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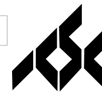

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# Shopping Center Legal Update

***The legal journal of the shopping center industry***

**In Depth**

California Becomes the First State to Require Energy Usage Disclosures by Commercial Property Owners 2

California Supreme Court Puts the Zip Back into Zip Code Consumer Protection Class Actions 5

How Do I Fix This Holey Mess? A Case Study of Title Trauma 9

Gift Cards: Opportunities and Issues for Retailers 12

Tenant Options for Landlord Financial Distress and Landlord Bankruptcy 18

Supreme Court Tightens the Rules for Employment Class Actions 22

*Cases* 24

Florida Appellate Court Examines the Question of the Scope of Commercial Easement 24

California Appellate Court Rules Against Mall Operator in a Free Speech Case 24

Party Signing Lease on Behalf of an Entity Found to Be Potentially Personally Liable 25

Florida Adopts *Landmark Community Planning Act* 26

**From Canada**

Supreme Court Clarifies When Insurance Companies Must Respond to Defend Construction Deficiency Claims 27

# California Becomes the First State to Require Energy Usage Disclosures by Commercial Property Owners

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Just as automakers have used "miles-per-gallon" labels for years to advertise fuel efficiency, the real estate industry is now being pushed to use similar labels to become more transparent, energy-conscious and fuel-efficient.

In 2012,[1] owners and operators of non-residential buildings in California, which are solely owner-occupied, or which contain a total floor area measuring 50,000 sq. ft. or more, must disclose the building's U.S. Environmental Protection Agency (EPA) Energy Star® Portfolio Manager benchmarking data and ratings for the most recent 12-month period to any prospective buyer, lessee of the entire building or lender that proposes to finance the entire building.[2] Although the California Energy Commission's proposed phase-in schedule initially set a Jan. 1, 2011, start date for these requirements, the Draft Regulations have not yet been formally adopted, and it is now estimated that the program will begin in 2012. The Draft Regulations also originally required these same disclosures for non-residential buildings containing 10,000 sq. ft. to 50,000 sq. ft., beginning Jan. 1, 2012, and for all non-residential buildings containing more than 1,000 sq. ft., beginning July 1, 2012. (See AB1103/AB531, codified at California Public Resources Code, § 25402.10.) These dates will slip into late 2012 or 2013, as a result of the continued delays in implementing this Regulation.

While these are the first such state-wide regulations in the country, Washington D.C., New York City and Seattle require annual public disclosure of similar information on energy usage. It is quite possible that other large metro areas will also require annual public disclosure of similar information on energy usage, and that these regulations will become a standard for the real estate industry.

**Operation of California's Regulations**

The stated goal of these Regulations is to encourage owners to manage energy use and achieve a 20 percent reduction in energy use by 2015. The schedule was developed by the California Energy Resources Conservation and Development Commission, after conducting studies and collecting data directed at reducing costly and inefficient energy use.

For those owners and operators of commercial property that have already voluntarily enrolled in the EPA's Energy Star® Portfolio Manager database, these mandatory disclosures may be fairly painless. For others, however, the challenges could be substantial.

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To start, it is imperative that a building's energy score be accurately calculated, as inaccurate disclosure could create liability to those who rely upon the disclosures in the purchase, leasing or financing of a property. Potential claims include intentional or negligent misrepresentation, statutory claims such as violation of California's Unfair Competition Law (found at Business & Professions Code, § 17200) and even fraud. Individuals who may have the standing to make such claims include buyers, tenants and lenders. Potential remedies include actual damages, restitution and possible potential punitive damages.

The Energy Star® website, www.energystar.gov/index, contains helpful suggestions for gathering and tracking energy use data; but determining the appropriate level of detail to be used for purposes of data collection and reporting will vary from organization to organization and from property to property. Some may find it appropriate to use smart meters and submeters. For others, the total cost on the monthly utility bill may be sufficient. All energy sources should be accounted for in physical units (i.e., kilowatt hours for electricity, million cubic feet for natural gas, etc.) and on a cost basis. Energy Star® recommends gathering at least two years' monthly data, if available, to formulate a benchmark.

The California regulations require that, at least 30 days before a disclosure must be made to a third party, a building owner must open an account at the Energy Star® Portfolio Manager website. In that account, the building owner must provide contact information, the building identity and Portfolio Manager building type, and the building characteristics. The owner also must identify all utility company meters and utility company accounts serving the building, and authorize all utility companies serving the building to release energy use data for the most recent 12-month period into the owner's Portfolio Manager account.

Within 15 days of an owner's request, a utility company must upload the entire building's energy use data into the owner's Portfolio Manager account. The Regulations prohibit the utility company from releasing tenant energy use data for any purpose other than compliance with Public Resources Code, § 25402.10, and also prohibit the owner from using or releasing any tenant energy use data for any purpose other than compliance with the law.

The data in the owner's Portfolio Manager account is then used to generate a Statement of Energy Performance for the building as well as a California Energy Performance Disclosure Report that is to be electronically submitted to the California Energy Commission. Actual data, not estimates, is required. Monthly updates are worthwhile. An audit team with appropriate expertise can then help plan and develop an energy audit strategy, with periodic progress reports.

Suggested best practices for data collection and reporting include having only knowledgeable building personnel collect the raw data, and retaining a knowledgeable and experienced third-party energy consultant or engineering firm to review and evaluate the data for accuracy.

The EPA's benchmark or "target" energy efficiency score for a particular property type is identified on a scale of 1-100; buildings that have a score of at least 75 are eligible for the Energy Star® label. Unfortunately, at the present time, the EPA's Energy Star® Portfolio Manager only provides benchmarks for office buildings, K–12 schools, grocery stores, hospitals and hotels. Accordingly, for parties owning a property that does not fit into one of these categories, benchmarking and accurate Energy Star® ratings may be problematic. While the EPA plans to add additional types of buildings to its system of benchmarks in the future, it has not yet set a timetable for doing so.

**New Law Creates Conundrum for Landlords and Tenants**

California's new requirements create some grey areas for landlords, tenants and utilities—particularly, in situations where existing lease language does not require the tenant to disclose energy use data to the landlord and the tenant refuses to do so. The California Energy Commission has wrestled with these issues for the last two years.

- One proposed solution is for utility companies to release energy use totals for the entire building to the owner's Portfolio Manager's account.
- Another option is for the utility companies to create a "virtual meter," which identifies, by tenant, all energy use. This information would also be downloaded in the owner's Portfolio Manager account. Utilities have, quite understandably, been concerned about breaching confidentiality rights; therefore, it is anticipated that utilities may require that owners sign non-disclosure agreements.
- Another option being discussed by the California Energy Commission is the possibility of requiring an owner to rate only permanent "energy assets" in a building—for example, HVAC (heating, ventilation, air-conditioning) systems, elevators, lighting and chillers.

There is, as yet, no official rating information of this nature for such permanent assets. Energy asset ratings are expected to be developed, but it could be quite some time before they are available. And, it may take even longer before they are integrated into the California Energy Commission's regulatory framework. Therefore, stay tuned ….

**Things to Consider**

Absent a legislative "fix" on these issues, landlords should consider the following:

1. Examine existing leases. While lease provisions requiring the tenant to comply with applicable law may be helpful in this instance, a narrowly drawn provision may be problematic. Similarly, non-disclosure provisions (such as those found in percentage rent/gross sales clauses), if overly broad, also may be problematic. If existing lease documents do not contemplate disclosure of information on energy usage as required by the statutory scheme, the landlord should seek voluntary compliance from the tenant, and perhaps consider an amendment to the lease to formalize the parties' agreement as to future compliance.
2. Both landlords and tenants should consider including lease language that addresses the disclosure and use of information relative to energy usage, including issues relative to privacy, confidentiality and trade secrets, as well as remedies short of termination and eviction for the breach of such provisions.

**Conclusion**

California's energy disclosure requirements are likely only the beginning for building owners, as there is continued growth in the public's awareness of the cost of energy dependence on foreign sources and concern about the risks of global warming. The early implementation of compliance programs will provide a competitive advantage for landlords as they develop information about properties in their portfolios and are able to identify areas for cost savings through the adoption of energy use reduction programs. Such programs also may lessen legal expenses that arise from the adoption of a compliance program at the last minute or (even worse) under threat of an enforcement action by state authorities.

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[1] The exact date has not yet been set, as the Draft Regulations implementing AB1103 have not been formally implemented as of June 16, 2011.

[2] "Entire building" is defined as "the portion of the building for which the owner possesses title."

# California Supreme Court Puts the Zip Back into Zip Code Consumer Protection Class Actions

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With the advent of new platforms and methods of advertising, retailers are constantly defining and redefining their customer base and advertising campaigns to properly target their markets, solicit business and open new stores. One means used for doing this is to request a customer's personal information when making a purchase. Retailers use this information to possibly contact customers at a later date or to establish where the bulk of consumers reside, for purposes of marketing and new store development.

Both federal and state consumer protection laws have been enacted to protect consumers against fraud and abusive retail practices, and more recently to identity theft when using credit cards. In California, retailers have found that the courts—in applying consumer protection laws—have virtually eliminated a retailer's ability to request information from credit card customers beyond what is actually necessary to complete the transaction. Retailers in all jurisdictions need to reexamine their business practices and determine how to ask customers for personal information without violating laws.

A recent California Supreme Court case decided against the collection and recordation of customer Zip Codes by some retailers. (Retailers frequently use this "tool" to identify their customer base and create a targeted marketing plan.) In doing, so, the court's decision has further defined what personal information cannot be sought from customers. Attorneys representing retailers in all jurisdictions need to heed this court decision and advise their clients to carefully balance their need for customer information with the possibility of incurring risks that may violate laws enacted to protect consumers' privacy.

**California Legislative History**

In 1971, California enacted the *Song-Beverly Credit Card Act* ("*Song-Beverly*"), which was "designed to promote consumer protection"[1] and to "impose fair business practices for the protection of consumers."[2] In 1990, *Song-Beverly* was amended to include provisions aimed at addressing

> the misuse of personal information for, inter alia, marketing purposes and (finding) that there would be no legitimate need to obtain such information from credit card customers if it was not necessary to the completion of the transaction.[3]

To accomplish this, the prohibition against retailers' practices was expanded from prohibiting a retailer to require customers to provide the information to allow retailers to simply "request" customer information. A year later, the provisions were fine-tuned to close a loophole and prevent the abusive practices that the Act sought to eliminate.

At the heart of *Song-Beverly* is the provision that prohibits retailers from

(1) Requesting or requiring a customer to write "personal identification information" on the credit card transaction form in order to complete the transaction,

(2) Requesting or requiring a customer to provide personal information that store personnel may insert on the credit card transaction form in order to complete the transaction, and

(3) Using pre-printed forms that include sections within which a customer must insert personal information.

The key "triggers" are seeking personal information from customers during a credit card transaction and recording that information, even if the information sought is beyond what is necessary to have the credit card approved. Thus, it appeared that a retailer made providing such information a condition [even if that isn't the intent] to completing the sale.[4] Under *Song-Beverly*, however, those triggers became irrelevant, even if a retailer had a defense that it had a legitimate business purpose to use information that had no direct impact on or invasion of privacy of the customer.

