Walters Levine Klingensmith & Thomison P.A.

Attorneys at Law

Elinor E. Baxter
Christy S. Berks
Heather A. Bradley
Heather A. Degrave
Michael A. Gold, LLM
Alan F. Gonzalez, LLM

Of Counsel
Robert M. Pretschner

H. Jack Klingensmith
Stuart Jay Levine
Michael J. Pugh
James E. Thomison
Thomas C. Valentine
Joel W. Walters

Report From Counsel

Insights and Developments in the Law **Spring 2008**

Real Estate Roundup

Flood Zone Fraud

A jury recently gave a hefty damages award to homeowners who sued a real estate company for falsely representing that the home they were buying was not located in a flood zone. When the rains came after the homeowners had moved in, the front yard, backyard, and a patio were under three feet of water. The house itself was never flooded. While this was fortunate, it limited the economic damages that a lawsuit would yield, prompting the homeowners to use an unusual legal theory.

The company and, in particular, its manager knew about the flooding problem and kept that fact from the home buyers.

The homeowners successfully argued that the realty company had committed fraud. The use of fraud as a cause of action allowed the homeowners to recover noneconomic damages of the kind not commonly awarded in litigation between the buyers and sellers of real estate. In addition to recovering damages for the difference between what they paid for the property and its real value, the homeowners also received a significant award for mental anguish, and an even larger amount as punitive damages.

The company and, in particular, its manager knew about the flooding problem and kept that fact from the home buyers. There was evidence that others who bought nearby property from the same company had battled flooding and had complained about the flooding to the realty company. Moreover, real estate agents testified that sales contracts with prospective buyers for the very property that was in dispute had fallen through when those buyers became aware of the potential for flooding.

The failure to disclose continued in the time after the purchase, when the company manager unsuccessfully tried to get the new homeowners to sign a drainage release, which would have absolved the company of liability for any damage from flooding.

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Careful What You Click

A Texas online purchaser used her daughter-in-law's credit card to order some automobile seat covers and have them delivered to the daughter-in-law in Alabama. When they were delivered, it was discovered that the covers were the wrong color. The daughter-in-law sent them back to the company and reversed the charge on her credit card. The company claimed that it never received the seat covers, and eventually sued the purchaser and the daughter-in-law for breach of contract.

The lawsuit against the customers was reason enough for heartburn, but adding to the problem was the fact that the action was filed in a state court in Indiana, far from either of the defendants' homes. The defendants' attempt to avoid having to defend the suit in Indiana failed. The "clickwrap" agreement that the customer had accepted with a click of the mouse when she purchased the items included a requirement that any legal proceeding between the purchaser and seller had to be filed in Indiana and governed by Indiana law.

It may be that most customers only skim the language in a clickwrap agreement, if they read it at all, while looking for the "I accept" button. However, the agreement, and everything in it, is no less binding because of that. Both the customer and the owner of the card she used were bound to litigate the dispute in Indiana.

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Walters Levine Klingensmith & Thomison P.A.
1800 2nd Street, Suite 808 • Sarasota, FL 34236 • Phone: (941) 364-8787 • Fax: (941) 361-3023
601 Bayshore Boulevard, Suite 720 • Tampa, FL 33606 • Phone: (813) 254-7474 • Fax: (813) 254-7341
Website: www.walterslevine.com

The Power of a Power of Attorney

A power of attorney is an instrument that authorizes an "agent" to act on behalf of someone else (the "principal") in a legal or business matter. When an elderly woman executed a power of attorney that gave her younger sister certain powers, a dispute arose when the younger sister used her power to name herself as the beneficiary of the elderly woman's life insurance policy. The dispute was with the elderly woman's children and grandchild, who had been beneficiaries under the policy until the younger sister with the power of attorney put herself in their place.

A power of attorney can be a valuable tool in estate planning, but it should be properly drafted to ensure that the powers contained therein are appropriate.

The children and grandchild argued to no avail that the terms of the power of attorney instrument did not give the younger sister the authority to name herself as the beneficiary of the life insurance policy. Unfortunately for them, the instrument language was broad enough to authorize the agent to change the beneficiaries of the principal's policy, where it authorized the agent "to transact all insurance business on [principal's] behalf, to apply for or continue policies, collect profits, file claims, make demands, enter into compromise and settlement agreements, file suit or actions or take any other action necessary or proper in this regard."

