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IMPACT

An Overview of Current Legal Events of Concern and Interest

From the Attorneys of Strauss & Troy, Cincinnati, Ohio, and Northern Kentucky *Fall 2002*

TITLE INSURANCE — SHIELD AND SWORD

By: William V. Strauss

Any reader of recent Cincinnati and Northern Kentucky newspapers is aware of a disastrous situation in the local residential marketplace involving unpaid mortgages and mechanics' liens on single-family homes. Suddenly title insurance is in the spotlight, and literally in the headlines ("Title Insurance Sales Heat Up," *Cincinnati Post,* April 29, 2002). The purpose of this article is to go behind the headlines to describe the nature of title insurance and to show how title insurance can be used not only to protect owners and lenders, but also proactively, *i.e.* to make deals happen. In other words, title insurance can be a sword as well as a shield. (In the interest of full disclosure, I should point out that our firm owns title agencies in both Cincinnati and Kentucky, each of which writes title insurance for major national underwriters.)

The Shield

A title insurance policy is a contract of indemnity, providing that if the status of title to real estate is not as represented in the policy, the insurer will reimburse the insured for the resulting loss (up to the face amount of the policy) plus the cost of defending the title or the lien of the insured mortgage. The costs of defending a claim are a major part of the insurance coverage and are not limited by the face amount of the policy.

Even though insurers have a title search performed as the basis for the policy, the policy also provides coverage against title defects that cannot be ascertained from the records in the course of a title search, such as documents that are improperly indexed or even fraudulent. This is one reason why title insurance is preferable to opinions of title, which are usually limited to matters of record and are collectable only if the injured party can show that the person rendering the opinion (usually an attorney) was negligent. Also, because title insurance provides a national standard and comfort level required by companies who are in the business of buying mortgages, it provides liquidity in the marketplace, where mortgages are packaged, bought, and sold like any commodity.

Most forms of insurance protect the insured against losses or damages caused by an event such as a fire or an automobile accident during the policy period. Title insurance protects against loss or damage caused by matters in existence as of the date of the policy; for title insurance, there is only a one-time premium, due at the time the policy is issued.

The title insurance shield covers both owners and lenders. A protected property owner is entitled to recover damages in an amount equal to the difference between the value of the property with and without the lien, encumbrance, or other defect. Lenders normally are not damaged unless the title defect lowers the value of the property below the amount necessary to repay the loan, or if there is an impairment of the mortgage priority.

The Sword

Contrary to popular belief, all title insurance is not created equal. Since premiums generally are standardized, title agencies may provide additional value and services in order to compete. In addition to providing protection to owners and lenders, title agencies provide escrow and closing services, and handle disbursements during construction projects to protect against mechanics liens.

Title agencies can also add value by resolving title problems prior to closing. For example, our firm's Cincinnati title agency was able to insure necessary access for a commercial development when our examiner determined that an 1849 street dedication was ineffectively vacated in 1905 for the very *portion* of a street which was located between the subject property and the highway. (For title examiners and real estate attorneys this is fodder for animated cocktail party conversations!) More routinely, title problems can be handled prior to closing by obtaining quitclaim deeds, affidavits as to title, and other documents to clear the title.

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In addition, the title insurance industry has progressed beyond its historic role and has taken on untraditional kinds of risks:

- Title companies provide "gap" coverage against unknown events that could adversely affect the status of title between the pre-closing title update and the time the closing documents are recorded.
- Title insurance can "insure over" certain types of problems that cannot otherwise be resolved. For example, the company may insure against loss or damage where the survey shows a utility easement under a building, because it is improbable that there will be a resulting economic loss. In another example, the company might insure against loss or damage where a parcel violates a single-family residential restriction, but is located in an area with a pattern of commercial use.
- Title companies have gotten into areas beyond traditional title insurance by covering matters relating to zoning, survey, and environmental issues; typically, this is accomplished by issuing endorsements to the policy to provide additional coverage (which in some cases may involve an increased premium).

An experienced title agency knows how to work with its clients to overcome title problems and get to closing. Underwriters allow such agents to be flexible and creative in these matters because of their confidence in the title agency, its judgment, and their fiduciary relationship.

Bill Strauss is President of Strauss & Troy and President of Security Title and Guaranty Agency, Inc.