Penalties for violating *Song-Beverly* are $250 for the first violation and up to $1,000 for each subsequent violation, plus attorney fees, costs and interest. Although the law provides the courts with some flexibility, retailers facing large class actions are exposed to huge penalties.[5]

**California Judicial History**

Since *Song-Beverly* became law, consumers in California have sued retailers in class actions, and individually asserted violations of *Song-Beverly*, based on retailers' use and misuse of their personal identification information in violation of the law. The applicability of several types of transactions under *Song-Beverly* has been challenged. The courts have been asked to both apply the law to clarify its provisions and determine what information would be deemed "Personal Identification Information," which the retailer is prohibited from seeking and recording. If found guilty of wrongdoing, what penalties should be imposed on retailers?

Recent issues being reviewed by California courts are: What information falls within the definition of Personal Identification Information? Does a request for a customer's Zip Code, without any further information as part of a credit card transaction, fall within that definition in violation of § 1747.08 of *Song-Beverly*?

In *Party City Corp. v Superior Court* (2008) 169 Cal. App. 4th 497 ("*Party City*"), the court concluded that a retailer may request a customer's Zip Code because a Zip Code refers to an area in which many people reside and thus could not be viewed as specific information relating to the individual customer.

***Jessica Pineda v. Williams-Sonoma Stores, Inc.*—California Supreme Court, Feb. 11, 2011**

The facts in the *Williams-Sonoma* case are simple. During her checkout, the cashier allegedly asked Ms. Pineda to provide her Zip Code; she complied, and the cashier entered the information into the cash register. Ms. Pineda asserted that she believed she was required to provide the Zip Code as a condition to completing the credit card transaction.[6] After the transaction was completed, upon reflection, Ms. Pineda thought that the request for her Zip Code was a violation of *Song-Beverly* and in 2008 filed a putative class action against Williams-Sonoma.

The California Supreme Court reviewed the plaintiff's appeal of both the trial and the appeals courts' decisions, which held that a retailer's request for the customer's Zip Code alone would not be deemed protected personal identification information under *Song-Beverly*. The court relied on the previously decided *Party City* case. The supreme court had to make a final resolution of the issue of "whether [California Civil Code] Section 1747.08 is violated when a business requests and records a customer's Zip Code during a credit card transaction."[7] The court sought to look to the meaning of the statute and addressed whether a Zip Code is "Personal Identification Information" under *Song-Beverly*—that is, "information concerning the cardholder, other than information set forth on the credit card, and including, but not limited to, the cardholder's address and telephone number."[8] Of particular importance, the court examined how the retailer used the Zip Code information and whether such practice would, in fact, be a misuse of personal identification information that the Act sought to prohibit.

The court rejected the retailer's arguments, holding that Zip Codes were within the definition of personal identification information under *Song-Beverly*. In making its decision, the California Supreme Court found that, under *Song-Beverly*, reference to a cardholder's address meant both the specific address and its individual components (such as a Zip Code) since a Zip Code is, in fact, information concerning a customer.

The court also focused on the provisions of *Song-Beverly*, which state that the information sought was not necessary to complete the transaction, which it clearly was not. In weaving these concepts together, the court found that a retailer could, and did in fact, use the customer's name and Zip Code to find a customer's address, telephone number and even email addresses, and send direct marketing—which is exactly what *Song-Beverly* sought to prevent. In doing so, the court clearly sent a message to retailers that, even if the use of such information was not to contact the customer or to provide personal identification information to be used by others to contact the customer, it would not be an acceptable argument; retailers must stop requesting, and recording, such information in connection with credit card transactions. Or, retailers may face significant fines and attorney fees that are way in excess of the benefit that they might get from obtaining and using the information.

Since the *Williams-Sonoma* decision, over 150 class actions have been filed in California against well-known national retailers.

***Vincent Archer v. United Rentals, Inc.*, California Court of Appeal, May 19, 2011**

In *Vincent Archer v. United Rentals, Inc.*, 2011 IJDAR 7158 (May 19, 2011), the California Court of Appeal held that a credit card holder using a business card in making a purchase is not entitled to the privacy protection of *Song Beverly*. The court found that whether the personal card is used "occasionally" or "primarily" for business purposes, is a distinction without a difference. The purpose for which the credit card is used is of no import, the court noted. The Act protects "natural persons" in the personal use of credit cards.

***Folgelstrom v. Lamps Plus, Inc.*, California Court of Appeal, May 20, 2011**

The California Court of Appeal recently overturned a judgment in favor of Lamps Plus, which collected and recorded Zip Codes during credit card transactions. Lamps Plus allegedly used the information to mail marketing materials to its customers. *Fogelstrom v. Lamps Plus, Inc.*, 2011 DJDAR 7276 (May 20, 2011). Allegedly, Lamps Plus provided Zip Codes to Experian Marketing Services, which matched the information provided by Lamps Plus with customer addresses stored in its own records to produce a mailing list that it licensed to Lamps Plus. The trial court ruled, based on *Party City Corp. v. Superior Court*, *supra,* which upheld the practice of recording Zip Codes, sustained the retailers' demurrer to the complaint and entered judgment for Lamps Plus. The court of appeal reversed, based on the recent California Supreme Court *Williams-*

*Sonoma Stores* decision. (*See* Fn. 6.) It is interesting to note that the court disregarded, as speculative, the plaintiff's argument that the conduct of Lamps Plus subjected him to greater risk of identity theft.

**California Legislative Response to the Supreme Court's *Williams-Sonoma* Decision**

In response to the impact that the *Williams-Sonoma* case has had in California and the concerns of the business community, a bill has been sponsored by a member of the California Assembly (AB 1219) to address and clarify certain portions of *Song-Beverly* that may be ambiguous. Examples of changes in the proposed legislation are that the request for Zip Codes would be permitted (1) if needed for shipping purposes; (2) if the credit card is not physically present; or (3) to prevent fraud or identity theft, provided the information is used for those purposes and then deleted. The legislation has been passed by the Assembly Judiciary Committee; whether it eventually is enacted, and in what form, will be learned in the future.

**Applicability to Other Jurisdictions**

*Beverly-Song* may be considered the most far-reaching state consumer protection law. However, other state laws follow similar paths, and savvy consumers certainly may challenge retailers' practices under those states' consumer protection laws. New Jersey, Wisconsin, Kansas and Maryland consumer protection laws are less restrictive than, but similar to, California's. Other states—such as Delaware, Georgia, Louisiana, Massachusetts, Minnesota, Nevada, New York, Ohio, Oregon, Pennsylvania and Rhode Island—all have laws with limited provisions that also may possibly be used by consumers who are aware of the success in California.

**Advice to Clients**

The experience in California has had a major impact on retailers, resulting in expensive protracted litigation and the imposition of fines. Similar litigation is apt to take place in other jurisdictions. In advising clients on best business practices, attorneys should:

- Understand and implement applicable state and federal consumer protection laws, including recently enacted ones to prohibit unsolicited emails, text messaging and unsolicited Internet marketing.
- Explain to clients that the applicable laws go beyond any actual fraud or identity theft.
- Have retailers carefully examine their practices, policies and procedures for requesting personal identification information from customers, as well as the purpose for doing so; retailers also should then meet with customers to determine whether there is a potential risk of violating consumer protection laws.
- Suggest that clients change their business practices so that they stop asking for personal identification information when processing credit cards; if there is a necessity to ask for a form of identification (e.g., government-issued photo ID) to verify that the party using the credit card is, in fact, the owner of the card; then, after obtaining the information, none of the information should be recorded electronically or otherwise.
- Encourage retailers to establish best practices and find alternative ways to obtain personal information. Examples include establishing a policy that permits the retailers' employees to seek customers' written consent after a transaction is complete to provide information for a specific purpose such as inviting the customer to join a mailing list, email list, or loyalty or awards programs to be advised of promotions. In agreeing to provide personal information, customers will need to receive a written disclosure of exactly how the information will be used to avoid unwanted communications. Timing is critical; the customer need not feel intimidated or believe that not providing the information will prevent completion of the transaction. It is imperative that retailers develop, implement and provide clear evidence that no personal confidential information has been requested or recorded in any company database beyond the purposes agreed to by the customer.
- Have retailers explore the use of software in the point-of-sale system that would preclude completion of a transaction if a clerk tries to insert personal identification into the system.
- Ask if the client has asked customers for their cell phone numbers for texting purposes. While texting is simple, fast and can cover thousands of customers in one easy step, it can be expensive and obtrusive to customers. A text once a month or every other month may be acceptable, but daily texts can cause trouble. Many cell phone plans limit the number of free texts a customer can receive; if a retailer bombards customers with texts, they may push the customer over the monthly limit and be costly to the consumer, possibly causing new types of lawsuits.
- Have retail clients preserve all electronically stored information regarding policies, practices and procedures immediately—particularly, database parameters that prohibit the systemwide recordation of personal identification information during California (and in any other jurisdiction with similar laws) credit card transactions.

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[1] *Florez v. Linens 'N Things, Inc*. (2003) 108 Cal. App. 4th 4447, 450.

[2] *Young v. Bank of America* (1983) 141 Cal. App. 3d 108, 114.

[3] *Asher v. AutoZone, Inc.* (2008) 164 Cal.App.4th 345.

[4] The *Song-Beverly Credit Card Act of 1971*, as amended Civ. Code § 1747.08.

[5] *Id.* § 1747.08 (e).

[6] *Jessica Pineda v. Williams-Sonoma Stores, Inc* (2011) 51 Cal. 4th 524.

[7] *Id.*

[8] *The Song-Beverly Credit Card Act of 1971*, as amended Civ. Code § 1747.08(b).

# How Do I Fix This Holey Mess? A Case Study of Title Trauma

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A client recently brought a very interesting business offer to my attention. My client was offered the opportunity to invest in an existing business. The business is currently owned by a partnership of two family-controlled entities, and is being operated on approximately 250 acres of land. The current owners, through a series of steps, will transfer the property to a limited liability company ("RE LLC") and the business to an unrelated—except for common ownership—limited liability company ("Operating LLC"). In exchange for a cash contribution by my client, the current owners will transfer a third of the membership interests in the RE LLC and the Operating LLC to my client.

By all initial appearances, this is an excellent deal for my client, who is very familiar with the business involved and has the capacity to bring relevant expertise to the table. Everyone on both sides of the table was ready to proceed with what they thought would be a "sign and close" transaction. I thought it strange that the owners did not want to obtain a commitment for title insurance on the property. However, I was told that their resistance was merely economic because the family had owned the property since the 1920s.

In spite of the owners' resistance, I ordered a title commitment anyway. And I am very glad I did this! The commitment indicated that several tracts of five (5) acres each, more or less, could not be insured under the title policy. For some of the tracts, the reason given was that the tract was subject to claims of the heirs of various estates. One of the tracts could not be insured because "no vesting deed is found of record." At this point, instead of looking at this as a transaction my client was ready to jump into, everyone had to take some giant steps backwards to see where things stood.

How could I advise my client to proceed with a substantial investment in this location—specific business when the business owners appeared to be unable to convey title, much less clean title, to significant portions of the real estate involved? The obvious answer to this question is that the only way to justify proceeding is if the title company agrees to insure title to the insurable tracts. Therefore, after first informing counsel for the owners of the title problems, I quickly got on the telephone to see what the title company's position was going to be. All of the title company's initial responses were not very encouraging. The insurable tracts were identified as the same tracts that were uninsurable in at least one previously issued title commitment.

