nevada (for instance), but is doing business in California, California will always tax that business on its income apportionable to California, regardless of the state of organization or type of entity.

27 For California tax purposes, even if the LLC is disregarded, it has a tax return filing requirement and is subject to the $800 minimum franchise tax and the gross-receipts tax.


30 If it is likely that some foreign jurisdictions would offer more charging order protection to single-member LLCs than domestic states.

31 Examples include bifurcation of gain for real estate dealers or in situations in which the corporation is generating phantom income that the shareholders do not want to pass through.

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YOUR BLUEPRINT FOR RESOLVING CONSTRUCTION LITIGATION

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On May 4, 2004, a two-year investigation by New York State Attorney General Elliot Spitzer into record industry royalty payments ended with a $50 million settlement paid to thousands of artists. Spitzer claimed that major U.S. record companies failed to maintain contact with artists or their estates and, therefore, failed to pay royalties that were due.

Record companies, however, face a difficult accounting challenge to fulfill their royalty obligations, one that has grown more complex as online sales of music have increased. In commenting on the challenge, the chief information officer of Warner Music Group stated: “It’s a huge transactional nightmare. The number of contracts is in the thousands, and each one is different. And there is no off-the-shelf software that can scale to what we’re talking about. This is tens of millions of transactions a month.” While this assessment may be true, the Spitzer settlement confirms, as many recording artists have long suspected, that a complete failure to pay royalties due and owing to artists, producers, and songwriters remains a significant problem.

Artists usually have the right to audit the books and records of the distributor, but this may be insufficient—and litigation may be necessary. Indeed, on December 16, 2005, the Beatles sued the EMI Group and Capitol Records after an audit allegedly revealed an astounding failure to pay royalties of $53 million. Record companies like EMI claim that such disputes are a result of true differences in contractual interpretation. However, critics—including the California Senate Select

Royal Treatment

While many legal remedies may exist to collect unpaid music royalties, artists may find themselves stymied in the absence of a fiduciary relationship

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Committee on the Entertainment Industry—contend that artists are forced by the record companies to sue so that record companies can settle the lawsuits at a discount. In fact, the committee stated that record company accounting departments appeared to be guilty of, at a minimum, “purposeful neglect.”

The committee probably is correct, since California law provides no penalty or other disincentive for underpayment or nonpayment of music royalties. In order to prevail in a lawsuit for royalties, attorneys must understand the different sources of royalties as well as the various causes of action available to an aggrieved recording artist, producer, and songwriter.

Sources of Royalties
Artists are entitled to multiple types of royalties for any composition or sound recording. While the right to receive royalties may vary from contract to contract, the sources of income to creative participants in the music industry fall into the following general categories: artist/producer royalties, mechanical royalties required by the Copyright Act, synchronization fees, master use licensing fees, fees for Internet use, and public performance royalties.

A “sound recording” usually is created by an artist and a producer, and both jointly own the copyright to the work. Typically, the copyright to the sound recording is assigned to a record company in return for an agreement by the record company to pay advances and royalties. Artist and producer royalties generally are computed by a complicated formula based upon the retail price and number of copies sold. However, the artist and producer are not entitled to any royalties until the advances paid to them have been recouped by the record company.

Copyright owners of compositions are entitled to mechanical royalties pursuant to Section 115 of the Copyright Act. This provision allows record companies to record and manufacture records pursuant to a “compulsory license” provided that they pay a royalty to the owner or owners of the copyright in the composition. Under the compulsory license, the mechanical royalty is fixed by law at a flat rate per song per record made and distributed. As of January 1, 2006, the flat rate is 9.1 cents or 1.75 cents per minute of playing time or fraction thereof, whichever is greater.

Under a compulsory license, royalties are due whenever records are considered “made and distributed.” However, compulsory licenses rarely are used in practice, as most music publishers and record companies opt to employ “negotiated licenses” and “controlled composition” clauses that require mechanical royalties to be paid for records sold, or paid for and not returned—and only require the payment of royalties at 75 percent of the “statutory rate.”

A synchronization license must be obtained from the publisher anytime a musical composition is used in conjunction with an audiovisual work, such as a movie or television show. Customarily, these licenses provide for a one-time fee to include the composition in the work and, sometimes, a royalty for the sale of a DVD or VHS tape of the audiovisual work.

The use of a sound recording in an audiovisual work also requires a master use license from the copyright owner of the sound recording. Usually, master use licenses are obtained directly from the record company that owns the copyright to the sound recording. Master use licensing fees are similar to fees for synchronization licenses. The key difference is that these fees are paid to the owner of the sound recording rather than the owner of the underlying composition. Master use licenses also are required when the sound recording is “sampled” and used in a different sound recording.

Music may be downloaded legally through the Internet. Internet downloads are treated in a similar manner to the sale of a CD—that is, each transaction is divided among the distributor, the songwriters, the producer, the artist, and the label. Artists must be wary of labels that charge for “packaging deductions” despite the fact that Internet downloads quite obviously do not involve any physical packaging.

Compulsory licenses in the Internet context are referred to as “DPD licenses”—DPD being the initials for digital phonorecord deliveries. DPD license fees are paid at the maximum mechanical royalty statutory rate. For recordings produced pursuant to contracts entered after 1995, the law prohibits a controlled composition provision of the artist’s contract from discounting the compulsory DPD rate. Therefore, for these recordings, even if there is a controlled composition clause in the contract, a singer-songwriter should receive the maximum statutory rate for downloads.

In addition to Internet downloads, artists should monitor “non-terrestrial” radio. On February 6, 2004, the U.S. Copyright Office designated SoundExchange—a nonprofit organization established in 2003 as a spinoff from the Recording Industry Association of America Inc. (RIAA)—as the sole designated agent to collect and distribute royalties for music transmitted via digital means. These include Internet radio, Internet “Web casts,” and the increasingly popular satellite radio services such as XM and Sirius. Because these services are akin to traditional radio, they are considered performances rather than reproductions of the copyrighted work.

Finally, cellular telephone ringtones are an increasingly lucrative area of revenue in the music industry. In the United States, the Harry Fox Agency issues ringtone licenses for its principals, though some publishers prefer to issue the licenses directly to the ringtone providers. Royalties from ringtones typically are the greater of either a fixed amount per download of the song or a percentage of the gross retail receipts.

When music is played on the radio or television, or in nightclubs, live concerts, and retail establishments, the writers and publishers of the composition are entitled to public performance royalties. These royalties are collected by public performance organizations, such as ASCAP and BMI. The way in which these organizations apportion and distribute the moneys they receive for public performances has not been disclosed and remains a mystery.

Underpayment or Nonpayment of Royalties
No California statute explicitly requires a correct and timely payment of music royalties. At the same time, California courts have limited severely the scope of relief and claims available to artists by, among other things, denying artists the ability to pursue causes of action for breach of fiduciary duty in certain situations.

Arguably, an important case in California for artists seeking proper payment of their royalties is Wolf v. Superior Court. While the Wolf case was not an action for the nonpayment of music royalties, its holding might, under analogous circumstances, be applied to that claim. In Wolf, writer Gary Wolf pursued a claim against Walt Disney Pictures and Television arising out of the 1988 film Who Framed Roger Rabbit. Wolf asserted that Disney underreported revenues (including merchandising) related to the film and failed to pay him his due contingent compensation. One of Wolf’s claims was for breach of fiduciary duty. Essentially, Wolf alleged that Disney owed him a fiduciary duty to properly report revenues and pay contingent compensation, such as profit participation. The California Court of Appeal dismissed Wolf’s breach of fiduciary duty claim.

The court of appeal held that a contractual right to contingent compensation by itself was not sufficient to create a fiduciary relationship because every contract requires parties to reposes trust and confidence in the other to perform. The appellate court also rejected Wolf’s contention that revenue-sharing agreements or the right to accountings created fiduciary relationships because the relationship of the parties was akin to a joint venture. In its rejection of this contention, the appellate court analogized that the relationship between royalty recipient and the licensee was similar to a debtor-creditor relation-
ship—a relationship that does not include the existence of a fiduciary relationship.

The Wolf decision may be crippling for recording artists. A cause of action for a breach of fiduciary duty may give rise to damages beyond the amounts underpaid, such as general or punitive damages. Without a tort claim, the most an artist can hope to win at trial is simply the amount due. Since record contracts typically do not include provisions for attorney’s fees, recording artists usually must settle their claims at a discount, lest they see their royalties disappear or substantially diminish in a blizzard of litigation-related attorney’s fees.

There is some hope that Wolf will be overturned. In a dissenting opinion in Wolf, one of the appellate justices wrote that a fiduciary duty relationship was vital in order to avoid an inherent conflict of interest:

The opportunity and temptation to cheat are present in the relationship here just as much as in the trustee-beneficiary, partnership, or other traditional fiduciary relationships. Wolf must depend entirely on the honesty and accuracy of Disney in the performance of the accounting function Disney is carrying out for both of them. Every sale of a toy “Roger Rabbit” that Disney fails to include in its report of receipts from exploitation of Wolf’s character means less money for Wolf and more profit for Disney. The conflict of interest inherent in this relationship, therefore, is more than apparent. So there appears to be just as great a need to impose a fiduciary duty on the performance of that accounting responsibility in order to discourage Disney “from taking unfair advantage of” its special position as there is for partners who manage a partnership business or for trustees who keep the books for a beneficiary’s property interests.

In addition, it is difficult to reconcile Wolf with prior case law, in particular those decisions aligned with the longstanding principle that when one party collects moneys for another and has a duty to account for a portion of those proceeds—which is precisely what record companies do—a fiduciary duty exists regarding the party’s payment obligations. For example, in Waverly Productions v. RKO General, Inc., the California Court of Appeal held that a motion picture distributor that had a written contract with a production company was not a fiduciary “except as to accounting for rentals (proceeds) received from the motion picture.” Also, the court of appeal held in Parsons v. Ticknor that assignees of copyrights to songs authored by a recording artist owed duties to the artist’s heirs “as fiduciaries of [the artist].”

Wolf has been distinguished in two court decisions, one of which is on review. In Celador International Ltd. v. Walt Disney Company, the creators of the game show Who Wants to Be a Millionaire sued ABC and Buena Vista Television—both subsidiaries of Disney—in federal court for breach of fiduciary duty and other claims. The plaintiffs asserted that a joint venture existed between the plaintiffs and the defendants because the plaintiffs allegedly possessed reversionary rights, merchandising rights, approval rights, and consultation rights concerning the program. The defendants filed a motion to dismiss the claim for breach of fiduciary duty based upon Wolf.