It was significant that the power of attorney did not incorporate by reference the various powers listed in the Uniform Durable Power of Attorney Act. In cases in which the powers listed in the Act are incorporated by reference into the power of attorney, an agent is not authorized to change the beneficiary of the principal's life insurance policy unless the principal has expressly authorized the agent to do so within the power of attorney. Since there was no mention of the Act in the instrument in question, but only a broadly worded grant of authority, the sister had not exceeded her powers.

Although the children and grandchild lost on the issue of how to interpret the agent's powers, they were still free to raise other arguments if they had factual support. These included arguments that the elderly woman did not have the mental capacity to execute the power of attorney, that her execution of the instrument was not of her own free will but was rather the result of the duress, coercion, control, and/or undue influence exercised by her sister/agent, and that the sister/agent's action in changing the beneficiary of the policy to herself was a violation of her fiduciary duty to the principal.

A power of attorney can be a valuable tool in estate planning, but it should be properly drafted to ensure that the powers contained therein are appropriate. Always consult with a qualified professional before executing a power of attorney.

Is It "Work" to Dress for Work?

Six times a day, for 6 to 10 minutes each time, workers at a chicken processing plant were required to put on, take off, and clean safety and sanitary clothing that they had to wear while on the job. The special gear consisted of smocks, hairnets, gloves, earplugs, and safety glasses. When a dispute arose between the workers and their employer over whether the employees were entitled to be paid during this time, the workers claimed a right to compensation under the federal Fair Labor Standards Act (FLSA).

A jury initially ruled against the workers on the ground that the dressing, undressing, and cleaning activities were not "work" within the meaning of the FLSA. The jury had been instructed that, under the FLSA, the activities were not work without a sufficiently laborious degree of exertion, such as may be required if the gear were cumbersome, heavy, or required significant concentration to put on and take off.

An appellate court disagreed with the "exertion" standard and ruled in favor of the workers. Under the FLSA, it is not appropriate to focus on whether an activity requires a certain level of exertion in deciding whether it is "work." Instead, the key for treating an activity as "work" is finding that it is an integral and indispensable part of the primary activities undertaken for the employer's benefit, and that it is controlled or required by the employer.

Even though the dressing, undressing, and cleaning jobs done by the poultry workers were, in a sense, peripheral to the main tasks, they still were an essential part of the job, for which the workers had a right to compensation. (Do not expect a similar result if you are a white-collar worker hoping to be paid for the time taken to put on a coat and tie in the morning.)

Intrafamily Loans Subject to Tax Laws

For parents with the financial means to do so, there may be a natural impulse to help a child get started in his or her adult life by making a loan to the child, on terms that are favorable to the child. Notwithstanding the virtues of such generosity, the cold reality is that, if the terms are too favorable to the child, the loan could end up with some undesirable tax consequences.

The better choice may be to go forward with the loan, but with the child repaying the loan with enough interest to avoid the tax bite. Think of this approach as generosity tempered with practicality and as a borrowing position for the child that is closer to the "real world" marketplace.

For a loan from a parent to a child, the IRS measures the interest rate on the loan against a benchmark interest rate, the "applicable federal rate" (AFR), which it sets each month. Currently, that rate is about 5%. To the extent that the interest due on the loan is less than the interest calculated with the AFR, that amount will be "imputed" income to the parent, even though it was not in fact collected by the parent. The IRS will also treat the same amount as a gift to the child, requiring the filing of a gift tax return. (There would be no gift tax due, however, unless the parent had used up the $1 million lifetime gift tax exclusion.) From the standpoint of the child's taxes, he or she may be able to deduct the amount of the imputed interest on a loan secured by a residence.

Exceptions

There are two important exceptions to this scenario. If the amount of the loan to a relative does not exceed $10,000, and the loan is not used for an income-producing investment, the IRS will not impute any interest. In addition, loans of up to $100,000 do not lead to imputed interest if the borrower's net investment income in a given year does not exceed $1,000.

To avoid the income tax or gift tax ramifications for all kinds of intrafamily loans, the simplest approach is to use an interest rate that is at least as high as the AFR. Also, although it may seem unduly formal among relatives, it is advisable to set forth the terms of the loan in a written agreement, signed by all parties. Not only does this protect against faulty memories, but it decreases the odds that the IRS will consider the entire transaction to be a gift rather than a loan.