Nevertheless, I persisted in demanding that the title company provide me with a detailed chain of title report for each uninsurable tract as well as copies of all the vesting deeds in the various chains. I also went back to the owners' attorney to see what other information might be available to help convince the title company to insure these tracts. Working together with the owners' attorney, I was able to convince the title company that the "family" had owned all the tracts, including the ones considered to be uninsurable, since the 1920s. Proof was provided in the form of older deeds, along with probate records for a couple of deceased family members whose estates were probated in a county other than the county in which the property is located. This proof, together with affidavits from some of the living family members and the length of time during which the family has obviously controlled the property without receiving any adverse claims, was enough to convince the title company to revise its commitment for title insurance to indicate that coverage would be available for the previously uninsurable tracts.

My client was very fortunate that the title company ultimately agreed to insure title to the entire property. Otherwise, my client would have been faced with some very difficult investment decisions. I would have been called upon to give advice as to the risk factors involved in making such an investment. In order to give effective advice, I would have been required to analyze the risk factors created by the uninsurability of title to significant portions of the property.

This analysis would begin, much as the title company's analysis did, with an examination of the owners' underlying claim to title to the entire property, including a review of all vesting deeds to the property. Then I would need to verify the location of each tract covered by a vesting deed on a survey of the property. A new survey commissioned by my client showed the perimeter boundaries of the property. A review of the original set of vesting deeds provided by the title company showed the location on the survey of the bulk of the original tracts that made up the property. By a process of elimination, the uninsurable tracts were also located on the new survey. Additional vesting deeds into individual family members provided by the owners confirmed the locations of the uninsurable tracts. A review of the probate records from cases filed in a separate county confirmed that the uninsurable tracts were, in fact, conveyed to family members and later passed by wills to surviving family members who later conveyed these tracts to the current owners, which are family-controlled entities.

As part of the transaction, the parties entered into an Asset Contribution Agreement. Pursuant to that agreement, the property owners would contribute the property to a new entity, and my client would contribute cash to the new entity. In the agreement, the owners made a number of representations, including representations that they owned good and marketable title to the property. These representations, combined with the indemnities included in the agreement, give my client a valid claim against the owners if they do not actually own all the property. However, we all know that a valid claim is only as good as the ability of the owners to live up to their indemnity obligations. In this particular transaction, the principals are very substantial economically. This personal wealth is probably a factor in the title company's decision to insure the property, partly in

exchange for a separate indemnification agreement from the owners. The owners' wealth also is a factor in analyzing the risks involved in this transaction. Even without title insurance, if a third party were to appear and make a claim against title to one or more tracts, my client can take comfort in having received the representations, warranties of title and indemnification from the owners because they are wealthy enough to make my client whole.

If I had not been able to locate the additional vesting deeds and probate records to verify the owners' claims of ownership, I would have had to analyze whether or not the owners had a valid adverse possession claim. Even though I did not get to that point in my particular transaction, I think I would have been able to advise my client that the owners had a very strong claim to title, based on adverse possession. A significant factor in accepting this risk is, again, the personal wealth of the principals involved on the owners' side.

According to § 16.021 of the Texas Civil Practice and Remedies Code ("Code"), "adverse possession" means an actual and visible appropriation of real property, commenced and continued under a claim of right that is both inconsistent with and hostile to the claim of another person. The owners claim to have been in actual and visible possession of the entirety of the property since the 1920s. At various times since the 1920s, the owners have completely fenced in the property. The construction of such fencing constitutes appropriation of the uninsurable tracts, and is inconsistent with and hostile to the claim of any other persons.

We must next examine the various statutes of limitations to determine if any record title holder can bring an action against the owners or the RE LLC, as the new owner, to recover any of this land. The Code provides several different limitation periods. The three-year limitations period provided in § 16.024 and the five-year limitations period provided under § 16.025 are not applicable in this case. Section 16.026(a) of the Code states: "A person must bring suit not later than 10 years after the day the cause of action accrues to recover real property held in peaceable and adverse possession by another who cultivates, uses, or enjoys the property." Section 16.030(a) provides that if an action for the recovery of real property is barred by the ten-year statute of limitations, the person who holds the property in peaceable and adverse possession has full title, precluding all claims. Any ouster by the record titleholder after the ten-year limitations period comes too late. *Kazmir v. Benavides*, 288 S.W.3d 557 (Tex.App. Houston [14 Dist.] 2009).

To prevail on a claim of adverse possession under § 16.026(a), the elements to prove by a preponderance of the evidence are: (1) actual and visible possession of the disputed property; (2) that is adverse and hostile to the claim of the owner of record title; (3) that is open and notorious; (4) that is peaceable; (5) that is exclusive; and (6) that involves continuous cultivation, use or enjoyment for ten years. *Kazmir v. Benavides*, 288 S.W.3d 557; *Glover v. Union & Pac. R.R. Co.*, 187 S.W.3d 201, 213; *Natural Gas Pipeline Co. v. Pool*, 124 S.W.3d 188, 193-194.

Actual and visible possession of the disputed property consists of open, visible and unequivocal acts of occupancy in their nature referable to exclusive dominion over the property, that is sufficient upon observation to put an intending purchaser on inquiry as to the rights of such possessor. *Madison v. Gordon*, 39 S.W.3d 604, 607; *Strong v. Strong*, 98 S.W.2d 346, 350. The property owners' actual visible use and fencing of the property satisfy this element.

Adverse and hostile to the claim of the owner of record title does not require an intention to dispossess the rightful owner, or even knowledge that there is one, but there must be an intention to claim the property as one's own to the exclusion of all others. *Tran v. Macha*, 213 S.W.3d 913, 915. The property owners treated the property as belonging to them since the 1920s and fenced it in to exclude all others. These actions satisfy this element.

In determining whether possession is open and notorious, the issue is really whether the claimant's possession was sufficiently open to put the record titleholder on notice of the possessor's claim. *Fletcher v. Minton*, 217 S.W.3d 755, 762. The owners used the property as their own in an open and notorious manner, fencing it in for their own exclusive use. They have thereby satisfied this element.

Section16.021(3) states: "'Peaceable' possession means possession of real property that is continuous and is not interrupted by an adverse suit to recover the property." There has been no adverse claim of any kind, and no adverse suit has ever been filed against any of the owners. This element is also satisfied.

Exclusive "possession must be of such character as to indicate *unmistakably* an assertion of a claim of exclusive ownership in the occupant." *Rhodes v. Cahill*, 802 S.W.2d 643, 645 (Tex. 1990) [quoting *Rick v. Grubbs*, 214 S.W.2d 925, 927 (Tex. 1948] (emphasis in original); *McDonnold v. Weinacht*, 465 S.W.2d 136, 141 (Tex. 1971). The owners' actions in surrounding the property with a fence satisfy this element.

The owners have cultivated, used and/or enjoyed the property to the exclusion of all others for a period that is well in excess of the required ten years. The owners have conducted farming operations, oil and gas exploration operations, and fish farming operations on the property since the 1920s. Building a structure on property may be sufficient evidence of adverse possession. See *City of El Paso v. Fort Dearborn Nat'l Bank*, 74 S.W. 21, 23 (Tex. 1903); *McDow v. Rabb*, 56 Tex. 154, 161 (1882). There must be an intention to claim property as one's own to the exclusion of all others; "[m]ere occupancy of land without any intention to appropriate it will not support the statute of limitations." *Ellis v. Jansing*, 620 S.W.2d 569, 571 (Tex. 1981) (quoting *Wright v. Vernon Compress Co.*, 296 S.W.2d 517, 522 (Tex. 1956)); *Nona Mills Co. v. Wright*, 102 S.W. 1118, 1120 (Tex. 1907). The final element has also been satisfied.

Because the owners are able to satisfy all the elements for adverse possession of the potentially uninsurable portions of the property, and because of the financial ability of the owners to fulfill their representation, warranty and indemnity obliga-

tions under the Asset Contribution Agreement, I would be in a position to recommend to my client, based on his informed willingness to accept the risks involved, to proceed with this transaction.

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# Gift Cards: Opportunities and Issues for Retailers

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**Introduction**

Gift card sales have surged in recent years. With electronic or virtual gift cards and mobile applications that allow consumers to purchase and redeem gift cards from their mobile/smart phones, sales only continue to grow. While consumers flock to them for their flexibility, businesses have embraced gift cards as a means to increase sales. Not only are buyers spurred into making new purchases, but they often spend more than the gift card amount.

For retailers, gift cards can also be instrumental for improving cash flow and managing inventory. Perhaps the greatest benefit to retailers is that a sizable number of consumer gift card purchases are never redeemed. Estimates of the percentage of gift card balances that remain unredeemed—otherwise known as "breakage"—range from 10 to 19 percent. While gift card breakage has certain accounting and state escheat implications, since it affects income recognition, these unredeemed dollars can have a significant influence on many companies' bottom lines.

But with the growth in the use of gift cards comes an uptick in scrutiny and regulation, especially within the past year. For consumers, there is increased protection under Title IV of the *Credit Card Accountability, Responsibility and Disclosure Act of 2009* (*CARD Act*), which went into effect in early 2010. The *CARD Act* restricts gift card issuers from charging fees on cards for 12 months and extends card expiration until five years after purchase. In addition, the Federal Reserve Board (FRB) and the IRS have recently issued new rules for companies with gift card programs, providing much-needed guidance.

Gift cards have become an area of both opportunity and risk for retailers. They have come to provide a critical source of earnings; yet, at the same time, the regulatory environment, including tax and financial reporting for gift cards, has become increasingly complex. The bottom line is that financial executives within the retail industry cannot afford to be blindsided by tax, regulatory and financial reporting changes in this area.

**Growth of Gift Cards**

As the National Retail Federation (NRF) observes in a discussion of its first holiday survey, gift cards have been the most popular holiday gift request for four years running.[1] And shoppers agree: 77.3 percent of them were likely to purchase one or more gift cards during the 2010 holiday season, according to another NRF survey, *2010 Gift Card Consumer Intentions & Actions Survey*, which was conducted by BIGresearch.[2] The survey predicted that total spending on gift cards during 2010 would reach $24.78 billion—a hefty sum that translates to average amounts of $41.48 per gift card (up from $39.80 in 2009) and $145.61 in total purchases of gift cards (up from $139.91 in 2009).[3]

Among the popular destinations for those planning to purchase gift cards in 2010 were department stores (39.2 percent), bookstores (23.7 percent) and electronics stores (19 percent). Others expected to buy gift cards from restaurants (33.4 percent) and coffee shops (13.9 percent). Still others planned gift card purchases at entertainment venues such as movie theaters (14.1 percent). Many holiday shoppers (45.8 percent) purchased gift cards so that recipients could choose their own gifts. Convenience was a consideration for 17.8 percent of shoppers choosing gift cards.[4]

Dining is high on the list for many consumers who purchase gift cards. Analysis conducted by First Data shows that from January through June 2010, quick-service restaurants posted a 14 percent increase from first half (H1) of 2009 levels in the dollar values of gift cards sold, while casual-dining restaurants enjoyed a 6.1 percent increase from H1 2009 levels in the number of gift cards sold.[5]

Several factors contribute to the growing popularity of gift cards among quick-service restaurants. *QSR* magazine notes that many consumers are looking for value pricing, especially given the recession. Loyalty programs account for another portion of the growth. And during 2010, many quick-serves, in a bid to market themselves to entities that conduct fundraising activities, sold gift cards in bulk.[6]

**Gift Cards and State Tax Nexus**

Gift cards can create state income tax problems for retailers. For gift card issuers to be subject to state taxation, the issuer must have nexus—a physical or economic presence sufficient to establish jurisdiction to tax—in that state. It is important for companies to understand what establishes nexus in the various states in which their gift cards are sold, since each state's rules differ.