THE NEW AND YOUNGER FACE OF AGE DISCRIMINATION

By: Paul B. Calico

The Age Discrimination in Employment Act of 1967 (ADEA) protects persons 40 years of age and older from employment discrimination "because of age." The statutory protection relates to all aspects of employment, including hiring, firing, promotions, layoffs, compensation, benefits, job assignments, and training.

Because the ADEA was enacted in response to perceived problems of discrimination against older employees, most age-related cases have focused on situations in which an employer allegedly discriminated in favor of younger applicants or workers. If the older plaintiff/employee can show that the employer discriminated against him or her in favor of a younger person, the employer is liable for damages, which can be extensive and include attorney's fees.

Until recently, one of the few novel questions to arise under the Act was whether there could be discrimination within the protected class (persons 40 and over). For example, could an employer lawfully favor a 42-year-old worker over a 59-year-old worker? In 1996, the United States Supreme Court held that it is unlawful for an employer to discriminate in favor of a substantially younger worker, even if the younger worker is over the age of 40.

The converse of that issue is whether an employer could lawfully favor the 59-year-old worker over the 42-year-old worker. There was a difference of opinion on this issue of so-called "reverse age discrimination." The Equal Opportunity Employment Commission (EEOC) has interpreted the ADEA as prohibiting age discrimination within the protected class, regardless of whether the more favorably treated workers are older or younger than the other workers. Under the EEOC's reasoning if a 42-year-old and a 52-year-old apply for the same position, the employer may not reject either applicant on the basis of age, but must instead make its decision on the basis of the applicants' qualifications.

In contrast, the majority of courts to consider this issue have held that the ADEA does not provide a cause of action for reverse age discrimination. However, only weeks ago, the Sixth Circuit Court of Appeals (the federal Circuit that includes Ohio and Kentucky) issued an opinion in which it concluded that a company may be held liable for discriminating against *younger* workers, as long as they are over 40.

In the case of *Cline v. General Dynamics Land Systems, Inc.*, the company enacted a new policy that substantially altered employees' eligibility for health care benefits upon retirement. Previously, the company provided full benefits to all retiring employees with 30 years of seniority. Under the new policy, only those employees who were over 50 years old as of a certain date could receive full health benefits upon retirement. A group of employees between the ages of 40 and 49 as of the effective date filed suit, alleging that the favorable health benefits provided solely to workers over the age of 50 constituted illegal discrimination on the basis of age.

The district court acknowledged that the company's policy appeared to discriminate against the younger workers, but it concluded that the ADEA was intended to aid only older workers. Thus, it dismissed the suit.

On appeal, the Sixth Circuit examined the literal language of the statute, stating that such was the best way to determine Congressional intent. Based on the plain language of the ADEA, which forbids employment discrimination "based on age," the court found that workplace discrimination is prohibited, regardless whether the plaintiffs are older or younger than the favored employees. The only restriction is that the plaintiffs must be members of the protected class - those at least 40 years of age. Because the General Dynamics policy clearly favored older employees, the court reversed the lower court's dismissal, allowing the case to proceed to trial.

Priming the Issue for the Supreme Court

In contrast to the Sixth Circuit, courts in the First, Second, and Seventh Circuits (covering different geographical areas in the United States) have held that that the ADEA does not protect younger workers from employment practices favoring older employees. Because of the different decisions reached in different circuits, it is likely that this matter will be addressed by the United States Supreme Court. One obvious goal of our federal laws is uniform interpretation so that employers in Ohio are governed by the same principles as those in Idaho, for example.

However, any appeal to the Supreme Court would not be heard and finalized for at least a year, probably considerably longer. Unless and until the Supreme Court addresses this issue, the *Cline* decision remains the governing law in Ohio and Kentucky. **For employers in this Circuit, the safest course of action is simply not to take age into account — one way or the other — when making employment decisions.** According to the Sixth Circuit, that is precisely what Congress had in mind when it prohibited employment discrimination "based on age."

Paul Calico is a member of the Strauss & Troy Litigation Department and devotes a substantial portion of his practice to issues relating to employment law.

Limited Liability Companies and the Passive Activity Loss Rules

By: Jeremy A. Hayden

The limited liability company ("LLC"), a relatively new form of doing business, is gaining popularity as the choice of entity for many small business owners. An LLC is a "hybrid entity" that borrows advantageous elements from other business entities. For example, LLCs offer limited liability protection similar to that of corporations, while simultaneously offering the flexibility, informality, and favorable tax treatment afforded to partnerships.