The district court sided with the plaintiffs on the grounds that their allegations were sufficient to support the existence of a joint venture or other “confidential” relationship. The district court made this ruling despite a contractual provision between the parties that expressly disclaimed the existence of a joint venture. The Celador decision may provide little solace to less established recording artists who, in most cases, will not be able to plead similar rights to support the existence of a joint venture or confidential relationship.

Wolf also was distinguished in a patent case, City of Hope National Medical Center v. Gentech, Inc. However, in February 2005 the California Supreme Court granted review of the court of appeal’s decision and, therefore, the fate of this case is uncertain. The essential issue before the supreme court is whether the contractual relationship between the parties rose to the level of a fiduciary relationship. The appellate court found that the contractual relationship—under which the plaintiff submitted its ideas and research to the defendant, and the defendant was charged with patenting and licensing the ideas—created fiduciary duties that flowed from the defendant to the plaintiff. The court of appeal distinguished Wolf on the grounds that literary rights are different than the “secret ideas” the plaintiff transferred to the defendant.

A recent decision in the U.S. District Court in the Eastern District of Pennsylvania suggests a glimmer of hope for artists filing lawsuits in California who wish to plead a cause of action for conversion for the failure to pay royalties. In Levert v. Philadelphia International Records, members of the O’Jays, a rhythm and blues band, brought a conversion claim against their record company, alleging that they were owed royalties on record contracts dating back to 1972. The defendants filed a motion to dismiss the conversion cause of action, claiming that the failure to pay royalties constituted a debt, and the failure to pay a debt is not conversion. The district court denied the defendants’ motion and held that the failure to pay royalties was not analogous to a debt but was actually more similar to a lack of payment by a consignor to a consignee.

The court in Wolf characterized the profit-participation arrangement in that case as a debt, but this conclusion was based in part upon a contractual provision stating “nothing herein contained shall be deemed to...create a relationship between [Disney] and [Wolf] other than creditor-debtor.” However, in Casanto v. Klein, a Central District of California court—interpreting New York law—held that a claim for conversion in a case involving an alleged failure to pay royalties could not be maintained if it was “predicated on a mere breach of contract.” The additional facts that must be pleaded, at least under New York law, remain unclear. California courts have not
specifically addressed this claim in a factual scenario involving the wrongful withholding of royalties that are due and owing. However, plaintiffs risk dismissal of conversion claims if they are filed prior to an accounting, because conversion requires a specific, identifiable sum to be at issue.43

Because punitive damages are potentially available for conversion claims,44 the Leverett line of reasoning could be an important development for artists seeking redress for a failure to pay royalties. In addition, attorney’s fees are available for a successful conversion claim pursuant to California Civil Code Section 3336. Finally, conversion claims potentially give rise to general damages as well as emotional distress damages.45

A breach of contract claim is almost always available when an artist is entitled to royalties pursuant to a record contract.46 However, most record contracts do not provide for the recovery of attorney’s fees or for termination as a result of the underpayment of royalties. In addition, no general or punitive damages are available.

Even when there is no written contract, artists also should be entitled to assert a breach of implied contract claim. In essence, the use of intellectual property implies the obligation to pay for it.47 Like any breach of contract claim, plaintiffs should be entitled to “expectancy damages”—that is, what they would have received had the contract not been breached. Creative participants also may have a third-party beneficiary claim against the distributor in the absence of a contract.48

If there has been a virtual failure of consideration, artists are able to rescind license agreements and pursue copyright infringement claims.49 However, in Nolan v. Sam Fox Publishing Company, rescission was denied in a New York case in which 26 percent of the artist’s royalties due had been paid.50

If the artist or producer has entered into a contract with the record label, copyright infringement claims are an unlikely alternative because some money usually is paid up front as an “advance.”51 Furthermore, recording agreements may contain a clause that provides that in the event of a breach, the artist is limited to its remedies at law and does not have the right to terminate or rescind the contract.52 Nevertheless, in situations involving a failure to pay mechanical royalties, the Copyright Act provides that copyright owners can revoke mechanical licenses and pursue infringement claims for any subsequent reproduction or distribution of the composition.53

If a license to use a copyrighted work is limited in scope, any exploitation of the copyrighted work outside of the prescribed limits also constitutes infringement.54 For example, in Frank Music Corporation v. Metro-Goldwyn-Mayer, Inc., a licensee exploited musical compositions pursuant to an ASCAP license for “non-dramatic use” of the compositions.55 The Ninth Circuit held that the licensee infringed the copyrights to those compositions when it used the compositions in a dramatic work.56

**Audits and Delayed Discovery**

Most record contracts provide for accounting rights. In addition, accounting claims are available as a matter of law when there are complicated accounts and a dispute arises over whether or not money is owed.57

Artists who receive incorrect royalty statements may try to pursue causes of action for fraud or deceit, but these causes of action have not found much favor with the courts. In Casano, the court dismissed a fraud cause of action on a motion to dismiss.58 The case involved one of the songwriters for the band KISS, who claimed that the royalty statements he received were incorrect and thus were fraudulent in their representation of the amount that was due to him. The Central District held that the cause of action for fraud should be dismissed because it merely stated a breach of contractual duties, not the breach of a legal duty independent of the contract.59 While there is no case directly on point under California law, California courts generally have not allowed fraud causes of action to proceed when the fraud was indistinguishable from the breach of contract.60

The failure to pay mechanical royalties, as required by the Copyright Act, is an unlawful practice that may give rise to an unfair competition claim under California Business and Professions Code Section 17200.61 California courts have consistently interpreted Section 17200 broadly “precisely to enable judicial tribunals to deal with the innumerable ‘new schemes which the fertility of man’s invention would contrive.’”62 A successful Section 17200 claim may entitle the prevailing party to attorney’s fees.63

Often artists are not aware of accounting irregularities until long after they occur. This situation leads to the issue of the statute of limitations as applied to an artist’s claims of underpayment or nonpayment of royalties. Record companies have argued that the statute of limitations should run as soon as an incorrect accounting report is released, since it is the artist’s responsibility to conduct audits regularly to determine whether any underpayment has occurred.64 Despite this argument, however, the issue appears to have been resolved. In 2004, the California Court of Appeal in Weatherly v. Universal Music Publishing Group held that the delayed discovery rule applied to royalty payments in the music industry.65

The defendant in Weatherly had argued that the statute of limitations had run because the plaintiff could have audited the defendant’s books at any time, and if the plaintiff had done so he would have discovered the underpayment more than 20 years prior to filing his lawsuit. The appellate court ruled that because of the misrepresentations in the royalty statements, the plaintiff was not put on notice of his claims—and his discovery was delayed until he conducted an actual audit of the defendant’s books and records.66

When artists seek legislative solutions to their accounting woes, they can expect to face the recording industry’s well-funded lobbying machine. One Web site estimates that the RIAA spends $550,000 every six months on lobbying efforts, and that Universal Music Group alone spends $220,000 every six months for this purpose.67 It is probably unlikely that artists will be able to persuasively argue their case in the face of that sort of economic power.

For example, in July 2004, Governor Arnold Schwarzenegger signed SB 1034 (Recording Artist Contracts) into law.68 In its original form, the bill imposed fiduciary duties on record companies regarding their obligation to account for royalties owed to creative participants in the music industry.69 However, after lobbying from the record companies,70 the final bill was watered down. Lawmakers excluded the provisions imposing fiduciary duties from the bill. Instead, the compromise version—now codified as California Civil Code Sections 2500 and 2501—provides artists—individually or in groups—with a statutory right to an audit.71 Section 2501 also codifies the established practice of hiring auditors on a contingency fee basis. The audits must take place within three years after the end of a royalty earnings period under the contract.72 To date, there are no published or unpublished cases interpreting these statutes. The statutory right to an audit has some value, particularly if artists take advantage of the provisions allowing for multiple royalty recipients to audit a company’s books and records simultaneously under a contingency fee arrangement. The failure to provide relevant records to the auditor (a frequent complaint by artists) might also constitute an unlawful practice pursuant to Business and Professions Code Section 17200. Whether this provides any incentive in the long term for record companies to account correctly and pay royalties remains to be seen.

Until then, recording artists and their counsel should remain vigilant in demanding regular accounting statements, examining those statements, and exercising their audit rights. Unfortunately, this will
not always be enough—and litigation frequently will be the only way for artists to recover their royalties.


4 Id.


6 Id.

7 The Copyright Act defines “sound recordings” as works that result from the “fixation of a series of musical, spoken, or other sounds.” 17 U.S.C. §101 (2006). A composition “consists of music, including any accompanying words” and “may be in the form of a notated copy (for example, sheet music) or in the form of a phonorecord.” Copyright Office, Copyright Registration of Musical Compositions and Sound Recordings, Circular 56a, available at http://www.copyright.gov/circs/circ56a.pdf. A copyright in the composition is separate and distinct from the copyright in the sound recording.


10 Muller, supra note 9, at 86-91.

11 Kohn & Kohn, supra note 9, at 114-15.


13 Id.


16 Siegel & Newmark, supra note 8, at 878-79.

17 6-30 Nimmer on Copyright § 30.02 (2005).


19 See, e.g., Newton v. Diamond, 349 F. 3d 591 (9th Cir. 2003).


22 A controlled composition clause is a voluntarily negotiated mechanical license limiting the amount of money the record company is required to remit in mechanical royalties. See Kohn & Kohn, supra note 9, at 692-96.


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32 Los Angeles Lawyer Realty Co., 658 N.Y.S. 2d 122, 124 (1997)); Rodgers
32 Cal. 2003) (quoting MBL Life Assurance Corp. v. 555
32 Cal. Rptr. 3d 234 (2004).
32 soundexchange.com/artist_home.html#agent.
32 40 Id
32 38
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32 34 Parsons v. Tickner, 31 Cal. App. 4th 513, 529
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32 32 See
32 31 Id
32 30 Id.
32 28 See
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32 26 Siegel & Newmark, supra note 5 (2003).
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What should a lawyer do when he or she receives, through the inadvertence of opposing counsel, documents clearly subject to the attorney-client privilege or attorney work product doctrine? This question was how the court of appeal framed the issue in *State Compensation Insurance Fund v. WPS, Inc.* (commonly referred to as the *State Fund* case).\(^1\) The issue, like so many others facing the appellate courts, is easier to state than it is to resolve. Indeed, it has perplexed courts and ethics experts for a long time.