In general, the sale of a company's gift card from a non-company-owned venue, such as the sale of gift cards through third-party retailers in a state where the company does not otherwise have a physical presence, may cause state income tax exposure to the issuing retailer. For example, if the gift card is issued pursuant to a license granted by the retailer, then the retailer may have economic nexus in the states where the cards are sold. Economic nexus means that the state of sale will have jurisdiction to tax the issuer, based on the gift card issuer's intent to access the taxing state's market.

Gift cards, although they represent intangible value, are nonetheless physical objects (with the exception of virtual gift cards). Physical presence creates nexus in states in which property is present. Gift cards often contain specific disclaimers

such as "This card is the property of the issuer until sold at retail to a consumer." Further, if a company's sale of a gift card is made on a consignment basis, in which the issuer retains title to the cards until they are sold to the customer, then gift cards may create nexus for the issuer in the state or states in which they are offered for sale, since the issuer would own property in the state in which the gift cards are present. This can prove problematic because in third-party arrangements, the issuer frequently may not know where its gift cards are offered for sale and, therefore, where it might have nexus.

Many gift cards sold at larger stores—for example, a Starbucks card sold at the supermarket—are considered owned by the issuer until the purchase transaction. But that gift card's presence on a shelf in that store, even if the card is issued and owned by a company otherwise without a presence in that state, gives the issuer physical nexus in some states. This is a particularly important issue when one related party is issuing the gift card and another related party is selling the card, and the entity issuing the gift card assumes it has no nexus outside its state of commercial domicile.

**Gift Cards and State Escheat Rules**

The increasing popularity of gift cards also makes the management of escheat—or unclaimed property—liabilities an important issue. All U.S. states and the District of Columbia, as well as Puerto Rico, Guam, the U.S. Virgin Islands and certain other foreign jurisdictions, have explicit unclaimed property reporting requirements. Unclaimed property liability is not a tax, but rather a liability under state succession laws relating to property rights.

Because unclaimed property liability is not a tax, tax nexus rules do not apply. Rather, states have the authority to claim unclaimed property through the derivative rights doctrine. Under this doctrine, states acquire the same rights to unclaimed property as the owner held in the property. If the property cannot be returned to its owner, the state claims all of the rights over the property that the owner had, takes the property and holds it in a custodial capacity for the owner. In recent years, a number of states have intensified their pursuit of unclaimed property as a method of raising additional revenue.

A company's unclaimed property liability represents the property that the company holds for others, which is deemed abandoned under states' governing escheat laws. Property is deemed abandoned after it has been left unclaimed for a certain period of time, referred to as the dormancy period, which varies among states. Upon expiration of the dormancy period, most states require the property holder, if practicable, to attempt to contact the owner in order to return the property. Any property that remains unclaimed after such due diligence must be reported and turned over to the appropriate state, based on the following priority rules established by the U.S. Supreme Court:

> **First priority rule**—The jurisdiction of the owner's last known address is entitled to custody of the unclaimed property.
> **Second priority rule**—If the owner's address is unknown, or if the state of the owner's last known address does not provide for escheat of the property, the jurisdiction in which the holder is domiciled is entitled to custody of the unclaimed property.

As a result of these rules, the holder's state of domicile often has a claim to estimated unclaimed property for years in which there are incomplete books and records. Certain states also have adopted a transaction rule, which has not yet been considered by the U.S. Supreme Court, whereby the state in which the transaction that created the unclaimed property occurred claims custody of the property when the owner's most recent address is unknown and the holder is domiciled in a state that does not provide for the escheat of the property.

Many states such as Arizona and Maryland have either fully or partially exempted gift cards as a property type subject to escheat laws. However, a number of other states, including Delaware and New York, generally continue to treat dormant unredeemed balances on gift cards as unclaimed property.

Because the company's state of domicile has a claim to unclaimed property with no last known address, and because gift cards are often sold without recording the owner's address, a company that issues gift cards may face a significant escheat liability, depending on its state of domicile.

Reviewing specific state rules is necessary to determine whether a business is required to report and remit unclaimed property. Since state escheat laws change frequently, it is important to revisit the relevant rules in your state.

**Changing State Laws: New Jersey's New Unclaimed Property Rules**

State laws related to unclaimed property change frequently; therefore, it is important for a company to stay current on these laws to determine whether it is required to report and remit unclaimed property.

For example, in June 2010, New Jersey amended its *Uniform Unclaimed Property Act* to add, for the first time, stored value cards such as gift cards as a type of property subject to escheat.[7,8] A controversial place-of-purchase provision of the new law mandates that issuers of stored value cards must obtain the name and address of the purchaser or owner of each stored value card issued or sold and must, at a minimum, maintain a record of the Zip Code of the owner or purchaser.[9] The provision further states, in apparent contradiction to the U.S. Supreme Court's second priority rule, that if the stored value card issuer does not have the name and address of the card's purchaser or owner, that address will be assumed to be the address of the New Jersey business where the stored value card was purchased or issued.[10]

To study the impact of the new law, the state treasurer continued to extend the law's implementation date.[11] On Sept. 23, 2010, the state treasurer issued guidance stating that New Jersey would only assert custody over unredeemed balances of stored value cards if the issuer was domiciled in a state that exempts such cards.[12]

The guidance also states that the place-of-purchase provision would be applied retroactively so that the state would claim unredeemed balances of stored value cards issued prior to the date of the announcement. On the same day, American Express Travel Related Services Co. Inc. and others filed separate lawsuits against New Jersey, seeking a preliminary injunction to bar enforcement of various provisions of the new law.[13] On Nov. 13, 2010, the district court granted a preliminary injunction against the place-of-purchase presumption. Among other reasons, the court stated that the presumption appeared to be preempted by the U.S. Supreme Court's priority rules.[14] In addition, the court stated that the presumption may harm plaintiffs that were domiciled in states that exempted unredeemed balances of stored value cards, as those plaintiffs would now be required to remit cards with no last known address to New Jersey if the cards were sold in the state.

Although certain provisions of the new law are currently not being implemented as a result of the preliminary injunction, the litigation is ongoing and other provisions are now in effect. New Jersey's recent changes are a reminder that gift card issuers must continually monitor their state's unclaimed property laws.

**Breakage and GAAP Accounting**

Retailers routinely sell gift cards to individuals with the expectation that a certain portion of these cards will never be used—breakage—which mostly results from lost cards. If the card does not fall under specific state escheat rules, the question arises as to when companies can recognize income from breakage for financial statement purposes under generally accepted accounting principles (GAAP). (Note that if the amounts must be remitted to a government agency under state escheat rules, no income will be recognized as breakage under GAAP.)

But if these transactions are not covered under state escheat rules, the question arises as to when companies can recognize revenue for gift cards that are not used. In most transactions, GAAP does not allow a company to de-recognize a liability until the company is relieved from the liability—in this case, when the gift card is used. However, a special exception has been made for gift cards: When the company can establish that the chance of redemption is remote and is able to estimate the amount that will not be used, the company can recognize that breakage.

The Securities Exchange Commission staff has described two acceptable methods for recognizing breakage: specific identification and homogenous pool. Using specific identification, companies can recognize breakage income when the chance of redemption of a specific card is remote. There are no hard-and-fast rules related to how long a card needs to be inactive, but typically retailers using this method wait at least two years prior to recognizing breakage income.

Using the second method—homogenous pool—companies can recognize the expected unused percentage as breakage income in proportion to the amount of redemptions over the card's estimated useful life, based on historical patterns. To use this method, all of the following conditions must be met: (1) The pool of cards using this method, for which historical redemption patterns exist, must be homogenous. (2) There must be only a remote likelihood that the customer will require full performance. (3) The amount of breakage can be reasonably and objectively determined. (4) The estimated time period of actual gift card redemptions can be reasonably and objectively determined.

For companies to recognize revenue from breakage, they need to have accurate current and historical redemption data to support that there is a remote chance of the cardholder redeeming that card. Most retailers use a third party to manage their gift card programs, and these third parties typically provide this data; but companies that administer their own gift card programs have to track redemption on their own.

There is an additional question for companies about where to recognize breakage on the income statement. Many retailers recognize the breakage as part of net sales, while others recognize it as a reduction of selling, general and administrative costs. While there is not currently any specific literature addressing the classification, there has been an increased number of comment letters from the SEC staff requesting registrants to substantiate their classification if outside of revenue.

Companies should include robust disclosures such as (1) whether the gift cards have any expiration dates or monthly fees; (2) the policy for recognizing breakage income, including method, timing and amount; (3) consideration of state escheat laws; (4) the amount of breakage income recognized during the year; (5) the amount of unredeemed cards; and (6) where on the income statement that amount is included.

**Federal Tax Treatment of Gift Card Revenue**

In recent years, the IRS has issued two industry directives on the examination of gift cards and gift certificates (collectively referred to as gift cards) in the retail and hospitality industries. In those directives, the IRS announced its plans to focus on revenue recognition in connection with gift card sales.

In addition to the directives, the IRS issued advice to field offices (field advice) discussing revenue recognition issues arising from the sale of gift cards in specific fact patterns. Specifically, one major revenue recognition issue raised by the directives and the field advice arises when the entity that sells a gift card will not be the entity that actually satisfies the gift card obligation (as in the case of a gift card company) or where the entity that is selling the gift card might not be the entity that satisfies the gift card obligation (such as when a franchisor-franchisee relationship exists). As discussed below, while the

field advice had reached conclusions unfavorable to taxpayers on these issues, a recently issued IRS revenue procedure provides taxpayers with the opportunity to obtain a more favorable outcome.

In addition to the aforementioned issues, another issue raised in the directives was how a taxpayer should recognize revenue where it issues a gift card in exchange for returned merchandise. When merchandise is returned and a gift card is issued in exchange for the returned merchandise, most companies reverse the revenue from the sale of the item and record deferred revenue related to the gift card liability. Initially, the IRS indicated—informally—that it would not allow a taxpayer to apply this treatment for tax purposes. Instead, the IRS believed that the revenue from the original sale should not have been reversed. Fortunately, the IRS recently released a revenue procedure that resolves this issue in a taxpayer-favorable manner.

This section describes both of these factual situations in more detail as well as the IRS activity in this area.

***Use of a Gift Card Company***

Because of the potential unclaimed property liability that may result from the issuance of gift cards, many companies establish a separate gift card management company and locate it in a state with favorable escheat rules. Typically, gift card management companies will earn income either from a service fee related to issuing cards or from the gift cards' breakage. There are two main revenue recognition issues that arise when a taxpayer uses a gift card management company.

- The first issue is whether the gift card company should recognize revenue at all from the sale of gift cards. Specifically, some taxpayers have argued that since the gift card company is liable to pay over the cash from gift card sales, it does not recognize revenue as a result of the sale of the gift cards. Taxpayers in those situations argue that the cash received from the gift card sale is in the nature of a deposit.
- The second issue, assuming that the sale of gift cards creates revenue for the gift card company, is whether the gift card company may defer revenue from the sale of gift cards under either Treasury Regulation (Treas. Reg.) § 1.451-5, which allows a two-year deferral for advance payments related to goods, or Revenue Procedure (Rev. Proc.) 2004-34, which allows a one-year deferral for advance payments related to goods or services, or a combination thereof.

The IRS has issued field attorney advice and a Technical Advice Memorandum discussing these revenue recognition issues in the context of a gift card company.