Despite the increased popularity of LLCs, there are potential drawbacks. One notable drawback is the applicability of certain tax law provisions, including "passive activity loss" rules. The position of the IRS in this area can make LLCs a less than desirable choice for taxpayers with passive losses.

Passive Activity Loss Rules In General

Passive activity loss rules are applicable to partnerships, S-corporations, LLCs, and closely held corporations and are an important consideration for most small business owners because they can limit the ability to offset income with losses. As a general rule, losses from passive activities can only offset income from the same passive activity. In addition, if the losses from a passive activity exceed the profits from that activity, they are suspended until the profits increase to a level sufficient to absorb the losses or the taxpayer disposes of the activity. Further, income from dividends and interest is classified as "non-passive" to avoid easy contravention of these rules.

An activity is considered "passive" when the taxpayer does not materially participate. To qualify as materially participating, the taxpayer's involvement in the activity must be "regular, continuous, and substantial." While there are Treasury regulations interpreting this standard, they were promulgated before the advent of the LLC and thus do not provide express guidance for application of the rules to LLCs.

Nonetheless, the regulations are still important since the IRS relies on them in determining the proper tax treatment of LLC members. Under the regulations, there are seven tests to determine whether general partners qualify as materially participating in a partnership. In contrast, limited partners are presumed not to materially participate and may only qualify under three of the seven tests. Thus, whether an LLC member is equated with a general or limited partner can have significant consequences in the application of the passive activity loss rules. A recent case of first impression is instructive on this issue.

The Gregg Case

In the *Gregg* case, a federal district court in Oregon held that members of LLCs are not *per se* considered to be limited partners for purposes of the passive activity loss rules. Principally relying on the Treasury regulations, the IRS argued that LLC members should be treated as limited partners because the liability of an LLC member is limited under state law. The court rejected this argument and held that the limited partnership test was obsolete as applied to LLCs. The court noted that the regulations were promulgated before LLCs existed and that LLCs are materially distinguishable from limited partnerships.

The Controversy Continues

Unfortunately, because lower federal courts and U.S. tax courts are required to follow only the case law of the federal appellate court for their own district, the Gregg case is binding precedent only in tax courts in Oregon. Thus, the *Gregg* case did not resolve the dilemma about application of passive activity loss rules to LLCs for taxpayers outside of Oregon.

Not surprisingly, the IRS has not embraced the decision in *Gregg*. In a recent controversy between a taxpayer and a state taxing authority concerning application of the passive activity loss rules to an LLC, the state indicated that the IRS has decided to ignore *Gregg* and instead will strictly apply its own interpretation under the Treasury regulations. Therefore, the IRS continues to adhere to the position that LLC members are subject to the more restrictive passive activity rules for limited partners.

While the *Gregg* case did not ultimately resolve the issue, it does provide support for taxpayers asserting that members of LLCs are not *per se* limited partners for purposes of the passive activity loss rules. In fact, although Gregg is not binding outside of Oregon, it does provide the basis for taxpayers to take a position regarding passive losses without risking subsequent fines and penalties. Further, the case could not have made a better and more direct plea to Congress for specific legislation in this area. In the absence of Congressional action, the well-written and very well reasoned opinion provides a framework for similar decisions in other jurisdictions. Finally, the IRS did not appeal the *Gregg* decision, which suggests that the IRS may be unwilling to litigate where the facts favor the taxpayer. This is potentially good news for taxpayers similarly situated to the taxpayers in the Gregg case.

Advice

It is difficult to predict what future action may be taken regarding the application of passive activity loss rules to LLCs. Fortunately, there are a number of potential solutions that are both fair to LLC members and yet do not create a large tax loophole that would be a drain on the Treasury. For example, a distinction might be made according to whether an LLC is managed by its members or outside managers. Arguably, where an LLC is member-managed, its members would be treated as general partners, while members of an LLC with an outside manager would be considered limited partners. Alternatively, the determination could be made on an individual facts and circumstances rest. Finally, perhaps the best solution is to adopt new legislation or regulations that refer directly to LLCs rather than continuing to classify members based on the distinctions relating to partnership law.