Now, this troublesome issue involving the inadvertent production of documents is before the California Supreme Court in *Rico v. Mitsubishi Motors Corporation*, which could be one of the court’s most important legal ethics decisions in recent years. In *Rico*, the supreme court will review the decision by the Fourth District Court of Appeal to affirm the trial court’s order disqualifying an attorney who was the recipient of a privileged document through the inadvertence of opposing counsel.\(^2\)

For more than 20 years, California courts have vacillated between
two opposing positions. Initially, courts found that an attorney receiving inadvertently produced documents had no duty to return the documents or to refrain from looking at them—and may even use the documents to benefit his or her client in the case. Later courts have held that an attorney must immediately return the inadvertently produced documents to opposing counsel, looking at the documents only to the extent necessary to determine their privileged nature.

One of the early seminal decisions on this issue is *Aerojet-General Corporation v. Transport Indemnity Insurance.* In *Aerojet,* the court of appeal reversed a sanctions order against the recipient attorney, noting that: “Once he had acquired the information in a manner that was not due to his own fault or wrongdoing, he cannot purge it from his mind. Indeed, his professional obligation demands that he utilize his knowledge about the case on his client’s behalf.” The *Aerojet* court found it significant that the attorney receiving the purportedly privileged information did not violate any statutes, judicial decisions, rules of court, or rules of professional conduct in using the information he received to his client’s advantage. In fact, the court noted that the attorney’s primary duty was “to protect the interests of his own clients.”

The *Aerojet* decision, however, was not the final word on the inadvertent production issue. As discovery in complex litigation became more wide-ranging and voluminous, and the routine use of facsimile transmission made document production instantaneous, the problem of inadvertently produced privileged documents became even more prevalent and difficult. In 1992, the American Bar Association’s Standing Committee on Ethics and Professional Responsibility issued Formal Opinion 92-368, which addressed the inadvertent disclosure of confidential material. The committee stated in its opinion that a lawyer who mistakenly receives privileged or confidential documents from opposing counsel should refrain from examining the documents, immediately notify opposing counsel who sent the documents, and return the documents if opposing counsel requests their return. The ABA opinion represented a departure from the standard rule enunciated in *Aerojet,* which seemed to place a greater emphasis on the lawyer’s duty to zealously represent the interests of the client than on the lawyer’s duty of fair play as an “officer of the court.” For this reason, ABA Formal Opinion 92-368 was not well received.

Bowing to criticism, the ABA modified its position two years later in Formal Opinion 94-382, which created a course of action for a lawyer who, as a result of opposing counsel’s mistake, receives privileged or confidential material. In this circumstance, the lawyer 1) may review the materials only to the extent necessary to determine whether they are privileged and how appropriately to proceed, 2) should promptly notify opposing counsel that he or she has the materials, and 3) should follow the instructions of opposing counsel about the documents or refrain from using the materials until the court rules on how the materials should be handled. Even though the ABA Model Rules of Professional Conduct and ABA Formal Opinions are not controlling in California, California courts tend to give them substantial weight and deference—especially when the California Rules of Professional Conduct and the State Bar Act do not address the issue and the rule does not conflict with California public policy.

### State Fund and the ABA Opinions

In 1999, the Second District Court of Appeal in *State Fund* moved California away from the *Aerojet* decision and closer to the ABA standard. Although it did not disapprove *Aerojet,* the court in *State Fund* limited *Aerojet* to its facts and adopted a rule for California that was nearly identical to ABA Formal Opinions 92-368 and 94-382. In *State Fund,* the appellate court reversed a sanctions order against an attorney who received—through the mistake of opposing counsel—privileged documents, which the attorney used against his opponent and even gave to another attorney litigating claims against the State Compensation Insurance Fund. After the receiving attorney refused opposing counsel’s request to return the documents, the trial court found the attorney’s conduct to be unethical and in bad faith and imposed monetary sanctions on the attorney and his client.

In reversing the sanctions order, the *State Fund* court noted that the receiving attorney had not violated any California decision, statute, or rule of professional conduct. The court found that the attorney did not comply with ABA Formal Opinion 92-368 but emphasized that California did not follow the ABA rules. Nonetheless, the court used ABA Formal Opinion 92-368 as a guide in formulating a rule for California attorneys to follow. The court ruled that a lawyer who receives clearly privileged documents from an adversary should: 1) stop reading the documents as soon as the privileged nature of the documents becomes apparent, 2) immediately notify opposing counsel that the lawyer has the documents, and 3) resolve any disputes about the handling of the documents with opposing counsel or refrain from using the documents until the court determines their disposition.

The court in *State Fund* devised this rule after balancing the competing duties that lawyers owe to their clients and to “the administration of justice.” Placing great weight on the “sanctity of the attorney-client privilege,” the court made a pronouncement: “We believe a client should not enter the attorney-client relationship fearful that an inadvertent error by its counsel could result in a waiver of privileged information or the retention of the privileged information by an adversary who might abuse and disseminate the information with impunity.”

Notwithstanding the rule in *State Fund,* which places clear obligations on the lawyer receiving privileged documents, the court offered some consolation to the receiving attorney in its opinion. In reversing the sanctions order, the court held that “whenever a lawyer seeks to hold another lawyer accountable for misuse of inadvertently received confidential materials, the burden must rest on the complaining lawyer to persuasively demonstrate inadvertence.” The court commented further that an attorney should not be subject to disqualification simply because he or she has been exposed to the confidential information of an adversary. Nevertheless, even though the court referred to disqualification as a “draconian” remedy, the court made it clear that in an appropriate case—presumably when the recipient attorney fails to follow the court’s newly articulated rule—disqualification might be warranted.

### The Rico Challenge

The *State Fund* court’s discussion of disqualification of the receiving attorney as a possible sanction seems to have set the stage for the court of appeal’s decision in *Rico.* The *Rico* court moved the rule on the receiving lawyer’s ethical duty 180 degrees from the rule established in 1993 by *Aerojet* and well beyond the middle ground staked out by the court in *State Fund.*

*Rico* arose when counsel for a plaintiff in an SUV rollover case obtained a written summary of a conference between the defense attorney and defense experts about certain strengths and weaknesses in their case. The plaintiff’s attorney testified that he got the summary when a court reporter mistakenly delivered the document to him at a deposition. Defense counsel claimed that the plaintiff’s attorney took the document from his files while defense counsel was out of the room. Despite the apparent conflict in the evidence, the trial court determined that the document had been inadvertently produced to plaintiff’s counsel. The production of the defense memorandum came to light when plaintiff’s counsel used the document at a subsequent deposition in the case. Defense counsel learned of the document’s use and demanded its prompt return.

After plaintiff’s counsel refused to return
the document, defense counsel immediately filed a motion to disqualify the plaintiff’s attorney and the plaintiff’s experts, who had also reviewed a copy of the document. Following a lengthy hearing, the trial court found that the defense memorandum was subject to the attorney-client privilege and work product doctrine and that plaintiff’s counsel violated his ethical duty by failing to notify opposing counsel that he had the document and was using it. The court, relying on the State Fund decision, granted the motion and disqualified the plaintiff’s attorney and of opposing counsel. The situation in states that follow the ABA Model Rules is even more confusing. Last year, as Rico came under review by California’s highest court, the ABA reversed itself and withdrew Formal Opinion 92-368—the opinion that strongly influenced the State Fund decision. On October 1, 2005, the ABA’s ethics committee adopted Formal Opinion 05-437, which states:

A lawyer who receives a document from opposing parties or their lawyers and knows or reasonably should know of the documents to the opposing counsel. However, an argument could be made that the more rigorous standard in Formal Opinion 94-382 applies when the inadvertently produced documents are clearly privileged or confidential. Rule 4.4 does not expressly address the inadvertent production of privileged documents.

The Privilege Issue

With these sometimes conflicting developments, the California attorney who has the fortune (or misfortune) to receive, through the

Even though the State Fund court considered disqualification of the receiving attorney a draconian remedy, the court in Rico had no difficulty in affirming the disqualification order.

experts because the attorney’s review and use of the privileged document caused “unmitigable prejudice” to the defense. The Fourth District Court of Appeal affirmed the disqualification order, and the California Supreme Court granted review on June 9, 2004. At press time, oral argument in the case had not yet been scheduled.

The appellate court in Rico found that the rule for attorney conduct enunciated in State Fund provided the decisional basis that was lacking when the Aerojet case was decided. Even though the State Fund court considered disqualification of the receiving attorney a draconian remedy, the court in Rico had no difficulty in affirming the disqualification order. Both the trial and appellate courts in Rico were highly critical of the receiving attorney because he “studied the document carefully, made his own notes on it, discussed the meaning of the notes with the experts and based his litigation strategy and expert witness cross-examination upon the information contained in the document.” The appellate court acknowledged that the receiving attorney relied on the Aerojet case but still found his conduct to be unethical because he failed to make any “further inquiry into his ethical responsibilities,” and “made full use of the privileged document” in violation of the ethical standards in State Fund.

Hopefully, in deciding Rico, the state supreme court will resolve the uneasy tension between the Aerojet and State Fund decisions and give California attorneys a clear ethical standard to follow when they receive privileged documents through the mistake of opposing counsel, possibly privileged or confidential documents that opposing counsel did not want the attorney to see, faces some significant dilemmas. Certainly, the rule in State Fund is still good law in California, although its basis has been undermined by the ABA’s withdrawal of ABA Formal Opinion 92-368 and the California Supreme Court’s impending review of Rico. However, the efficacy of an ethical rule should be measured in its clarity and consistent application. At this point, at least until Rico is decided, California’s standard—as well as the national standard—regarding what a receiving attorney should do with inadvertently produced documents is neither clear nor consistent.