***Field Attorney Advice 20082801F and Technical Advice Memorandum 200849015***

Field attorney advice (FAA) 20082801F and Technical Advice Memorandum (TAM) 200849015, issued by the IRS, address several revenue recognition issues that arise in connection with the sale of gift cards by a gift card company. The gift card companies described in both the FAA and TAM were separate, wholly-owned subsidiaries of the respective taxpayers that did not hold inventory of their own and did not provide services to customers. The FAA and TAM both discussed whether the cash received by the gift card companies was required to be recognized in income upon receipt. The FAA and TAM stated that the gift card companies received the cash under claim of right and, therefore, had income from the sale of gift cards. The IRS specifically rejected the taxpayers' argument that the money received by the gift card companies was a deposit.

The FAA and TAM further held that the gift card companies could not rely on Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34 to defer revenue recognition. Both cases denied the taxpayers the ability to use Treas. Reg. § 1.451-5 because the gift card companies did not have inventory of their own. The FAA and TAM each disallowed the use of Rev. Proc. 2004-34, but for different reasons. The FAA held that the taxpayer could not rely on Rev. Proc. 2004-34 to defer revenue recognition because the gift card company was unable to determine the extent to which the amounts received would be recognized as revenue in the gift card company's applicable financial statements in a particular year. The TAM stated that Rev. Proc. 2004-34 contemplates that in order to meet the definition of an advance payment, the payment must be received by the same taxpayer that provides the goods or services with respect to that payment. Accordingly, both taxpayers were denied the use of Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34 to avoid the immediate recognition of income.

***Use of a Single-Member LLC***

In FAA 20100901F, the IRS held that a taxpayer that used a single-member LLC (an entity disregarded for federal income tax purposes) could use either of the deferral provisions discussed above, where the gift cards are sold by its single-member LLC and the inventory is held by the owner of the single-member LLC. In short, use of a single-member LLC avoids the revenue deferral issue discussed in the TAM and the field attorney advice above.

***Franchisor-Franchisee Situations***

In the case of a gift card company, the entity selling the gift card will not provide the goods or services that relate to the gift card. There are other situations where entities sell gift cards that may or may not be satisfied by them. FAA 20093801F involved a corporate taxpayer in the restaurant business. The restaurant chain was made up of both corporate-owned restaurants and franchisee-owned restaurants. The corporate taxpayer sold gift cards that could be redeemed at either corporate-

owned or franchisee-owned stores. The corporate taxpayer did provide goods and services with which the gift card liability could be satisfied. However, the taxpayer did not know whether and to what extent the gift card purchasers would redeem gift cards at its corporate-owned stores.

The corporate taxpayer took the position that it had to recognize revenue in connection with the gift cards only if the gift cards were redeemed at corporate stores. The IRS disagreed and held that the amounts received for the gift cards were required to be taken into income upon receipt. As part of its analysis, the IRS held that the taxpayer could not use the deferral provisions in Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34 because the taxpayer did not know whether gift cards would ultimately be redeemed at the taxpayer's restaurants or at franchisee restaurants. In the IRS's view, in order to rely on Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5, the taxpayer must be the entity that will provide the services or goods to the customer. In the IRS's view, the fact that the taxpayer has, in some instances, passed along that obligation to the franchisee makes the taxpayer ineligible to use either deferral provision. Hence, the fact that the gift cards might not be redeemed at the corporate-owned stores was enough to render the payments ineligible for deferral under either Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34.

***Recent IRS Guidance***

In January 2011, the IRS issued two taxpayer-favorable revenue procedures relating to gift card sales. Rev. Proc. 2011-18 relates to taxpayers that sell gift cards that are redeemable for the goods or services of either the taxpayer or a third party. Because of the aforementioned TAM and FAA, it was unclear, prior to the publication of Rev. Proc. 2011-18, whether such taxpayers could rely on Rev. Proc. 2004-34 to defer revenue recognition in connection with the sale of gift cards. Rev. Proc. 2011-18 clarifies that a taxpayer that sells gift cards that are redeemable for goods or services of either the taxpayer or a third party may rely on Rev. Proc. 2004-34 to defer revenue recognition, assuming that all of the other requirements of Rev. Proc. 2004-34 are met.

In providing this favorable result, Rev. Proc. 2011-18 modified the definition of advance payments in Rev. Proc. 2004-34 to allow deferral under that provision, but did not modify Treas. Reg. § 1.451-5 to allow revenue deferral. Rev. Proc. 2011-18 allows a taxpayer to defer revenue under Rev. Proc. 2004-34 related to eligible gift card sales. A sale of a gift card is an eligible gift card sale only if (1) the taxpayer is primarily liable to the cardholder for the value of the gift card until redemption or expiration and (2) the gift card is redeemable by the taxpayer or by any other entity legally obligated to the taxpayer to accept the gift card from a customer.

Rev. Proc. 2011-17 relates to taxpayers that issue gift cards to customers in exchange for returned merchandise, and provides a safe harbor method of accounting for such transactions. Taxpayers that meet the scope of Rev. Proc. 2011-17 may treat gift cards issued for returned goods as the payment of a cash refund by the taxpayer followed by the sale of a gift card to the customer who made the return. Taxpayers that are engaged in the trade or business of selling goods at retail, that use an overall accrual method of accounting and that issue gift cards in exchange for returned goods are eligible to use this method. Under this method, the taxpayer may account for the amount deemed received for the sale of the gift card under Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34, if otherwise eligible.

Rev. Proc. 2011-18 and Rev. Proc. 2011-17 are effective for tax years ending on or after Dec. 31, 2010 (the effective date). For taxable years ending before the effective date, the IRS will not raise the issue of whether a taxpayer may use the method described in Rev. Proc. 2011-17 or whether a taxpayer may defer revenue under Rev. Proc. 2004-34 in connection with eligible gift card sales. The IRS will not pursue the issue further if a taxpayer's use of the method described in Rev. Proc. 2011-17 or a deferral method for eligible gift card sales is an issue under consideration in examination, in appeals or before the U.S. Tax Court in a taxable year that ends before Dec. 31, 2010.

Both revenue procedures provide that accounting method changes made to a permissible method under either of those revenue procedures may generally be made via the automatic accounting method change procedures. However, a taxpayer that wishes to use the deferral provisions of Treas. Reg. § 1.451-5 can use the method described in Rev. Proc. 2011-17, but must do so using the advance consent accounting method change procedures. Furthermore, both revenue procedures waive certain scope limitations for a taxpayer's first or second taxable year ending on or after Dec. 31, 2010.

***Reading Between the Lines: What Does the Recent IRS Guidance Mean for Gift Card Issuers?***

The recent IRS guidance provides certainty to taxpayers regarding many gift card issues. Although the guidance is not favorable in all respects, companies with gift card programs should consider filing a change in method of accounting to obtain a limited deferral of income related to gift cards, and to receive favorable treatment with respect to gift cards issued for returns. Alternatively, there is the ability in certain situations to obtain more favorable treatment that is related to income recognition through restructuring, as with the use of a single-member LLC. Taxpayers who continue to use a method inconsistent with the guidance run the risk that the IRS will challenge such a method upon examination.

**Mitigation of Exposure: Next Steps**

Given that the IRS did not provide relief in the context of Treas. Reg. § 1.451-5, taxpayers fitting into one of the above fact patterns that are using Treas. Reg. § 1.451-5 might want to change from that method to the deferral method outlined in Rev. Proc. 2004-34. Alternatively, a taxpayer that desires to use Treas. Reg. § 1.451-5 might consider setting up its gift card company as a single-member LLC, assuming that this structure provides the company with the favorable escheat treatment it desires.

Another area of risk could exist if a company merely uses its book method of accounting for gift cards as its tax method. Usually, a taxpayer's financial statement method of accounting for gift cards will not be a permissible method of accounting for tax purposes. These taxpayers, too, might want to consider asking for a change in accounting method.

**Looking Ahead**

The popularity of gift cards shows no sign of abating and will likely continue to grow as more consumers both begin to use gift cards via convenient new mobile applications and to enjoy heightened consumer protections under the *CARD Act*. The benefits to gift card issuers remain numerous: increased sales, improved inventory management, better cash flow and higher profitability. While there is also more scrutiny of gift cards from the IRS and the FRB, the new rules mean more clarity for gift card issuers with respect to federal tax accounting rules and the financial accounting treatment of advance payments.

While many companies have done a significant amount of work in the past to ensure that they are able to recognize gift card breakage income, companies must continue to evaluate and monitor the legislative changes in the various states in which they operate. The last thing retailers want is to have a financial restatement that is due to lack of awareness of changes in state laws affecting gift cards.

With the increasing sales and use of gift cards, retailers will continue to focus on maximizing revenue and earnings from gift card sales. Maximizing earnings is dependent on minimizing breakage subject to state escheat laws, managing state income tax consequences of issuing and distributing gift cards, and achieving the ability to defer revenue from the sale of gift cards for federal income tax purposes. These will be ongoing issues for retailers for the foreseeable future.

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[1] www.nrf.com/modules.php?name=News&op=viewlive&sp_id=1033

[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] www.firstdata.com/downloads/thought-leadership/gift-card-2010-first-half-recap.pdf

[6] www.qsrmagazine.com/news/loyalty-programs-bulk-sales-fuel-gift-card-growth

[7] N.J. Stat. Ann. 46:30B-1 *et seq*.

[8] P.L. 2010, c.25.

[9] P.L. 2010, c.25 § 5c, N.J. Stat. Ann. 46:30B-42.1(c).

[10] *Id.*

[11] The implementation date was initially extended to Sept. 1, 2010, then to Oct.1, 2010, and then to Nov. 1, 2010. To accommodate ongoing litigation over the new law, the implementation date was eventually extended to Nov. 15, 2010. Treasury Announcement FY 2011-01, *Notice of Temporary Exemption of Certain Provisions of A-3002 until September 1, 2010* (N.J. State Treasurer, July 1, 2010); Treasury Announcement FY 2011-02, *Notice of Temporary Exemption of Certain Provisions of L.2010, c.25 until October 1, 2010* (N.J. State Treasurer, Aug. 26, 2010); Treasury Announcement FY 2011-03, *Guidance on Implementation and Notice of Exemption From Certain Provisions of L.2010, c.25* (N.J. State Treasurer, Sept. 23, 2010). *American Express Travel Related Services Company, Inc. v. Sidamon-Eristoff*, No. 10-4890, 2010 U.S. Dist. LEXIS 120153 at *2 fn 1 (D. N.J. Nov. 13, 2010).

[12] Treasury Announcement FY 2011-03, *Guidance on Implementation and Notice of Exemption from Certain Provisions of L.2010*, c.25 (N.J. State Treasurer, Sept. 23, 2010).

[13] *American Express*, 2010 U.S. Dist. LEXIS 120153 at *18; http://dockets.justia.com/docket/new-jersey/njdce/3:2010cv04890/246952/

[14] *American Express*, 2010 U.S. Dist. LEXIS 120153 at *108, 142.

# Tenant Options for Landlord's Financial Distress and Landlord's Bankruptcy

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Landlords have traditionally guarded against possible tenant financial failures by conducting economic reviews of prospective tenants, demanding guaranties and other forms of security, and crafting remedies for tenant defaults. Tenants, however, have not engaged in the same scrutiny of prospective landlords or customarily included remedies for landlord financial failures or defaults. To that end, the United States Bankruptcy Code (the "Code") has enacted measures in an effort to protect tenants. In its current version, the Code provides that a trustee of a bankrupt commercial property may only assume the lease if that trustee:

> (1) Cures the default;
> (2) Compensates a party to the lease, other than the debtor, for any pecuniary losses that result from the default; or
> (3) Provides adequate assurance of future performance under the lease. 11 U.S.C. 365(b)(1)(A)-(C).