Jeremy Hayden is an associate in Strauss & Troy's Tax Department. His practice includes providing assistance regarding LLCs and representing taxpayers in matters before the IRS and state and local taxing authorities.

Sponsorships

In recent months, you may have noticed Strauss & Troy's name as a sponsor of a variety of deserving causes. Such sponsorships are an integral part of our commitment to the Greater Cincinnati community. We have a long and rich tradition of sharing our gifts and talents with others in our community through charitable donations, community service, and civic involvement. As a part of Strauss & Troy's "Your community — Our Commitment" program, we are proud to have supported the following events in the last few months:

- Make a Difference Team — *WCPO United Way Community Care Week*
- WVXU — *Morning Edition*
- *Downtown Cincinnati, Inc.*
- *The School for Creative and Performing Arts/Annual Giving Campaign*
- *Playhouse in the Park* — Abracadabra Gala
- *NAACP* — Cincinnati Freedom Dinner
- *Jewish National Fund Dinner*
- *Jewish Community Center*
- *Cedar Village*
- *Loveland Chamber of Commerce*
- *Tour de Loveland* — Corporate Challenge Race
- *City of Loveland Fourth of July Celebration*
- *Northern Kentucky University Norse Athletics*
- *Laura P. Elizabeth Golf Outing*
- *University of Cincinnati College of Law*
- *American Corporate Counsel Association*
- *Cincinnati Bar Association*

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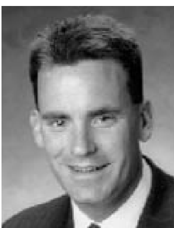
Claudia Allen

Claudia Allen recently spoke at the *Jay Brinker Tax Semina*r at the Metropolitan Club in Covington, Kentucky. This annual seminar is offered to insurance professionals to provide Continuing Education credits and includes speakers from several other Cincinnati firms. Claudia's presentation, entitled *Qualified Plans: A Tax Law Update and Some New Twists*, included an overview of recent tax law changes affecting IRAs, 401(k), Profit Sharing and Pension Plans, and related savings opportunities. She also discussed Employee Stock Ownership Plans and their uses in transaction planning as a financing tool and as a tax minimizer. Additionally, Ms. Allen will speak on *College Savings Plans at the Southwest Ohio Tax Institute* on December 6, 2002.


August T. Janszen

In September, **August T. Janszen** hosted attorney Yost Kaeger from Munich, Germany was part of the *Cincinnati Bar Association/Munich Bar Association Exchange Program*. The program is designed to facilitate cooperation and international marketing opportunities between the cities and the bar of each city. Mr. Janszen has been part of the program for 3 years.

Anthony M. Barlow

In July, **Anthony M. Barlow** presented a seminar for the *Better Housing League* at the offices of the *Northern Kentucky Home Builders Association*. The seminar was designed for private persons interested in serving as general contractors for the construction of their own homes. Mr. Barlow, **Charles Ashdown** and **Pete Smith** teach a number of these classes each year in both Kentucky and Ohio and Kentucky.

Paul Calico

Paul Calico was on the faculty of a seminar entitled *Construction Lien Law in Ohio* in Dayton, Ohio. Paul's topics were "Residential Liens: Home Construction and Home Purchase Contracts" and "Alternative Dispute Resolution in Construction Matters."

Inner City Youth Opportunities Honors Strauss & Troy and its Make a Difference Team

Friends and supporters of Inner City Youth Opportunities, a local non-profit organization, recently honored Strauss & Troy and the members of our Make a Difference Team at a dinner-fundraiser at J's Fresh Seafood Restaurant. Emcees of the event were Rob Williams and Sheila Gray from Channel 19's Morning Show.

Strauss & Troy has teamed with Riverfront Kiwanis to send 36 inner city children to YMCA Camp Ernst every summer for the past five years. In addition to Strauss & Troy's financial contributions, members of the firm's Make a Difference Team ensure that each child has ample provisions for camp, and personally participate with the children to enrich their experience. The children enjoy a week of making new friends, riding horses, swimming, and other camp activities that most inner city children may never have the opportunity to experience.

Jeanne Bell, Director of ICYO, said that "Strauss & Troy and its Make a Difference Team show how contributing to the community through Inner City Youth Opportunities can help change the lives of Cincinnati's inner city children." Strauss & Troy is proud to support Inner City Youth Opportunities as a part of our continuing commitment to the city in which we work and live.