The most problematic portion of the rule outlined in State Fund, and expanded in the Rico court of appeal decision, is the determination of whether the inadvertently produced document is actually privileged. The difficulty begins with discerning when the receiving attorney’s duty to contact opposing counsel about a mistakenly produced document arises. In State Fund, the inadvertently produced documents were clearly stamped with the heading “Attorney-Client Communication/Attorney Work Product” and the word “Confidential” on the first page of each form. Thus, on their face, the documents put to the question of whether the privileged status of a document has been waived. The ABA standard is further clouded because even though ABA Formal Opinion 94-382 was withdrawn, ABA Formal Opinion 94-382—which addresses a lawyer’s duty when the lawyer inadvertently receives “privileged or confidential materials” of an adverse party—apparently is still viable.

Thus, it is unclear whether the lawyer’s duty is simply to notify opposing counsel of the receipt of the materials or if the more extensive duty outlined in ABA Formal Opinion 94-382 controls. Nonetheless, ABA Model Rule 4.4 and its commentary would most likely control in the jurisdictions that follow the ABA standards. The attorney’s only duty under the rule is to disclose the receipt
each of those cases, the appellate court offered an in-depth analysis of whether and to what extent the mistakenly produced documents were privileged at all.

In Aerojet, the court concluded that the document itself may have been confidential or even privileged, but the underlying information in the document (the identity of potential witnesses) was not privileged. This conclusion that the mistakenly produced information was not privileged was used by the State Fund court to distinguish Aerojet and limit the case to its facts. But how can the receiving attorney make the kind of analysis necessary to determine the privileged nature of a document if extensive review and analysis of the document is considered improper? There was no way the receiving attorney could have properly determined whether the document was privileged or not without reading and thoroughly analyzing it.

In Rico, the privilege issue was even more complicated. The trial court based its ruling on its assumption that any reasonable attorney would have known that the defense memorandum was subject to the attorney-client privilege and the work product doctrine. However, the appellate court found that the trial court was only half right. After extensive analysis, briefing, and oral argument by counsel, the trial court ruled that the memorandum was subject to the attorney-client privilege. This was an error, according to the appellate court. Nonetheless, the appellate court found that the memorandum was still protected because it consisted of attorney work product, even though the document had been prepared by a paralegal, apparently at a lawyer’s request.

The appellate court reached this conclusion after an extensive analysis of the document and how it was prepared. According to the court, if the memorandum had been a transcription of a discussion between defense counsel and defense experts, it would not have been subject to absolute work product protection. However, the trial court found that the document included the thoughts and impressions of the defense attorney—and was therefore entitled to absolute attorney work product protection.

If a proper determination of the privileged nature of a document requires the extensive analysis of a trial court and an appellate court—after full briefing and oral argument of counsel—then it is difficult to fault an attorney for “meticulously examining” and analyzing a document that the attorney inadvertently received. Indeed, as the court observed 23 years ago in Aerojet, an attorney has an ethical duty not only to examine and analyze the adversary’s document but to use the evidence to further the interests of the attorney’s client.

Of course, an ethical dilemma arises when the inadvertently produced document clearly appears to be privileged, such as when the document is so labeled or when the document appears on the producing party’s privilege log. Even then, the receiving attorney should not be faulted for reviewing and analyzing the document before contacting opposing counsel. Upon thorough review, the document may not be legitimately privileged or counsel may reasonably believe that any privilege has been waived. Moreover, given the high volume of documents produced in many cases and tight trial deadlines, the receiving lawyer may not appreciate the importance or privileged nature of the document until later in the case during trial preparation or expert discovery. In a close case, it would not be unreasonable for the receiving attorney to err on the side of protecting his or her client’s interests in using the documents rather than to help opposing counsel clean up an embarrassing mistake.

And what if a clearly privileged document mistakenly produced to opposing counsel revealed that the producing party had destroyed key discoverable documents, was hiding witnesses, or was encouraging them to lie under oath? Indeed, in Rico, the court of appeal rejected the plaintiff’s argument that the use of the inadvertently produced defense memorandum was justified because it revealed that the defense experts were lying about the technical evidence in the case. The court found that:

- Once the unintended reader ascertains that the writing contains an attorney’s impressions, conclusions, opinions, legal research or theories, the reading stops and the contents of the document for all practical purposes are off limits. Unlike with the attorney-client privilege, there is no crime-fraud exception to the attorney work product rule.
- The absolute attorney work product privilege is just that, absolute.

If the Rico court’s analysis survives supreme court review, then the smoking gun document that a litigator receives and reads may become a ticking time bomb that could result in the attorney facing disqualification, monetary sanctions, and public reproval from the courts for being “unethical.” Perhaps the courts have put an unreasonable, and ultimately unworkable, burden on attorneys who receive, through no misconduct of their own, privileged documents from the opposing side. The courts can, without imposing severe punishments on the receiving attorney, preserve the integrity of the judicial process and sanctity of the attorney-client privilege and other privileges and protections by excluding from evidence on dispositive motions or at trial inadvertently

**MCLE Test No. 149**

The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education legal ethics credit by the State Bar of California in the amount of 1 hour.

1. To determine the scope of a lawyer’s ethical duties when he or she receives, through the inadvertence of opposing counsel, privileged documents of the opposing side, the California Supreme Court currently has under review the lower court ruling in:
   A. Aerojet-General Corporation v. Transport Indemnity Insurance.
   B. State Compensation Insurance Fund v. WPS, Inc. (State Fund).
   C. Rico v. Mitsubishi Motors Corporation.
   D. All of the above.

2. The American Bar Association Model Rules of Professional Conduct and the ABA Formal Opinions are not controlling in California.
   True.
   False.

3. According to ABA Formal Opinion 94-382, a lawyer who receives an adverse party’s privileged or confidential material as a result of a mistake by opposing counsel should:
   A. Promptly notify opposing counsel that the lawyer has the material.
   B. Immediately return the material to opposing counsel without reviewing it and before talking to opposing counsel.
   C. Use the material against the adverse party to further the interests of the lawyer’s client.
   D. All of the above.

4. In Aerojet, the court noted that:
   A. The attorney’s primary duty was “to protect the interests of his own clients.”
   B. An attorney who receives and reviews inadvertently produced documents from the opposing side is subject to automatic disqualification.
   C. “If a client should not enter the attorney-client relationship fearful that an inadvertent error by its counsel could result in a waiver of privileged information by an adversary who might abuse and discriminate the information with impunity.”
   D. None of the above.

5. The ABA has withdrawn its Formal Opinion 05-437.
   True.
   False.
6. What do Aerojet and State Fund have in common?
   A. Both resulted in the court of appeal affirming the disqualification of a lawyer who received the opposition’s privileged documents through the inadvertence of opposing counsel.
   B. Both resulted in the court of appeal reversing a sanctions order against a lawyer who received the opposition’s privileged documents through the inadvertence of opposing counsel.
   C. Both resulted in the court of appeal affirming an award of monetary sanctions against a lawyer who received the opposition’s privileged documents through the inadvertence of opposing counsel.
   D. None of the above.

7. In State Fund, the court of appeal was highly critical of ABA Formal Opinion 92-368.
   True.
   False.

8. Which competing duties of lawyers did the State Fund court of appeal try to balance?
   A. The duties of loyalty and confidentiality.
   B. The duties to zealously represent the client and to serve the administration of justice.
   C. The duties of candor and to serve the administration of justice.
   D. The duties of loyalty and to avoid conflicting interests.

9. In California, a lawyer’s inadvertent production of privileged documents to opposing counsel results in an automatic waiver of the attorney-client privilege for those documents.
   True.
   False.

10. According to the court in State Fund, a lawyer who receives clearly privileged documents from an adversary should stop reading the documents as soon as the privileged nature of the documents becomes apparent.
    True.
    False.

11. The State Fund court distinguished Aerojet because:
    A. The rule in Aerojet conflicted with ABA Formal Opinion 92-368.
    B. Aerojet was bad law and should be overruled.
    C. The information in the inadvertently produced document in Aerojet was not privileged.
    D. The privileged document in Aerojet was not inadvertently produced.

12. The court in State Fund referred to disqualification of the attorney receiving inadvertently produced documents as:
    A. The best remedy.
    B. An improper remedy that is not recognized in California.
    C. A better remedy than monetary sanctions.
    D. A draconian remedy.

13. The court of appeal in Rico relied heavily on Aerojet.
    True.
    False.

14. In Rico, the trial court and the appellate court were highly critical of the receiving attorney because he extensively reviewed the inadvertently produced document and showed it to his expert witnesses.
    True.
    False.

15. Under ABA Model Rule 4.4, the attorney’s only duty upon receiving inadvertently produced documents is to promptly disclose receipt of the documents to opposing counsel.
    True.
    False.

16. In a dispute over an inadvertent production of confidential or privileged documents, who has the burden of proving that the production of contested documents was inadvertent?
    A. The producing attorney.
    B. The receiving attorney.
    C. The client.
    D. The issue has not yet been determined.

17. Until the California Supreme Court rules in Rico, the prevailing rule governing the conduct of California lawyers who receive their opponents’ privileged documents through the inadvertence of opposing counsel is set forth in:
    A. ABA Model Rule 4.4.
    B. State Fund.
    C. The court of appeal decision in Rico.
    D. Aerojet.

18. The court of appeal in Rico found that inadvertently produced documents protected by the attorney work product doctrine—but not the attorney-client privilege—could be reviewed and used by the receiving attorney without limitation or risk of sanctions.
    True.
    False.

19. While the scope of a receiving attorney’s duty is not entirely clear, the most important single thing for the receiving attorney to do when he or she receives possibly privileged documents inadvertently produced by the opposing side is to:
    A. Promptly notify opposing counsel in writing of the receipt of the documents.
    B. Immediately send the documents back to opposing counsel without reading them.
    C. Initiate judicial proceedings to determine how the documents should be handled.
    D. Do nothing.

20. In Aerojet and State Fund, the parties that inadvertently produced the documents to the opposing side ended up winning their respective cases at trial.
    True.
    False.