Nevertheless, a tenant still can implement additional measures to better protect its interests. The following are examples of clauses that a tenant may want to use to help protect itself against a landlord financial failure. The clauses are not meant to be a comprehensive list of all possible tenant remedies:

> Notwithstanding anything herein to the contrary, as of the effective date of a Restructuring Event (defined herein), Tenant shall have the immediate right to take all or any of the following actions:

1. Require Landlord (or, if applicable, the trustee, custodian or other third party acting on behalf of Landlord or any of Landlord's property) to return the entire amount of the Security Deposit to Tenant then being held by Landlord (or, if applicable, by such trustee, custodian or other third party) pursuant to **Section __** of the Lease upon notice to Landlord (or, if applicable, to such trustee, custodian or other third party) from Tenant, in which case Landlord (or, if applicable, such trustee, custodian or other third party) shall immediately return the entire amount of the Security Deposit to Tenant.[1]

2. Use all or any portion of the Security Deposit then being held by Landlord (or, if applicable, the trustee, custodian or other third party acting on behalf of Landlord or any of Landlord's property) pursuant to **Section __** of the Lease and apply it toward the payment of Rent (as defined in **Section __** of the Lease), in which case the amount of monthly payments of Rent payable by Tenant thereafter shall be reduced by an amount equal to the amount(s) applied by Tenant toward the payment of Rent.

3. Require Landlord (or, if applicable, the trustee, custodian or other third party acting on behalf of Landlord or any of Landlord's property) to return the original Letter of Credit[2] (as defined in **Section __** of the Lease) to Tenant then being held by Landlord (or, if applicable, by such trustee, custodian or other third party) pursuant to **Section __** of the Lease upon notice to Landlord (or, if applicable, to such trustee, custodian or other third party) from Tenant, in which case Landlord (or, if applicable, such trustee, custodian or other third party) shall immediately return the original Letter of Credit to Tenant.[3]

4. Exercise any or all of Tenant's remedies for a default by Landlord under **Section __** of the Lease, the parties agreeing that the occurrence of a Restructuring Event constitutes a Landlord default under the Lease. Require a Nondisturbance, Attornment and Subordination Agreement[4] (the "**SNDA**") in form and substance acceptable to Tenant (in Tenant's sole discretion) to be executed on behalf of any and all mortgagee(s) of any mortgage(s) that have been recorded against the Premises prior to the Restructuring Event. The SNDA shall provide that such mortgagee(s) shall recognize Tenant's rights under the Lease and, so long as Tenant is not in default beyond any applicable notice and cure periods under the Lease, Tenant shall continue to enjoy the uninterrupted possession of the Premises and such other rights as are granted under the Lease. Landlord (or,

if applicable, the trustee, custodian or other third party acting on behalf of Landlord or any of Landlord's property) shall cause such SNDA to be recorded in the county recorder's office immediately upon Tenant's request, and Landlord (or, if applicable, the trustee, custodian or other third party acting on behalf of Landlord or any of Landlord's property) shall deliver a recorded copy of the SNDA to Tenant within five (5) days of the recordation of the SNDA.

5. Require Landlord (or, if applicable, the trustee, custodian or other third party acting on behalf of Landlord or any of Landlord's property) to execute a memorandum of lease[5] (the "**Memorandum of Lease**") in recordable form and otherwise satisfactory to Tenant (in Tenant's sole discretion). The Memorandum of Lease shall not set forth the rent or other charges payable under the Lease and shall expressly read that it is executed pursuant to the provisions contained in the Lease and is not intended to vary the terms and conditions of the Lease. Landlord (or, if applicable, the trustee, custodian or other third party acting on behalf of Landlord or any of Landlord's property) agrees to cause the Memorandum of Lease to be recorded, at Landlord's (or, if applicable, at the trustee's, custodian's or the third party's) cost, with the recorder of deeds or other official in the county in which the Premises are located within ten (10) days after notice from Tenant.

6. Require a guaranty to be executed by ______________________ in the form attached hereto as **Exhibit** _.[6]

If a Restructuring Event occurs but Tenant does not exercise one or more of its rights based upon the Restructuring Event, Tenant shall nevertheless, if the same or a different Restructuring Event occurs, have the immediate right to take all or any of the above actions as if the previous Restructuring Event shall not have occurred. Landlord shall immediately notify Tenant of the occurrence of a Restructuring Event and Landlord's failure to do so shall not only constitute a non-curable default under the Lease, notwithstanding anything in the Lease to the contrary, giving rise to all remedies for a Landlord default under the Lease, but shall also constitute a Restructuring Event. A "**Restructuring Event**" shall, in addition to the aforesaid failure by Landlord, be any one or more of the following occurrences[7]:

1. If Landlord's Cash Flow (defined herein), aggregated over four (4) consecutive fiscal quarters, beginning upon the date hereof, is negative. Landlord's Cash Flow for any period shall mean the sum of (i) Landlord's net income attributable to common stock holders, (ii) interest on convertible debt that is accrued but not yet paid or payable, (iii) depreciation and (iv) amortization, all as reflected in the audited financial statements for the applicable period. Stock compensation amortization may be added as part of the definition of Landlord's Cash Flow, provided that said adjustment is as reported in the audited financial statements of Landlord.[8]

2. If Landlord's Cash Flow is positive but less than or equal to ____________________________________________ and no/100 Dollars ($______________.00). Landlord's Cash Flow shall be based upon Landlord's last full fiscal year immediately preceding the applicable Restructuring Event.

3. If Landlord's debt to equity ratio becomes ___ percent (__%) or greater. Landlord's debt to equity ratio shall be based upon Landlord's last full fiscal year immediately preceding the applicable Restructuring Event.

4. If Landlord's current ratio of assets divided by liabilities becomes less than ___ (_).

5. If Tenant has received notice from Landlord's mortgagee(s) or ground lessor(s) that Landlord is in default of any agreement with the mortgagee(s) or ground lessor(s).[9]

6. If Landlord has been in default or received a notice of default from Landlord's mortgagee(s) or ground lessor(s).

7. If (i) the price per share for Tenant's common stock calculated on the basis of a thirty (30) day trailing average and adjusted for any stock splits, reverse stock splits or mergers from and after the date hereof, is less than ___________________________________ and no/100 Dollars ($______________.00) (the "**Low Stock Price Event**"), and (ii) Landlord does not, within ten (10) days after notice from Tenant that Tenant claims that such Low Stock Price Event constitutes a Restructuring Event, provide Tenant with a certification from Landlord's chief financial officer, or from the independent certified public accountant that prepared Landlord's most recent financial statement, or from another independent certified public accountant reasonably acceptable to Tenant, that, as of the date of Tenant's notice, the aggregate amount of cash, cash equivalents, and short-term investments held by Landlord and which are free and clear of any liens or encumbrances is equal to or greater than ___________________________________ and no/100 Dollars ($______________.00).[10]

8. If Landlord shall commence or institute any case, proceeding or other action (a) seeking relief on its behalf as debtor, or to adjudicate it a bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition or other relief with respect to it or its debts under any existing

or future law of any jurisdiction, domestic or foreign, relating to bankruptcy, insolvency, reorganization or relief of debtors, or (b) seeking appointment of a receiver, trustee, custodian or other similar official for it or for all or any substantial part of its property.

9. If Landlord shall make a general assignment for the benefit of creditors.

10. If any case, proceeding or other action shall be commenced or instituted against Landlord (a) seeking to have an order for relief entered against it as debtor or to adjudicate it a bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition or other relief with respect to it or its debts under any existing or future law of any jurisdiction, domestic or foreign, relating to bankruptcy, insolvency, reorganization or relief of debtors, or (b) seeking appointment of a receiver, trustee, custodian or other similar official for it or for all or any substantial part of its property, which in either of such cases (i) results in any such entry of an order for relief, adjudication of bankruptcy or insolvency or such an appointment or the issuance or entry of any other order having a similar effect or (ii) remains undismissed or unstayed for a period of sixty (60) days.

11. If any case, proceeding or other action seeking monetary relief in excess of ____________________________ and no/100 Dollars ($_____________.00), which is not covered by insurance carried by Landlord shall be commenced or instituted against Landlord seeking issuance of a warrant of attachment, execution, distraint or similar process against all or any substantial part of Landlord's property which results in the entry of an order for any such relief which shall not have been vacated, discharged, or stayed or bonded pending appeal within sixty (60) days from the entry thereof.

12. If Landlord shall take any action in furtherance of, or expressly indicating its consent to, approval of, or acquiescence in, any of the acts set forth in clauses (8), (9), (10) or (11) above.

13. If a trustee, receiver or other custodian is appointed for any substantial part of the assets of Landlord, which appointment is not vacated or effectively stayed within thirty (30) days.

Landlord, within fifteen (15) days after request, shall provide Tenant with a current financial statement and such other information as Tenant may reasonably request in order to create a business profile of Landlord and determine Landlord's ability to fulfill its obligations under the Lease.

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**The views and opinions expressed in this article are those of the authors and do not represent the views and opinions of their employers or any other party.**

[1] See, for example, *In re Wayco, Inc*., 947 F.2d 1330, 1333 (7th Cir. Wis. 1991) (holding that the landlord does not have any property interest in the tenant's security deposit). In the Seventh Circuit, the security deposit is not a part of the debtor landlord's estate within the meaning of 11 U.S.C. § 541(a).

[2] Section 5-102 of the Illinois Uniform Commercial Code, for example, defines a letter of credit as a "definite undertaking … by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value." 810 ILCS 5-102. A letter of credit involves three separate transactions, including (1) "the contract between the issuer and its customer whereby the issuer agrees to issue the letter of credit to the beneficiary of the letter of credit (2) the contract between the customer and the beneficiary which is the agreement underlying the letter of credit and; (3) the letter of credit itself, whereby the bank agrees to pay the beneficiary the amount of the letter of credit, if the beneficiary complies with the terms of the credit." *Mount Prospect State Bank v. Marine Midland Bank*, 121 Ill.App.3d 295, 297 (1st Dist. 1983).

[3] Bankruptcy courts have held that letters of credit and their proceeds are not property of the estate in a bankruptcy case. *In re Oakwood Homes Corp*., 342 B.R. 59 (Bankr. D. Del. 2006). There have, however, been conflicting results as to how letters of credit are treated in bankruptcy. Three different circuits have ruled on this issue and produced three different results. In the

Third Circuit, the court held that, under the language of the lease, the letter of credit was intended to be treated as a security deposit by the parties. *Solow v. PPI Enterprises (U.S.), Inc.*, 324 F.3d 197 (3rd Cir. 2003). The Ninth Circuit declined to follow the Third Circuit and focused on the fact that the letter of credit was secured by a cash account, and that because this had the same practical effect as a forfeiture of a security deposit, should be capped by § 506(b)(6) of the Bankruptcy Code. (This section caps the landlord's recovery in a lease rejection.) *Redback Networks, Inc. v. Mayan Networks Corp.,* 306 B.R. 295 (9th Cir. 2004). The Ninth Circuit ruled that because the landlord had not filed a proof of claim, he properly drew upon the letter of credit. *In re Stonebridge Technologies, Inc.*, 430 F.3d 260, (5th Cir. 2005).