Baseball Strikes Out on Stats

Millions of sports fans participate in fantasy sports games in which the participants "draft" the names of real professional athletes and compete against other teams based on the actual statistical performances of the athletes during their seasons. In the case of baseball, until several years ago a fantasy sports company licensed the use of the names and information about big league players from the Players Association for Major League Baseball (MLB). When that deal expired, the Association instead gave an exclusive license to an online arm of the MLB, which operated its own fantasy baseball business.

The excluded company sued the MLB, seeking a ruling that it could use the names and statistics of the players, even without a license. Essentially, the question was whether the players themselves, or the public at large, own that information. A federal court sided with the excluded company. Simply put, the information at issue was already placed in the public domain, and there is a First Amendment right, available to everyone, to make use of it.

The court rejected an argument by the MLB that the names and information about the players are not "speech" at all. On that issue, the names and statistics in a fantasy game are not appreciably different from the constitutionally protected pictures, graphics, concept art, sounds, and other components of video games.

Fantasy baseball may not represent the purest form of protected speech—it is mainly about entertainment more than informing the public—but the information comes within the protection of the First Amendment. There is some informational value to the information in the fantasy games, since, as the court put it, "[t]he records and statistics remain of interest to the public because they provide context that allows fans to better appreciate (or deprecate) today's performances."

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

Real Estate Roundup

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Condemnation Action Dooms Business

When the District of Columbia condemned property on which it planned to construct a municipal office building, the corporation that owned the land received an award compensating it for the property, "including all interest therein." The quoted phrase was relevant, because the property had been occupied by the owner of a gas station and convenience store business under a franchise agreement with the landowner. Unfortunately for the holder of the franchise, the agreement's terms heavily favored the landowner insofar as the impact of a condemnation was concerned.

The business owner argued that it should receive compensation for the business's losses, goodwill, and other consequential damages that flowed from the condemnation.

First, in the event of a condemnation, the agreement would terminate 10 days before the effective date of the condemnation. This meant that the agreement ended before the condemnation, leaving the business with no remaining legal interest in the property for which it could receive compensation. Second, the agreement provided that the landowner would receive all of the money awarded in the condemnation proceedings.

Left without a share of the condemnation award for the property itself by the terms of its agreement, the owner of the business argued that, as part of the condemnation action, it nonetheless should receive compensation for the business's losses, for its goodwill, and for other consequential damages that flowed from the condemnation. The argument failed.

It could have been within the power of the District of Columbia to authorize such an award for nonowners situated on condemned property but, in fact, the relevant statute contained no such provision. As a result, the claim by the business fell under the rule, announced by the United States Supreme Court in a previous case, that "absent a statutory mandate the sovereign must pay only for what it takes, not for opportunities which the owner [or, in this case, franchise holder] may lose."

Mold Exclusion Enforced

Among the well-settled rules for interpreting insurance policies is one requiring courts to apply a policy according to what it says, not what regulators or individual insurers thought it said. While ambiguities in policy language generally are settled in favor of consumers, the ambiguity must be present in the policy itself, not from extraneous considerations such as other policies, an agency's interpretation, or the fact that the harm in dispute is part of a broader "crisis." All of which is to say that consumers need to understand and agree to all of the language in their insurance policies, and that it is folly to assume that in a dispute the policy language will always be given a loose reading in favor of coverage.

This lesson was demonstrated in a case in which insured homeowners sought coverage under their homeowners policy for mold contamination that was caused by small roof and window leaks in their home. The policy did cover "water damage," so the homeowners argued that there was coverage for the mold because it resulted from water getting into the house. Yes, mold is caused by water, but it is *not* a loss from "water damage," as that term was used in the policy.

The even bigger problem with their argument lay with another provision that expressly excluded coverage for "loss caused by mold." The court was hard-pressed to find any ambiguity that would warrant ignoring this clear exclusion:

> *Mold does not grow without water; if every leak and drip is "water damage," then it is hard to imagine any mold, rust, or rot excluded by this policy, and the mold exclusion would be practically meaningless.*

Careful What You Click

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The court emphasized that the online agreement gave reasonable notice of its terms. Its full text was immediately visible to the customer, who had to take the affirmative step of clicking on the "I accept" button. Not only that, but the heading for the "litigate only in Indiana" section was in bold print and capital letters.

In most cases and for most people, the legalese in clickwrap agreements is of little practical consequence, but online customers should be on notice that agreeing to buy a product may also entail agreeing that any dispute will be litigated on the other side of the country and be decided according to another state's laws.

Quotable

A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.

Winston Churchill