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Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

1. □ A □ B □ C □ D
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3. □ A □ B □ C □ D
4. □ A □ B □ C □ D
5. □ True □ False
6. □ A □ B □ C □ D
7. □ True □ False
8. □ A □ B □ C □ D
9. □ True □ False
10. □ True □ False
11. □ A □ B □ C □ D
12. □ A □ B □ C □ D
13. □ True □ False
14. □ True □ False
15. □ True □ False
16. □ A □ B □ C □ D
17. □ A □ B □ C □ D
18. □ True □ False
19. □ A □ B □ C □ D
20. □ True □ False
produced privileged materials and any other evidence derived directly from those materials. While the receiving attorney may have obtained some actual or perceived advantage over his or her opponent as a result of receiving an inadvertently produced document, this advantage is minimal if the attorney is unable to use the document or privileged information at trial. Moreover, the courts should not be in the business of compelling attorneys to clean up their opposing counsel’s mistakes. A lawyer should adhere to a duty of fair play as an officer of the court. However, the courts should be careful not to advance amorphous interpretations of fair play at the expense of the lawyer’s fundamental duty to zealously represent his or her client.

In this time when ethical rules are not entirely clear and thus appear to be more like a moving target than they should be, California attorneys are well advised to protect themselves and their clients by promptly disclosing to opposing counsel in writing that they have received documents that may have been inadvertently produced. Thereafter, the burden should be on the producing attorney to put the issue before the court and demonstrate that: 1) the documents were given to opposing counsel through mistake, inadvertence, or neglect, 2) the documents are truly privileged, and 3) the privilege has not been waived.

The disclosure by the receiving attorney should be a safe harbor to defeat any subsequent motions by opposing counsel to disqualify the receiving attorney or experts or for monetary and other sanctions directed at the receiving attorney or his or her client. If appropriate, the court, after the disclosure, can exclude the privileged document from evidence and make any other in limine orders to protect the sanctity of privileged communications and the administration of justice.

2 Rico v. Mitsubishi Motors Corp., 116 Cal. App. 4th 51, 10 Cal. Rptr. 3d 601 (2004), Cal. Sup. Ct. Case No. S123808 (rev. granted June 9, 2004). The supreme court’s grant of review in Rico had the effect of depublishing the court of appeal decision so that it is no longer citable authority on this issue.
4 Id. at 1005-06.
5 Id. at 1005.
7 ABA’s Standing Committee on Ethics & Professional Responsibility, ABA Formal Op. No. 92-368.
8 ABA J., supra note 6.
9 ABA’s Standing Committee on Ethics & Professional Responsibility ABA Formal Op. No. 94-382.
10 State Comp. Ins. Fund v. WPS, Inc. (State Fund), 70 Cal. App. 4th 644, 656 (1999) [“[T]he ABA Model Rules of Professional Conduct may be considered as a collateral source, particularly in areas where there is no direct authority in California and there is no conflict...”].
with the public policy of California.” (emphasis in original)).

11 Id. at 644.
12 Id. at 651.
13 Id. at 655-56. Interestingly, the court did not appear to consider ABA Formal Opinion 94-382, which modified Formal Opinion 92-368. However, the rule developed by the court in State Fund is very similar to ABA Formal Opinion 94-382.

15 Id. at 657.
16 Id.
17 Id.
19 Id., 10 Cal. Rptr. 3d at 604. If the trial court had found that the receiving attorney had pilfered the document from opposing counsel, then the attorney would have been clearly guilty of misconduct and deserving of severe sanctions.

20 Id. at 616-17.
21 Id. at 614-15.
22 Id. at 614-15.
23 ABA J., supra note 6.
24 ABA MODEL RULES OF PROF'L CONDUCT R. 4.4 cmt.
25 Even more perplexing is how to treat inadvertently produced documents that are “confidential” but not privileged. Most businesses consider their internal documents produced in discovery to be confidential. It seems unworkable for an attorney’s obligation to be triggered every time he or she receives inadvertently produced confidential documents—especially when the documents (or information contained within them) are not privileged. Aerojet-General Corp. v. Transport Indem. Ins. Co., 18 Cal. App. 4th 996, 1005 (1993).
27 Aerojet, 18 Cal. App. 4th at 1003; Rico, 10 Cal. Rptr. 3d at 614.
28 Rico, 10 Cal. Rptr. 3d at 606.
29 Id. at 609.
30 Id. at 614-15.
31 Aerojet, 18 Cal. App. 4th at 1005.
32 See Mansell v. Otto, 108 Cal. App. 4th 265 (2003). The Mansell court declined to apply the rule in State Fund to a case in which a crime victim was suing a criminal defense attorney for reviewing her mental health records. The court found that defense counsel received the privileged medical records inadvertently from the prosecution. However, since the documents were produced pursuant to subpoena and defense counsel’s discovery requests, the court found that defense counsel could not reasonably have known that production of the records was “inadvertent.” Id. at 286.
33 Rico, 10 Cal. Rptr. at 616.
34 Courts for decades have used exclusionary rules of evidence in criminal cases to protect defendants from evidence obtained by the government through unlawful searches and seizures. In these cases—in which there is arguably more at stake than in most civil litigation—the exclusion of improperly obtained evidence is sufficient to protect the defendant’s interests and the administration of justice. Rarely are prosecutors or government officials punished for obtaining or trying to use evidence obtained from an unlawful search.
35 In Aerojet and State Fund, the parties that inadvertently produced the documents ultimately won their respective cases. Aerojet-General, 18 Cal. App. 4th at 1003-04; State Comp. Ins. Fund v. WPS, Inc. (State Fund), 70 Cal. App. 4th 644, 648 (1999).
It is often observed that, because of life insurance, a person may be worth more dead than alive. While the comment is usually played for ironic effect, it illustrates the essential role of life insurance in estate and financial planning. With many advisers recommending that their clients obtain life insurance in an amount equal to 10 years or more of expected earnings, a significant portion of a client’s estate—and financial legacy—may be in the form of life insurance.

Because income earned and the death benefit paid on a life insurance contract are not taxable as income, many assume that life insurance is wholly tax exempt, and some clients are surprised to learn that life insurance benefits received by designated beneficiaries may be substantially depleted by estate taxes. For those whose assets are exposed to estate taxes, the irrevocable life insurance trust (ILIT) has long served as a staple of tax-efficient wealth preservation and transfer planning—and for good reason. Perhaps no other estate planning option can match the benefits of an ILIT in terms of leveraging annual gifts, wealth building, preservation and protection, and tax savings.

As momentum for outright repeal of the estate tax appears to have stalled, rumors of the ILIT’s demise seem exaggerated. So long as the potential for estate taxation remains on the horizon, the ILIT will continue to pro-

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provide a proven structure for effective, tax-efficient wealth transfer. Therefore, attorneys should be familiar with the role of the ILIT in estate planning and the common issues presented in drafting an ILIT.

State Taxation of Life Insurance

Life insurance policies and proceeds are includible in an insured’s gross estate and subject to estate taxes if they are payable to the estate of the insured or if the insured retained any “incidents of ownership” over the policy at the time of death. The term “incidents of ownership” is far broader than ownership in a technical, legal sense and generally refers to the right of an insured or the insured’s estate to the economic benefits of a policy. An insured will be deemed to possess an incident of ownership if he or she possesses economic rights or benefits in a policy, such as the ability to change its designated beneficiary or to assign, pledge, cancel, or surrender the policy. Life insurance proceeds are also includible in the insured’s gross estate if a beneficiary of the policy may be required to use the funds to pay the obligations of the insured’s estate, such as child support or estate taxes.

A policy owned by an insured payable to his or her spouse, or to a qualified terminable interest property (QTIP) trust for the benefit of the spouse, will escape estate taxation on the death of the insured. However, estate taxation of the proceeds may only be deferred, not avoided, in these situations. Any portion of the death benefit left to a surviving spouse that remains unspent, or is converted into other property or investments, will ultimately be taxable on the spouse’s death.

Holding a life insurance policy in an irrevocable life insurance trust allows the insured to dictate to whom and in what manner the trust assets will pass, while avoiding the possession of any incidents of ownership over the policy at the time of death. A properly drafted and administered ILIT will prevent inclusion of life insurance proceeds in the insured’s gross estate and reduce estate taxes payable on the insured’s death. Ownership of a life insurance policy in an ILIT may also reduce the value of the insured’s taxable estate by serving as a repository for annual gifts eligible for exclusion from gift taxes. The benefits of an ILIT may be illustrated by looking at some of the circumstances in which they are commonly employed.

Provide liquidity for estate taxes. In perhaps the most common form of ILIT, a married couple who wish to retain ownership of assets until the death of the second spouse may establish an ILIT to hold a second-to-die or survivorship policy. The benefit paid to the trustee provides liquidity to beneficiaries and may enhance a family’s ability to maintain a business or profitable real estate holdings rather than sell them to pay taxes. A second-to-die policy is less expensive than a single-life policy and provides cash to beneficiaries at the time estate taxes become due.

Eliminate taxes on death benefit where the marital deduction is unavailable. If an insured is unmarried with young children, he or she may need to obtain substantial life insurance to replace lost income in the event of a premature death. An ILIT may hold life insurance, allowing the death benefit to pass to the insured’s children without reduction for estate taxes. If an insured is married with children from an earlier marriage, an irrevocable life insurance trust may provide for the children on death and allow the insured to pass other assets to a current spouse that qualify for the marital deduction.

Equalize or replace inheritances. When assets are not easily divisible, life insurance held in an ILIT may enable parents to equalize the value of property passing to each of their children. For example, parents who own a business may wish to provide equally to their children but pass control of the business to one child. Charitable donors of art or other property may also employ an ILIT to offset the loss of an inheritance, using the immediate income tax benefits of the charitable donation to fund an ILIT for their children.

Establish a generation-skipping-tax-exempt trust. An ILIT can provide an efficient vehicle for utilizing a trustor’s GST exemption and creating a long-term, multigenerational or “dynasty” trust. By allocating a trustor’s GST exemption to trust transfers and maintaining assets in trust for the lifetime of a trustor’s children, assets may be made available to children if needed, or allowed to grow and maintained for grandchildren or later descendants free from creditors and exempt from transfer taxes.

Protect against estate tax inclusion of transfers in trust. Life insurance also may be employed on a short-term basis to protect against estate taxes that may be levied if a grantor dies during the term of a grantor retained annuity trust or within three years of contributing an existing policy to an ILIT.

Establishing an ILIT

The trustor/insured should not act as trustee, as many powers normally held by a trustee—such as the powers to cancel, surrender, or borrow against a policy—will constitute incidents of ownership and result in the inclusion of policy proceeds in the insured’s gross estate, even if such powers were held solely in a fiduciary capacity. The initial trustee and successor trustees identified in the trust instrument may be related to the trustor. An insured should not, however, retain the power to remove and replace a trustee with himself or with a related or subordinate party. Cautious planners opt to have these powers held by a designated third party, commonly referred to as a trust protector, rather than by the insured.