[4] A Subordination, Non-disturbance, and Attornment Agreement is defined as a "standard agreement that defines the rights of lenders and tenant in the event that the landlord defaults in his mortgage and the lender forecloses." *CW Capital Asset Management, LLC v. Chicago Properties,* LLC, 610 F.3d 497, 502 (7th Cir. 2010). In a typical SNDA agreement, "the subordination provision subordinates the lease to the mortgage; the attornment provision requires that the tenant agree to continue the tenancy if as a result of the default and foreclosure there is a new landlord; and the nondisturbance provision assures the tenant that his lease will continue in the event of foreclosure." *Id.* at 502-503. The current trend is for SNDA agreements to have additional agreements put in place to further protect lenders and tenants. *Id.* For that reason, it is even more important for tenants to negotiate for provisions in the lease that protect against the lender's including detrimental conditions—such as a lender refusing to be bound by rent that may have been paid in advance by the tenant.

[5] A Memorandum of Lease is a recitation of the primary non-confidential elements of the lease and typically identifies the parties, the term of the lease and any options granted the tenant under the lease. The Memorandum of Lease is recorded so that third parties have notice of the existence of the lease and the recorded clauses in the Memorandum of Lease. The recording of the Memorandum of Lease provides a third party with constructive notice of the recorded terms of the lease and may prevent a claim by a third party that it did not have knowledge of the existence of the lease. Some states require the recordation of a Memorandum of Lease. See La. Rev. Stat. Ann. §44:104 and La. Civ. Code Art 3338. A Memorandum of Lease or the lease has to be recorded if the lease has a term of longer than one year in Connecticut [Connecticut General Statutes §§ 47-19 and 47-20] or at least two years (in Maine) [33 M.R.S.A § 201] in order for the lease to be binding on third parties. Different states have differing recordation requirements; thus, it is good practice to review each state's laws regarding the necessity and desirability of the recordation of a Memorandum of Lease.

[6] Courts will uphold the guaranty. *See Fieldcrest Cannon v. Meyer (In re Meyer),* 1996 U.S. Dist. LEXIS 16357 (N.D. Ill. Oct. 31, 1996) (holding that debtor-guarantor is liable for the defaulted loan and the debt will not be discharged despite the guarantor's claims that he guaranteed the loan through false representations to the creditor).

[7] The Restructuring Events listed below are examples of events that allow the tenant to exercise one or more of its remedies and is not meant to be a comprehensive list of all possible types of such events. In addition, although the language above requires the landlord to notify the tenant of the occurrence of a Restructuring Event, the landlord may not do so and so it behooves the tenant to monitor diligently the landlord's financial status and activities that bear on the landlord's financial status to determine if a Restructuring Event has occurred.

[8] The definition of Landlord's Cash Flow can be modified as the parties deem appropriate. The above definition of Landlord's Cash Flow, for example, is appropriate for a corporation whose stock is traded on a public exchange rather than for a private company. A generic definition of Landlord's Cash Flow would be: "Landlord's Cash Flow for any period shall mean the sum of (i) Landlord's net income, (ii) depreciation and (iii) amortization, all as reflected in the audited financial statements for the applicable period." The parties can modify the definition of Landlord's Cash flow in any number of ways. They might, for example, redefine the term "net income" and the other terms in the definition, exclude and include certain items from the definition, and change the percentages, amounts and number of days in the definition.

[9] The landlord's mortgagee(s) or ground lessor(s) absent a requirement to do so are under no obligation to provide notice to the tenant of a landlord default.

[10] This clause presumes that the landlord is a publicly traded entity. The parties may want, as with the other example clauses, to modify the terms of this clause to suit their circumstances and requirements.

# Supreme Court Tightens the Rules for Employment Class Actions

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The United States Supreme Court issued its opinion in the long-awaited *Wal-Mart v. Dukes* decision on June 20 of this year. The Court's decision makes it more difficult for plaintiffs to pursue large class actions against employers. Specifically, the Court held that: Plaintiffs cannot recover damages, such as back pay, in class lawsuits brought under the more lenient class certification standards applicable to claims for injunctive relief (decided unanimously, 9-0). A class action should not be certified absent a showing of "commonality"—that the class claims present a common question. To satisfy this burden, plaintiffs must produce substantial evidence of unlawful policies; a showing that an employer allows managers to have subjective discretion in making employment decisions is not enough (decided 5-4).

The case was brought by Betty Dukes and five other former Wal-Mart employees who worked in 13 of Wal-Mart's 3,400 stores. The plaintiffs claimed that the company discriminated against female employees in violation of Title VII of the *Civil Rights Act of 1964* and sought to represent a class consisting of all of the approximately 1.5 *million* female Wal-Mart employees employed at the end of 1998. The plaintiffs alleged that Wal-Mart's "corporate culture" enabled local managers to pay women less than their male counterparts and to promote males more rapidly than females. The class sought not only injunctive and declaratory relief, but also billions of dollars in punitive damages and back pay.

The district court certified the lawsuit as a single, massive class action. The district court found that the plaintiffs met the "commonality" requirement of Federal Rule of Civil Procedure 23(a)(2) and allowed the plaintiffs to tack on back-pay claims that would normally be forced to qualify for class-action treatment under the more stringent requirements of Rule 23(b)(3). A divided Ninth Circuit affirmed the decision in most respects, and the U.S. Supreme Court accepted review.

**The Supreme Court's Decision**

A 5-4 majority Court reversed the Ninth Circuit's "commonality" ruling, while ruling unanimously that the Ninth Circuit erred by allowing plaintiffs to seek billions in back-pay damages in a Rule 23(b)(2) class action. Justice Antonin Scalia wrote for the Court.

The 5-4 majority found the proposed class lacked sufficient "glue" holding its claims together. According to the Court, it is not enough for putative class representatives merely to pose a common question such as "Is that an unlawful employment practice?" Instead, the plaintiffs seeking such class treatment must show a "common contention … capable of class-wide resolution—which means that determination of its truth or falsity will resolve an issue that is central to the validity of each one of the claims in one stroke." The Court found that the plaintiffs' statistical and anecdotal evidence failed to establish that plaintiffs could prove their case on a class-wide basis. Instead, the claims would have to be addressed individually.

The Court also held, unanimously, that plaintiffs could not bring back-pay class-action claims under Rule 23(b)(2). The Court reasoned that plaintiffs could proceed under Rule 23(b)(2) only when they sought a single injunction or declaratory judgment for the entire class but *not* where each class member sought an individual award of damages.

The decision is enormously significant for employment class-action litigation and is likely to have a number of long-term implications:

- Decentralized decision-making models are likely to impede the plaintiffs' ability to obtain certification of sprawling classes—sweeping allegations of subjectivity or discretion in decision-making are insufficient to support class-action treatment
- Plaintiffs seeking certification of a discrimination class action must clearly identify common discriminatory policies that can be litigated through common evidence, which is a daunting task in most circumstances because nearly all employers have formal policies *forbidding* discrimination; statistics and anecdotal evidence will not satisfy the plaintiffs' burden to identify specific policies or practices they claim are unlawful
- Class-action plaintiffs cannot obtain damages without showing that common issues predominate over any individual issues—plaintiffs may not primarily seek injunctive relief and then ask for damages as an "inci-

dental" claim. This ruling is likely to be fatal to a number of pending cases and will greatly reduce the potential for awards of large attorney fees in class-action cases

- Depending on a company's management structure and policies, plaintiffs may have to pursue much smaller class actions, possibly even down to the store or unit level, where the claims can be directed at the decisions of specific decision-makers

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**Florida Appellate Court Examines the Question of the Scope of Commercial Easement**

The Florida 1st District Court of Appeal recently issued a decision involving the intent and scope of an easement affecting commercial property. In *Dama v. Bay Bank & Trust Co.*, 56 So.3d 827 (Fla. 1st DCA 2011), the court reviewed the trial court's ruling. The court had granted the party benefited by the easement—a mandatory permanent injunction requiring removal of a sign erected by the defendant/appellant.

In this case, the defendant/appellant, Frank Dama, owned the main parcel of a shopping center. Bay Bank, located adjacent to the shopping center, asserted that it was the beneficiary of an easement for access by virtue of a recorded "Concurrent Declaration and Agreement." Dama had erected a sign on a strip of land that he owned. However, the bank contended the land was subject to an access easement benefiting the bank. The bank further contended that the sign was inconsistent with the purpose and existence of the easement, and that it interfered with the bank's access rights.

The court in *Dama* reviewed several cases on which the bank was relying and concluded that they were all distinguishable from the instant situation. Those cases, for example, involved an easement that, by its terms, was "strictly limited to ingress and egress" from and to a specific road; other cases involved designated areas that were clearly and specifically to be subject to easements for ingress and egress. The court concluded that each of those earlier cases "hinged on the intent of the parties as evidenced by the written easements," and that the courts in those cases found that "where the documents provided an easement for the entirety of a specific piece of land, the servient tenement holder could not reduce or infringe the ability to ingress or egress across even a portion of that land." The court noted the contrast between those documents and the document at issue in *Dama*:

> Here, the clear intent of the parties was not to create an easement for ingress and egress over the entirety of a specific piece of land. Instead, the parties specifically stated in the Agreement, relied on by the Bank, that the easement identified in the Agreement was to apply only to "common areas" that were actually "devoted to the use by the general public" for ingress and egress, and that structures could not be built in those areas that would "prevent or substantially impair such mutual access."

Evaluating this situation, the court in *Dama* noted that "[c]ourts have found where, as here, an instrument creates generally 'an easement for ingress and egress,' the 'instrument should be construed as having created a nonexclusive easement allowing [the servient tenement owner] *any use of the land which does not interfere* with [the dominant tenement owner's] rights under the easement." (Emphasis in original.) Accordingly, the court ruled in favor of the shopping center owner, concluding that the bank had failed to demonstrate that the sign would "substantially impair" its rights of ingress and egress as provided in the Agreement.

**California Appellate Court Rules Against Mall Operator in a Free Speech Case**

The California Court of Appeals recently considered the question of whether the California Constitution permits a private property owner—in this case, the owner of a shopping mall—to enforce rules giving preferential treatment to labor speech, thereby discriminating against other types of speech. In *Best Friends Animal Society v. Macerich Westside Pavilion Property LLC*, 193 Cal.App.4th 168 (2d Dist. 2011), the court reviewed the trial court's ruling, which had denied the plaintiff's motion for a preliminary injunction against the owner.

Macerich owns and operates Westside Pavilion Shopping Center, a large shopping mall. The use of the common areas at the center is regulated by rules adopted by Macerich. In particular, with respect to the issue at hand in the case, the mall rules apply to "noncommercial expressive activity," including political and religious speech, and to "qualified labor activity," which is defined by several stated criteria. As the court noted, however:

> The two types of expressive activity are regulated differently. Noncommercial expressive activity is limited to areas designated by the [rules]; subject to Macerich's discretion, noncommercial expressive activity is not permitted on blackout days; and noncommercial expressive activity must cease when the store nearest to the designated area is closed to the public. In contrast, qualified labor activity is permitted in either a designated area or an area selected by Macerich that is proximately located to the targeted employer or business; the blackout days do not apply to qualified labor activity of people employed at Westside Pavilion; and qualified labor activity related to the fixing of the terms or conditions of employment is permitted during the hours the targeted person or business is engaged in work at Westside Pavilion.