Making A Difference

On Saturday, September 14, 2002, Strauss & Troy's **Make a Difference Team ("MAD Team")** will be working with *The American Red Cross* to assemble emergency first aid kits for disaster relief purposes. This is the ninth year that Strauss & Troy's MAD Team has participated in *Community Care Week* with the United Way. Over the years, the Team has been paired with Cincinnati Area Senior Services' Meals on Wheels Program, Winton Place Youth Services, Services United for Mothers and Adolescents, Freestore/Foodbank, United Home Care, Memorial Community Center and Redwood School. Community Care Week teams local business with agencies in the Greater Cincinnati area to provide much needed volunteer services for these agencies.

The Verdin Company

Steve George and James Verdin are discovering that manufacturing for history can be history-making itself.

Last year, George, executive director of the Ohio Bicentennial Commission, approached Verdin with an idea. George wanted to have bells manufactured and placed in Ohio's 88 counties to commemorate the state's bicentennial. And he knew that Verdin's Cincinnati-based company — known worldwide for excellence in clock and bell-making — would be perfect for the task.

"Bells are as old as civilization itself," George says. "They've always called people together for various purposes." Even the New York Stock Exchange, he notes, begins and ends with a bell-ringing.

So James Verdin, president of the 175-employee, $20 million corporation, took the idea to his cousins, Robert, CEO, and David, vice president. Although they foresaw several challenges — most notably the cost and logistics of taking a foundry on the road — the company accepted the job. It built a $1.7 million mobile bell manufacturing plant, and its employees are now on a bell crusade, making bells from scratch at county fairs and festivals. Their goal is to finish by October 2003.

"Each bell costs exactly $19,500," says George. "Once it's produced, and it looks excellent, then we see if it rings. If it does, then they get paid."

Verdin's first stop was Marietta in Washington County, where employees constructed a 2-foot-by-2-foot, 200-plus pound bell molded in the style of Philadelphia's Liberty Bell. The tour, which began in fall 2001, includes about 40 stops this year and 40 next year. Each model is inscribed with the county name, casting date, bicentennial logo and seal of Ohio.

"The process is expensive, of course," says James Verdin, part of the fifth generation of Verdins to run the business. "But what you have is something that will last a few centuries."

Founded in 1842, Verdin is the oldest family-owned business in Cincinnati and the oldest manufacturing company in Ohio. It is the world's largest supplier of bells, carillons, and clocks. Its most renowned works include the 33-ton, 12-foot tall World Peace Bell in Newport, Kentucky (the world's largest swinging bell), and the 40-foot wide steel and Plexiglas ceiling clock installed in the rotunda at the Lexington Public Library in Kentucky. But it's Ohio that gets to boast a bicentennial bell in every county.

"Back in the 16th century, bell foundries would actually take their foundry to the church and cast their bell on the site, because it was too heavy to transport," James Verdin notes. But these days, when you're working with molten metal, you don't just hop in the car and go make a bell.

Nevertheless, George envisioned bells being cast outdoors and with community participation, so safety is a top priority. In fact in each county, children form a line and pass ingots of 80 percent copper and 20 percent tin to the bell-makers.

Of course, the weather presents a challenge, Verdin says ("rain and metal don't mix"), and he adds that cold air doesn't help the process. So manufacturing takes place during summer and early fall.

Special-projects manager Pete Bolton was charged with designing a trailer — which became two trailers as the project grew — to transport the bell-making equipment. "For about three months, we worked a lot of nights and a lot of weekends," he says.

For this on-site project, the bell-making process typically lasts two days. It begins with casting preparation and igniting foundry fires; then melting and pouring 40-pound metal bars into the mold; then removing the mold the next day with sledgehammers; and finally polishing the bell for the ceremonial first ring.

And when this project ends, what will happen to The Verdin Company road show? Nobody knows, but the "foundry on wheels" won't be dismantled, Dave says. "I'd put them in my back yard before that happens."

For more information about The Verdin Company, please feel free to contact Mr. James Verdin at The Verdin Company, 444 Reading Road, Cincinnati, Ohio 45202, 1-800-543-0488, or visit its website at www.verdin.com.