A beneficiary may act as the sole trustee of a life insurance trust, but this decision should be made after consideration of the potential tax consequences. If a beneficiary is designated as a sole trustee, the distributive provisions of the trust should prevent the trustee from using trust property to satisfy his or her own personal obligations, such as child support, and should limit discretionary distributions to the beneficiary to an ascertainable standard, e.g., “health, education, maintenance and support,” to avoid inclusion of trust property in the beneficiary’s gross estate. An open issue exists as to whether trust income is taxable to the trust or to the trustee personally when a beneficiary acts as a sole trustee and possesses the right to distribute trust income or principal to himself or herself, although many believe the trustee will not be subject to income taxation individually on trust income if the trustee’s discretionary distributions to himself or herself are limited to an ascertainable standard.

Once an ILIT is established, the trustee generally obtains a policy on the life of the trustor. While an insured’s application for life insurance has been held not to constitute an incident of ownership in certain instances, it is a better practice to have the trustee alone deal with the insurance broker or agent and to submit an application for a policy after the ILIT has been established or to submit a new application from the trustee once an ILIT is in place.

At times, it may be necessary to transfer an existing policy owned by the insured into an ILIT, particularly if the insured has become uninsurable since the issuance of the policy. An insured’s transfer of an existing policy into an ILIT may require a gift tax return and the allocation of a portion of the transferor’s gift tax exemption to the transfer. In addition, if the insured dies within three years of the transfer of the policy to the ILIT, the death benefit is includible in the insured’s gross estate and subject to estate taxes. If an insured who is married plans to transfer an existing policy into an ILIT, the terms of the trust may include provisions that allow the payment of the death benefit to qualify for the marital deduction in the event of its inclusion in the insured’s gross estate, thereby deferring any estate taxation until the death of the surviving spouse.

Crummey Powers

One of the most common (and commonly misunderstood) features of an ILIT is the so-
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called Crummey withdrawal power, which allows the insured to transfer funds into the trust without incurring gift taxes and the trustee to obtain and pay premiums funds using annual gifts from the insured.24

A Crummey power transforms a transfer in trust from a future interest gift, which is not eligible for the annual gift tax exclusion, into a gift of a present interest in property that does qualify for annual exclusion.25 A transfer of property to an ILIT is a gift from the donor to the beneficiaries of the trust.26 The gift of a future interest, which would include most gifts in trust, does not qualify for the annual gift tax exclusion of $12,000 per donee.27 Consequently, a gift in trust may result in the use and depletion of some of the donor’s applicable credit amount, which is presently $1 million for lifetime gifts and $2 million for transfers on death,28 and may reduce some of the tax benefits of an ILIT or other irrevocable gift trust.29 The provision of Crummey rights allows a transfer in trust to be considered a “present interest gift” eligible for the annual exclusion and minimizes the unnecessary depletion of a donor’s lifetime gift and estate tax credits.30

A typical Crummey provision allows a trust beneficiary to withdraw a portion of a gift within 30 to 60 days of its contribution to the trust. The use of a period of less than 30 days is inadvisable.31 When a contribution is made to the trust, a written notification should be provided to those holding a Crummey power informing them of the amount contributed to the trust, the amount available for withdrawal, and the expiration date of the power.32 If the holder of a withdrawal power is a minor, notification should be sent to the minor’s legal guardian or, if none has been appointed, to the minor’s natural guardian or parent.33

In drafting the Crummey powers in an ILIT, it is essential not only to ensure that a gift will qualify for the gift-tax annual exclusion as a present interest but also to consider carefully the estate, gift, and GST tax consequences to beneficiaries of the release of a Crummey power.34 The holder of a Crummey power possesses a general power of appointment with respect to the property subject to a right of withdrawal.35 A beneficiary’s “release” of a Crummey power constitutes the release of a general power of appointment. Property subject to a general power of appointment released by the power holder is included in the beneficiary’s gross estate for purposes of calculating estate taxes on his or her death.36 The release of a Crummey power may also be considered a completed transfer subject to gift taxes.37

If a beneficiary simply fails to act, however, a Crummey power shall be deemed to have lapsed upon its expiration and will be considered a release of a general power of appointment only to the extent that the property subject to the lapsed power exceeds the greater of $5,000 or 5 percent of the value of trust property from which the withdrawal power could have been satisfied.38 For this reason, whenever possible, those establishing an ILIT should consider ways to avoid causing the release of Crummey powers and to limit lapses of Crummey powers to no more than $5,000 or 5 percent of a trust’s value in any year.

If a spouse is a beneficiary of the ILIT and provided Crummey powers, the spouse’s withdrawal right should be strictly limited to a period of no more than 60 days and should not exceed $5,000 or 5 percent of the trust, in order to avoid subjecting a portion of the trust to estate taxes on the spouse’s death.39

If the payment of policy premiums requires gifts to an ILIT in excess of $5,000 or 5 percent per trust beneficiary and exposes beneficiaries to potential transfer tax problems, one must weigh the options available to minimize adverse tax consequences to those granted Crummey powers. While a trustor may decide not to worry about such matters or to run the risk of potential adverse tax consequences for trust beneficiaries, this decision is one that should be made consciously. There is no simple, costless, or risk-free way to avoid taxable lapses that will fit all circumstances. There are, however, several options available to mitigate the potential for adverse gift and estate tax consequences.

Limit withdrawal powers and allocate trustor’s gift-tax exemption. If the amount required to pay policy premiums requires contributions to an ILIT in excess of the $5,000 or 5 percent limitation, the Crummey power may be limited to the greater of $5,000 or 5 percent, and the trustor may allocate a portion of his or her $1 million gift-tax exemption to the excess. To some extent, the use of exemption credit in this manner defeats one of the primary benefits of an ILIT, which is to provide a means of making gifts within the annual exclusion limits without utilizing a trustor’s transfer-tax credits. Each dollar of exemption credit used during the trustor’s lifetime is a dollar of credit that will be unavailable to shelter property from estate taxes on death. On the other hand, this cost may be acceptable when weighed against the overall benefits of the ILIT.

Grant additional Crummey powers. A trustor wishing to make larger gifts to an ILIT without applying his or her lifetime exemption may provide Crummey powers to persons who hold only contingent rights in the trust.40 The provision of these additional Crummey powers to potential trust beneficiaries may expand the available pool of donees and allow for larger premiums to be
paid annually without expending an insured’s lifetime exemption from gift taxes. Those not wishing to invite conflict with the IRS should avoid granting Crummey powers to those with no beneficial interest in the ILIT.

Limited power of appointment. If trust assets are to be distributed outright to an insured’s children on the death of the insured and would be subject to estate taxes on the beneficiary’s death, the trustor may decide not to be overly concerned about potential estate tax consequences to a beneficiary who dies prior to termination of the trust. In this circumstance, an ILIT may simply provide the beneficiary with a limited testamentary power to appoint property subject to Crummey powers on death. The limited testamentary power of appointment will prevent the release of a Crummey power from being considered a completed transfer for gift tax purposes and allow a trustor to utilize fully the $12,000 annual exclusion amount for gifts in trust. This strategy will not, however, eliminate the beneficiary’s exposure to estate taxes. Consequently, the use of limited powers of appointments alone is inadvisable if there exists a significant possibility that a beneficiary may die prior to the termination of the trust and have sufficient assets to incur estate taxes or if the trustor wishes to maintain assets in the ILIT for grandchildren or later generations. In either of these situations, it is critical that lapses be limited to the annual safe harbor of $5,000 or 5 percent, as estate taxes levied on a beneficiary’s death may substantially reduce the benefits of the ILIT.

Hanging powers. Another means of limiting lapses to $5,000 or 5 percent in any year is to include “hanging” Crummey powers in an ILIT. Hanging powers provide that Crummey rights granted to a beneficiary are cumulative and that each calendar year the withdrawal rights of a holder of a Crummey power shall expire in an amount equal to the greater of $5,000 or 5 percent of the value of the assets out of which the holder’s withdrawal rights could be satisfied, determined as of a particular date each year. The provision of hanging powers will work better when a trustor anticipates a limited duration for contributions to the ILIT, such as in the case of a 10-pay or 20-pay whole life policy. Hanging powers generally should not be granted when the ILIT holds only a term insurance policy, since there will exist no value in the policy if the insured survives the term. Since hanging powers are cumulative, an untimely death of a beneficiary could result in greater estate tax exposure than a simple Crummey power. If the trust is a GST-exempt trust, hanging powers should not be provided to a spouse, even if he or she is otherwise a beneficiary of an ILIT.
as the provision of Crummey power over more than the $5,000 or 5 percent limits or longer than 60 days would create an estate tax inclusion period preventing the allocation of GST exemption to the transfer.46

Generation-Skipping Trusts

A ILIT may provide for division among and distribution to grandchildren on the death of a child of the trustor or extend the term of the trust up to the maximum length permissible under law.47 However, assets contributed into the ILIT will generally not be eligible for the GST annual exclusion.48 For this reason, careful consideration must be given to the application of an insured settlor’s GST exemption.49

If a trustor’s intention is to create a generation-skipping trust, then the allocation of GST exemption to gifts made to the trust is advisable. Recent changes in the tax laws have made this process easier, indeed automatic, for lifetime transfers made to an ILIT defined as a GST trust.50 The term “GST trust” is defined as any trust “that could have a generation-skipping transfer with respect to the transferor,” unless 1) more than 25 percent of the trust corpus must be distributed to or may be withdrawn by a non-skip person before age 46, 2) more than 25 percent of the trust corpus must be distributed to or may be withdrawn by a non-skip person living on the date of death of another person identified in the instrument who is more than 10 years older than the non-skip person, 3) the trust instrument provides that, if a non-skip person dies on or before a date or event described in clause 1 or 2, more than 25 percent of the trust corpus either must be distributed to the estate or estates of a non-skip person or is subject to a general power of appointment exercisable by a non-skip person, or 4) any portion of the trust would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer.51

Under the definition of GST trust, contributions to an ILIT may be subject to automatic allocation one year but not the next. Accordingly, one should not assume that the automatic allocation rules apply or do not apply to a trust and should determine, at both the inception of an ILIT and in subsequent years, whether a trustor’s GST exemption should be applied to a particular gift.