In 2008, a division of Best Friends Animal Society, known as PAPLA, requested permission from Macerich to protest in front of a pet store in Westside Pavilion. Macerich responded, advising PAPLA that the protest could take place in a designated area and that protests would not be allowed on so-called blackout days. The designated area was not within visual or aural range of the pet store. PAPLA objected. Although Macerich eventually offered some additional locations, PAPLA did not find them suitable. PAPLA brought an action against Macerich, seeking declaratory and injunctive relief, alleging that the mall rules unconstitutionally discriminated between labor and non-labor speech and activity.

Per the court's decision, the "free speech clause" of the California Constitution is "broader and more protective" than the First Amendment to the U.S. Constitution. The California provision, Article 1, § 2, Subdivision (a), states:

> Every person may freely speak, write and publish his or her sentiments on all subjects…. A law may not restrain or abridge liberty of speech or press.

The court noted that even though the First Amendment does not protect free speech in a private shopping center, the California Constitution does protect free speech in a private shopping center. The court cited earlier decisions for the proposition that a shopping center, though privately owned, is a "public forum" in which the free speech guaranteed by the California Constitution may be reasonably exercised, subject to "reasonable regulations" as to time, place and manner. However, the court noted that such regulations may not prohibit certain types of speech based on content.

The court went on to examine the mall rules, and their application in this case, in light of both federal and state standards—noting, among other things, the federal standard that "people engaged in free speech must be given sufficient access to their intended audience." Continuing its analysis, the court reviewed in some detail the application of this federal standard to various types of protests. Then it examined that evolution of California law regarding limitations as to the time and place of free speech in shopping malls.

Having evaluated the evolution of such restrictions and the application of that evolution to the *Westside Pavilion* case, the court ruled in favor of Best Friends. The court concluded, among other things, that the mall rules were impermissibly content-based, distinguishing between the treatment of labor speech and other types of speech; it also found no basis for Macerich's argument that a distinction was necessary to assure compliance with applicable labor law. The court also rejected the argument that a ruling in favor of PAPLA would constitute a taking.

The court reversed the trial court's denial of a preliminary injunction, and went on to rule that, pending final resolution of the litigation, Macerich could not prohibit Best Friends/PAPLA from protesting within visual and aural range of the targeted pet store when the mall is open to the public—*unless* Macerich could prove that the protests could not be conducted in a particular place or at a particular time without "substantially interfering with normal business operations."

**Party Signing Lease on Behalf of an Entity Found to Be Potentially Personally Liable**

The Florida 2d District Court of Appeal recently decided a case involving the potential personal liability of an individual who executed a commercial lease on behalf of a corporate tenant. In *Coleman v. 688 Skate Park, Inc.*, 40 So.3d 867 (Fla. 2d DCA 2010), the court reviewed the trial court's ruling, which had dismissed the landlord's complaint against the individual.

The *Coleman* case involved a commercial lease executed in 2006. The tenant, 688 Skate Park, Inc., allegedly failed to perform its rent payment obligations. The landlord filed suit against the individual, Jay Turner, who had signed the lease purportedly on behalf of the corporate tenant, claiming that Turner was personally liable. The trial court granted Turner's motion to dismiss.

Turner had signed the lease in the signature block for "LESSEE/TENANT: 688 SKATE PARK, INC.," with "as its President" typewritten under his signature. The court of appeal focused, however, on the specific language of one provision of the lease, which stated:

> If the Tenant is a coporation [sic], limited liability company or limited partnership, the undersigned officer, manager or representative of the Tenant hereby certifies and warrants that said Tenant is in good standing and authorized to do business in the state of Florida and the individual executing this Lease on behalf of said corporation, limited liability company or limited partnership, guarantees the obligations of Tenant thereunder.

The court of appeal reviewed *de novo* the question of whether the complaint stated a cause of action against Turner. It disagreed with the trial court's distinction of the instant case, which turned on the lack of "joint and several" language that had been present in the lease at issue in an earlier case, *Onderko v. Advanced Auto Insurance, Inc.*, 477 So.2d Fla. 2d DCA 1985). The court of appeal found that "The plain language" of the lease in the instant case satisfied the requirements to state a claim for relief against Turner as being personally liable for all lease obligations of the corporate tenant under the lease. Accordingly, the appellate court remanded the case for further proceedings.

## LEGISLATION

**Florida Adopts *Landmark Community Planning Act***

Since 1985, real estate development in Florida has been subject to a series of growth management requirements, reflected in terms such as "concurrency," "level of service," "compliance," "financial feasibility," "need" and "urban sprawl." These terms, and the underlying law, have been significantly revised by Florida House Bill 7207.

As a result of the new legislation, Chapter 163, Florida Statutes, will now be called the *Community Planning Act* and the state land planning agency will reside within the new Department of Economic Opportunity. The amendments reflected in the bill will strengthen the role of local government in comprehensive planning, providing localities with greater discretion in such matters, while limiting the role of state government in approving comprehensive plans. Nevertheless, the legislation retains a measure of accountability for local governments by providing that comprehensive plan amendments instituted by local governments could constitute an "inordinate burden" subject to review.

The "concurrency" requirement for the approval of new developments—i.e., a prerequisite that public facilities be constructed and operational when needed to support that new development—was a principal feature of existing Florida law. The new *Community Planning Act* retains concurrency requirements for potable water, solid waste, drainage and sanitary sewer facilities, but eliminates those requirements for transportation, schools and parks. It also eliminates financial feasibility requirements. The eliminated concurrency items will now be deemed to be optional; accordingly, a local government may amend its comprehensive plan to delete transportation, schools and parks from its concurrency requirements. Also, if a local government wishes to continue enforcing concurrency requirements for these now-optional items, it must do so as part of the capital improvements plan, with decisions based on appropriate data and analysis and a level of service standard. For transportation concurrency, development projects will be able to satisfy concurrency requirements through a proportionate-share formula that deducts costs of providing for "transportation deficiencies."

Under the new legislation, the comprehensive plan amendment process has been expedited and revised for most amendments, although certain types of amendments will remain subject to the former review process. Localities also will no longer be limited to adopting plan amendments twice per year. Additionally, under the expedited review process that will now be applicable to most comprehensive plan amendments, review by various state agencies is limited to certain specific topics. And, for an amendment affecting a use of 10 acres or less and where the cumulative annual acreage for all small-scale developments in a locality does not exceed 120 acres, a small-scale plan amendment process applies, with various limitations and impediments having been deleted from that process.

Further key features of the new legislation include:

- Streamlining and simplifying the required elements for comprehensive plan details
- Adopting a more objective standard to determine if a comprehensive plan amendment will result in urban sprawl
- Recognizing innovative planning techniques that include visioning, sector plans, rural lands stewardship, urban service boundaries and mixed-use development; use of these strategies will mitigate against a project being declared as urban sprawl
- Eliminating the requirement in the plan for public school concurrency or for a public schools facilities element
- A four-year extension of all commencement, phase, build-out and expiration dates for all Development of Regional Impact (DRI) projects, and limitation on the scope of DRI review (including the removal of industrial areas, hotels/motels and theaters from the list of DRIs)
- Prohibiting voter referenda on local comprehensive plan amendments
- Extending the duration of development agreements between a locality and developer from 20 to 30 years

The foregoing list is only a brief, topical summary of certain elements of the extensive legislation. Readers are encouraged to review the entire legislation, and to seek expert legal advice as to the impact of the legislation on specific facts and circumstances.

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## From Canada

# Supreme Court Clarifies When Insurance Companies Must Respond to Defend Construction Deficiency Claims

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In *Progressive Homes Ltd. v. Lombard General Insurance Co., 2010, S.C.C. 33*, the Supreme Court of Canada recently ruled on an insurer's duty to defend a general contractor in the context of a construction deficiency claim. These cases often involve the decay of, or damage to, interior building component parts after the failure of an exterior cladding system, or portions of it. The Standards Council of Canada (S.C.C.) ruling settled differences among provincial appellate decisions when considering the coverage of such claims under a Comprehensive General Liability ("CGL") insurance policy. The *Progressive Homes* decision provided some guidance on the interpretation of policy definitions of "property damage," "accident," "occurrence" and the "work performed" exclusion. The *Progressive Homes* case endorsed a uniformed approach to these interpretive issues. The British Columbia courts, and the British Columbia Court of Appeal in particular, in cases that preceded *Progressive Homes,* had approached the interpretation of the policies in question that led to coverage denial under the particular CGL policies in question—and often in leaky condominium building envelope cases.

In *Progressive Homes*, the Supreme Court of Canada overruled the B.C. Court of Appeal as well as the lower court, which had decided that no coverage extended to the contractor for the claims it was being sued for in a number of lawsuits. The defence costs alone were going to be significant.

The main argument in the *Progressive Homes* case was that property damage does not result from damage to one part of the building arising from another part of the same building. According to the argument, damage to other parts of the same building is pure economic loss, not property damage. What follows from this argument is that property damage is limited to damaged third-party property. This argument builds on a distinction between property damage and pure economic loss; the argument is drawn in part from the Supreme Court of Canada's prior decision in *Winnipeg Condominium Corporation v. Bird Construction* [1995] 1 S.C.R. 85. In the *Winnipeg Condo* case, subsequent owners claimed negligence by the original general contractor, subcontractor and architect after a storey high section of exterior cladding fell from the side of the building to the ground below. The S.C.C., in *Winnipeg Condo,* found that the loss was not property damage but rather a recoverable form of economic loss. In short, the insurer argued that property damage does not include damage to the insured's own work, and the context matters; the work should be looked at as whole when a building is the context for the claim.

In answer, the S.C.C. said that an insurer's duty to defend only requires the possibility of coverage. Whether any specific property fell within the definition of property damage or not, would be a matter to be determined on the evidence at trial. For purposes of the application and the trigger of the insurer's duty to defend, it was a low threshold of showing that the pleadings reveal a possibility of property damage for the purpose of deciding that question.

The alleged property damage at the root of this case requires an application of sometimes confusing concepts of an exclusion to coverage, and exceptions to exclusions to coverage. The common exclusion to coverage is a "work performed," or "own work," exclusion. A common exception to such an exclusion is a "subcontractor exception." Exclusions do not create coverage, and neither do exceptions to exclusions. Exceptions bring an otherwise excluded claim back within coverage where the claim fell within the initial grant of coverage in the first place.

The central exclusion in the appeal was whether the work performed exclusion applied. To make matters more complicated, there were three versions of the work performed exclusion at play in the appeal since there were successive insurance policies that applied to the period of alleged damage, which spanned a number of years.

The Court persuasively traced changes in insurance policy language in their various forms and found that

1. On a plain reading, damage was excluded only where it was caused by Progressive Homes to its own completed work but was not property damage caused to, or by, a subcontractor's work;
2. The pleadings indicated the involvement of subcontractors, which was in and of itself sufficient to trigger to duty to defend (as it might, at trial, materialize that the damage was caused to a subcontractor's work or that a subcontractor's work itself caused the damage); and
3. Coverage for repairing defective components might be excluded in one version of the policy at play, but resulting damage would not be excluded.

It must be remembered that these issues were only determined at the pleading stage, which is to say very early in the lawsuit. Triggering a duty to defend requires the insurer to pay the investigation and litigation costs (i.e., defence costs) but

not necessarily provide an indemnity. Depending on what was ultimately proved at trial, as the Supreme Court of Canada noted: "if as Lombard alleges the buildings are wholly defective, then the exclusion will apply and Lombard will not have to indemnify Progressive" under one of the versions of the policy.

At the early stages of a construction deficiency claim, an insurer will be properly required to defend those claims that possibly result in coverage. These claims are often historical claims brought years later, and are not inexpensive to defend.

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