The breadth of the definition of a GST trust also means that a trustor’s GST exemption may be automatically applied to trusts that are not intended as generation-skipping trusts. For example, if the terms of the ILIT provide for the maintenance of a share in trust until a child of the trustor attains the age of 35, the trust would constitute a GST trust until children possessing rights to more than
25 percent of the trust principal turn 35. In such cases, the automatic allocation of the trustor’s GST exemption would be wasteful, and an election out of the automatic allocation rules should be filed. Prudence dictates that one not rely too heavily on automatic GST allocations.

An irrevocable trust, particularly multigenerational trusts, should be drafted with sufficient flexibility to allow the trustee or other designated power holder to address changed circumstances. In order to provide maximum flexibility, the trustee or a designated trust protector may be granted specific powers to address changed circumstances, such as the power to terminate the trust and distribute assets directly to beneficiaries in the event that one of its primary purposes, such as estate tax reduction or avoidance, becomes obsolete, or the power to terminate or amend Crummey powers.

With estate taxes remaining a possibility for the foreseeable future, irrevocable life insurance trusts should retain their utility as a means of preserving assets exempt from transfer taxes. While the inclusion of an ILIT adds a moderate level of complexity to a client’s estate plan, the tax benefits are sufficiently compelling to warrant consideration whenever an estate is subject to significant estate taxation or life insurance is being considered to meet nontax objectives.

1 26 U.S.C. §§101(a)(1), 7702(g).
2 Although the term “irrevocable life insurance trust” is commonly used, in most cases, the trustee of an ILIT, whether or not the term “life insurance” is used within the title given to the trust, is not and should not be limited to holding only life insurance.
3 Press reports indicate that, since Hurricane Katrina relief delayed a planned vote last year, proponents lack the necessary 60 votes in the Senate to enact estate tax repeal. J. Harwood, Republicans Eying Modest Tax-Cut Victory, WALL STREET J., Mar. 31, 2006, at A4. Although repeal seems less likely than it did last year, the Senate may yet enact significant reforms, most likely, a substantial escalation of the applicable exclusion amount and reduction in the estate tax rate.
4 Even repeal may not spell the end of the estate tax, which has been previously repealed and later revived at least three times. See National Center for Policy Analysis, available at http://www.ncpa.org/pi/taxes/po071900b.html.
6 26 C.F.R. §20.2042-1(c)(2).
7 26 C.F.R. §20.2042-1(c)(2).
8 26 C.F.R. §20.2042-1(b)(1). If a beneficiary’s receipt of policy proceeds is subject to an obligation to pay an amount enforceable against the insured’s estate, the proceeds are taxable in the decedent’s gross estate up to the extent of such beneficiary’s obligation to pay.
9 Id. If the purpose of an ILIT is to provide liquidity to pay estate taxes, the trust should not require the trustee to meet the legal obligations of the insured, and estate taxes should not be paid directly from the ILIT. Instead, to provide cash for the payment of estate taxes, the terms of the ILIT should authorize the trustee to purchase assets from the insured’s estate or to loan funds to the executor of the insured’s estate.
10 26 U.S.C. §§2056(a), (b)(7).
11 26 U.S.C. §§2031(a), 2044(a).
12 26 U.S.C. §2031(b)(1). Section 2503(b)(1) excludes from the definition of “taxable gifts” the first $10,000 to a person each calendar year. Section 2503(b)(2) provides that the annual gift exclusion is adjusted upward in increments of $1,000 to account for increases in the Consumer Price Index since 1997. The annual exclusion amount for 2006 is $12,000.
16 Rev. Rul. 95-58; Priv. Ltr. Rul. 200314009. Related or subordinate parties include a grantor’s spouse (if living with the grantor), parents, issue, siblings, employees, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive. 26 U.S.C. §672(c). The definition does not include a grantor’s attorneys or accountants.
18 Compare 26 U.S.C. §678(a)(1) (“A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which…such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself…”) with United States v. De Bonchamps, 278 F. 2d 127, 130 (9th Cir. 1960) (life tenant not taxable where right to consume principal and income is limited by ascertainable standard).
20 Once a policy is obtained, a trustee should continue to review its performance over time and consider the possibility of exchanging a policy if more insurance can be obtained for the same premium payment.
21 26 U.S.C. §2512(a); 26 C.F.R. §25.2512-6(a).
23 See Crummey v. Commissioner, 397 F. 2d 82 (9th Cir. 1968). In Crummey, the Ninth Circuit held that a trust beneficiary’s right to withdraw a contribution to a trust was sufficient to create a “present interest” eligible for the gift tax annual exclusion under I.R.C. §2503. The IRS has subsequently accepted the analysis and result in Crummey. See, e.g., Rev. Rul. 85-24; Rev. Rul. 73-405.
24 The raison d’être of most ILITs is to reduce the insured’s taxable estate by making annual gift transfers in trust without incurring gift taxes or depleting the insured’s applicable transfer tax credits. However, the insured may not be the only party who makes gifts to an ILIT, and premium payments may be funded from principal or the income of assets held in an irrevocable trust as well as from annual gifts.
26 26 C.F.R. §25.2511-2(b).
27 26 U.S.C. §2035(a) & (c), 2505(a).
28 If an insured utilizes $500,000 of his or her lifetime gift tax credit on transfers to an ILIT, the available credit for estate taxes on death is reduced by the same $500,000, resulting in the payment of $230,000 in estate taxes, or 46 percent of $500,000.
30 Although the annual exclusion has on occasion been allowed even if a gift was subject to the withdrawal right for less than 30 days, the permissible period for withdrawals was not an issue for determination in these cases. See, e.g., Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991) (15 days); Crummey, 397 F. 2d at 87 (12 days).
31 Written notification serves as evidence that a beneficiary had actual knowledge of the withdrawal right. See Rev. Rul. 91-7.
32 See Rev. Rul. 73-405 (acquiescing in Crummey deci-
The provision and lapse of a Crummey right may also have income tax consequences to the beneficiary. See D. Evans, Drafting Crummey Powers, Probate and Property, Nov.-Dec. 1987, at 54.

26 C.F.R. §2514(c).

If the noncharitable beneficiary is a non-skip person.

26 C.F.R. §2514(b)(2), 2514(e). A mere lapse within the $5,000 or 5% limitations is also not deemed to constitute a transfer for purposes of the GST tax. Thus, a beneficiary who allows a Crummey right to lapse is deemed a transferor only to the extent that a lapse exceeds $5,000 or 5% of the value of trust property.


The effects of the release of a general power of appointment by a beneficiary over a course of years can have substantial adverse effects in the context of a GST-exempt ILIT designed to be held for the lifetime of a trustor’s children and pass outright to the trustor’s grandchildren. Under the applicable regulations, the value of the released general powers of appointment to be included in a beneficiary’s estate is determined by multiplying the fair market value of trust property at the time of the beneficiary’s death by a percentage calculated by taking the value of the property subject to the released power over the value of the trust corpus at the time of the release, with the applicable percentage at the time of each release being aggregated. Id.

44 In drafting an ILIT, hanging powers should not be dependent upon a determination of the gift or estate tax consequences of a lapse, as such provisions may be deemed a “condition subsequent” and ignored by the IRS, causing all amounts subject to the Crummey power to lapse each year. See Commissioner v. Procter, 142 F. 2d 824 (6th Cir. 1944), cert. denied, 323 U.S. 756.

45 26 C.F.R. §2541(a)(2).

California retains the rule against perpetuities as an impediment against perpetual noncharitable trusts, subject to certain modifications that allow an otherwise impermissible nonvested trust interest to continue for up to 90 years after its creation. Prob. Code §21205.

46 26 U.S.C. §2642(c). To qualify for the GST annual exclusion, a transfer in trust must be a “direct skip,” meaning that it is distributable only to a “skip person” during his or her life and that the property is subject to a general power of appointment by the skip person on death.


51 This provision is subject to the sunset provisions of the Economic Growth and Tax Relief and Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, and will be repealed in 2011 absent further congressional action.

52 A transferor may opt out as to a particular gift to a GST trust, specific future transfers or all transfers made to the trust or to any trust or, alternatively, elect to have a trust treated as a GST trust even if it would not otherwise qualify.
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1001 Avenue of the Stars, Suite 1700, Los Angeles, CA 90067, (310) 286-1700, fax (310) 286-1728, e-mail: brian.ehrich@ehrichlawfirm.com. Contact Jeffrey Isaac Ehrich. Mr. Ehrich is certified as an appellate specialist by the California Board of Legal Specialization. He has handled or supervised more than 170 appeals and has argued more than 60 appeals in state and federal courts throughout the U.S., including the United States Supreme Court. He was recently honored by Consumer Attorneys of Los Angeles as the Appellate Attorney of the Year. Some of Mr. Ehrich’s precedents include the first published decision in California to hold that an HMO can be sued for bad faith for delays in providing care; the decision upholding the retroactive extension of the statute of limitations for victims of the 1994 Northridge earthquake; and the decision holding that state common-law consumer protections apply to ERISA plans. Mr. Ehrich is a former partner of Shermoff Bigard & Daras, where he headed the firm’s appellate practice group. He is a cum laude graduate of the Harvard Law School and was a law clerk for the Hon. Judith N. Keep, former Chief Judge of U.S. District Court for the Southern District of California.

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BUILDING A USEFUL DOCUMENT DEPOSITORY is a process that employs overlapping technologies. Understanding them can help ensure that a law office invests its resources appropriately and that the resulting depository provides a functioning knowledge base with which to automate a practice. A document depository consists of any information that is stored in digital format with a mechanism for searching the data. At a law firm, a depository may be created for a case or for the firm in general. Once a depository is in place, it is necessary to create a means by which the information will be available internally and externally. This should be done bearing in mind that pieces of information may need to be extracted for a variety of needs, such as the preparation of motions or trial presentations.

The construction of a document depository begins with data, which may come in digital or hard-copy format. Data that is already digitized is easily used, because it can simply be loaded into the appropriate program for reviewing and sharing.

Hard-copy documents present a challenge because they first must be scanned into a digital format before they can be indexed. The most difficult hard-copy documents to scan are those that include handwritten notes or that exist in a size or format that does not fit the scanner that is being used. Most optical character recognition (OCR) software works well with a clean sheet of paper produced from a computer printer, but when a document has handwritten notes, signatures, graphics, or illegible text, the OCR program will find it difficult or impossible to convert these images into searchable text, and the result is nonsense. It is therefore important to use the best OCR software. It is constantly improving, and no vendor has a program that is indisputably the best. For these reasons, it is important to conduct periodic reviews of OCR development to ensure the best program for a given set of parameters is being used.

Adding Unscanned Documents

Even with OCR technology, documents and other miscellany will remain that resist standard scanning and input into the depository. The best way to handle these items is to create a separate document that includes an exact description, including all pertinent language, of the original and adding this summary document to the depository. For example, in real property litigation, there may be blueprints and schematics that cannot be scanned because the material is graphic, contains minimal text, or simply does not fit into the scanner being used. Instead, a description of each unscanned document or thing should be created, with fields such as To, From, Re, Date, Bates Number or Range, and Storage Location.

Other fields may prove useful. For example, a field may exist to allow the indexer to enter personal observations about a document. The document may include a handwritten note, for example, that indicates that an employer had strong feelings about an employee that are not explicitly mentioned. An indexer can note “A hates B” in this comment field, and it can later form a fruitful search term.

Document depositories depend on the connectivity between three main technologies to function: 1) an application server or data storage program, 2) methods of data searching and retrieval, and 3) data sharing and accessing. Of the two data storage technologies, an application server is far superior and more expensive, but it is one case of getting what one pays for. The power of an application server to run multiple programs concurrently, with security measures and functioning Internet access, surpasses any single program designed to fulfill this role. If funds or technical expertise is limited, a document depository software program can be used.

Application servers (using, for example, Share Point and SQL software) can help a firm automate one or more depositories and allow users to access and share the firm’s depository via any Internet connection. Access to data on a Share Point server is provided through a password protected log-in.

The distinction between an intranet and an extranet may not appear great to a computer user, but it is important for security purposes. An intranet is the local area network (LAN) that is found in most firms. It provides similar services within a firm to those provided to users generally by the Internet, but a LAN is not necessarily connected to the Internet. An intranet starts and ends at the office door.

An extranet, on the other hand, is the extension of a firm’s intranet onto the Internet. A common method for remote access is to provide users with a means of logging in to the firm’s Web site. Each user name and password is confirmed by the Share Point server, and each user’s preassigned access rights are granted upon logging in. One user may only have access to documents in a single case, while another user may have access to all documents in all cases.

The benefits of a depository to a deadline-driven staff are numerous, but there is also a hidden benefit. A depository can form the framework for a knowledge base. By adding the entire firm’s work product (all motions, research, and so on) into a depository, a firm can transform the depository into a knowledge base. Not only will the data allow various tasks to become much more automated, it also can provide a firm with the ability to work as with one mind.

Benjamin Sotelo is president of Legal Friendly Technologies and can be reached at Benjamin@LegalFriendly.com. Gregory D. Brenner practices criminal law in Beverly Hills and can be reached at greg@beverlyhillsdefense.com.
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State of the Unions

ON THURSDAY, JUNE 8, the Intellectual Property and Entertainment Law Section (IPEL), with the cosponsorship of the Screen Actors Guild, will present a program titled “State of the Unions: An Update from DGA, SAG, and WGA: Labor and Entertainment Law and Negotiation.” The program, featuring speakers Robert S. Giolito, Anthony R. Segall, and David P. White, will take place in the James Cagney Room at the SAG offices, 5757 Wilshire Boulevard in Los Angeles. Those who attend will hear the general counsels of the big three discuss recent guild accomplishments and the challenges facing the industry in the near future. The panel will also be taking questions. Parking is free. On-site registration and the meal will begin at 11:45 A.M., with the program continuing from 12:30 to 1:30 P.M. The registration code number is 009328. The prices below include the meal.

$31—CLE+Plus members
$60—Intellectual Property and Entertainment Law Section members
$75—LACBA members
$85—all others
$90—at-the-door payment for all
1 CLE hour

Enforcement Proceedings in Family Law

ON SATURDAY, JUNE 10, the Family Law Section will present a program titled “Enforcement Proceedings in Family Law: A How-To Guide to Enforcing Court Orders.” Panelists Michael Brourman, Commissioner Keith M. Clemens, and Ira M. Friedman will discuss the preparation, recording, and execution of contempts, writs, wage assignments, abstracts of judgments, and liens. This panel discussion will take place at the Olympic Collection, 11301 Olympic Boulevard, Suite 204, in Los Angeles. Those who attend will hear the general counsels of the big three discuss recent guild accomplishments and the challenges facing the industry in the near future. The panel will also be taking questions. Parking is free. On-site registration and the meal will begin at 11:45 A.M., with the program continuing from 12:30 to 1:30 P.M. The registration code number is 009328. The prices below include the meal.

$50—CLE+Plus members
$90—Family Law Section members and Barristers
$105—other LACBA members
$115—all others
$120—at the door
3.25 CLE hours with family law legal specialization

BREAKFAST AT THE BAR

ON THURSDAY, JUNE 15, the Litigation Section will present a Breakfast at the Bar discussion about complex litigation. The program will take place at the LACBA/LexisNexis Conference Center, 281 South Figueroa Street, Downtown. Reduced parking is available with validation for $9. On-site registration and the meal will begin at 7:00 A.M., with the program continuing from 7:30 to 8:30. The registration code number is 009221. The prices below include the meal.

$15—CLE+Plus members
$45—attorneys with over two years in practice
$40—attorneys with under two years in practice
1 CLE hour
Are You the Problem? Ask Your Clients

YEARS AGO, WHEN I PRACTICED LAW—before I began coaching and consulting with lawyers—I was very involved with the State Bar of California's campaign to raise the image of lawyers. I believed this was a losing battle, because 50 percent of the parties in litigation lose their lawsuit and will likely think that the opposing side's attorney was mean spirited, unethical, and unprofessional. To my surprise, focus groups that the State Bar conducted proved me wrong. The focus group participants almost unanimously agreed that their attorney—not the opposing side's lawyer—created problems. They complained about poor service, failure to return phone calls, inaccurate arithmetic on billing statements, and on and on and on.

I firmly believe that running a law firm in a businesslike way improves the professionalism of the practice of law. A law firm run as a business will approach client service more efficiently, including returning phone calls promptly, creating and adhering to a budget, and providing sufficient detail on clients' invoices. You cannot truly be a professional service business until you understand the practice of law as a business.

Bar associations do not give practice management training enough respect. Some, in fact, reject MCLE credit altogether for programs dealing with practice management. The real message is that lawyers need not be concerned with what clients think about the way they conduct their business—that, in fact, lawyers need not answer to their clients. Yet, when more than 60 percent of California's discipline complaints involve client service (and 80 percent of our State Bar dues support the disciplinary system), practice management should be the major focus of the State Bar's education requirements. Why is it that most other professions require significantly more continuing education than the State Bar does?

The “conspiracy” between law schools and bar associations continues to demonstrate the archaic attitude that management and customer/client care issues are irrelevant. We do not require any type of client relations, business management, or quality improvement training in our law schools. In fact, educators have told me that their view of law as a profession means that programs about effective client communication or service improvement are trade-oriented and therefore inappropriate for law school curricula. Is it any wonder that our bar associations do not require law practice management programs as part of the MCLE requirements? And then we wonder why lawyers get a bad rap, why clients are angry and rightfully believe they have no recourse to redress the management wrongs committed by lawyers.

A Firmwide Commitment

It is important to note that the problem is not limited to lawyers alone. Everyone in a law firm—staff and support personnel—should be committed to client service. The success and satisfaction of any lawyer, even solos who frequently think of themselves as lone rangers, should depend on being part of an effective team. Technology has conspired with traditional attitudes to make many solo practitioners believe they truly can get away with an “I can manage 100 cases by myself because I always know what needs to get done” mentality. Thinking you can do it all yourself leads to an overwhelmed practice that is either headed into the hands of the State Bar disciplinary system or into insolvency.

In the larger picture, building a team is inseparable from teaching everyone in your office, including staff and associates, the skills to provide better service and enhanced performance to your clients.

The focus group participants almost unanimously agreed that their attorney—not the opposing side's lawyer—created problems.

Everyone in your office should be taking hours of client service education programs each year. When you are out with clients, the last thing you want to worry about is what someone back at the office might be saying to another client on the telephone.

For lawyers and staff the bottom line for client service must be client communication. A recent study reported that doctors talk three minutes longer with their patients/clients than other professionals and that doctors are sued less than lawyers. The study called this extra communication a “marketing” tactic that lowered the risk of malpractice. The conclusion is undoubtedly farfetched, but it is true that the focus of the conversation between a professional and a client/patient/customer must be to understand the intent and desires and wants of the client. If the professional and the client are in harmony and the client understands what to expect from the professional, there is little likelihood of a malpractice claim.

Lawyers help improve people's lives. And we need to let our clients know that. When that happens, fees are not an issue, and client complaints are not a problem. When that does not happen, lawyers are at best seen as a burdensome cost and a necessary evil. Without our clients we have no reason to exist as lawyers. We must find out not only what our clients need but also what they want. We must communicate with them at their level of understanding, learn what they need, and provide it to them in a way they can understand.

What can you do to change the way clients and prospective clients perceive you? How can you communicate the ways that you help improve their lives? The future of your practice may depend on your answers.

Edward Poll, a former practicing attorney, is a Venice-based consultant and strategist who coaches attorneys and law firms on practice management issues.
The Law School awarded 289 Juris Doctor degrees.

LL.M. degrees in U.S. Legal Skills were awarded to twelve students representing Canada, England, France, Germany, Korea, the Philippines, Russia, Spain, and Thailand.

JOSEPH DUNN, California Senator for the 34th District, gave the Commencement Address.

Honorary degrees were presented to:

JOSEPH DUNN, California Senator for the 34th District
CRUZ M. BUSTAMANTE, Lieutenant Governor, State of California

ARTURO LATAJ JOHNSON, President of the Student Bar Association Presented the Teacher of the Year Award to co-recipients PROFESSOR PATRICIA LEARY and ASSOCIATE DEAN MARIO MAINERO.

SARAH ANN HODGSON gave the Valedictorian Address.

KEITH RODENHUIS gave the student address.
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