THE RISK MANAGER

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> *"Never forget what a man says to you when he is angry."*
>
> *Henry Ward Beecher*

> *"You raise your voice when you should reinforce your argument."*
>
> *Dr. Samuel Johnson*

An October Surprise – The Check 21 Act and Client Trust Accounts

For years it has been good risk management as well as prudent business practice to have canceled checks returned with firm bank statements and filed as part of the documentation supporting financial transactions. Standard advice on client trust account management is to retain and file all pre-numbered canceled checks or other instruments drawn on an account for at least five years and preferably ten.

The Check Clearing for the 21st Century Act, effective October 28, 2004, will over time do away with the ability to receive original canceled checks. Under this law a bank may provide an image replacement document called a "substitute check" instead of the original check. A substitute check is the legal equivalent of the original check for all purposes – federal law, state law, and all persons – provided it contains all the information on the front and back of the check when it was removed (truncated) from the check collection process and complies with certain other technical requirements. ("Check 21 Act" – 12 U.S.C. 5001, Pub. L. No. 108-100, 117 Stat. 1177 Oct. 28 2003.)

The Check 21 Act may introduce valuable efficiencies in the check clearing process, but it also creates greater risk of multiple presentation of the same check for payment and makes it more difficult, if not impossible, to detect and prove alterations and forgery. At the time this is being written it is not clear how banks will implement the Check 21 Act, but some commentators believe that banks will seek to avoid sending substitute checks and try to obtain customer agreement to accept informal electronic check images that do not qualify as substitute checks. Until the implications of the Check 21 Act are fully understood, it is recommended that firms unable to obtain canceled checks from a bank request substitute checks for client trust accounts, firm business accounts, and fiduciary accounts.

It is beyond the scope of this newsletter to cover the specifics of the Check 21 Act. Lawyers need to understand how under this law original checks are truncated, what happens to the original check, how substitute checks are created, what bank warranties on substitute checks are, what drawer recredit rights are, what bank liability is, what remedies bank customers have, and the Act's relationship to other laws. A Google Internet search will provide this information and more.

ENVIRONMENTAL LAW MALPRACTICE WARNING FLAGS

*By Barry Steinberg**

Whatever your area of practice, environmental issues lurk. Unfortunately, they may not be recognized until after it is too late to address them in a legally proactive fashion. If your practice involves real property, production, or manufacturing activities, there is obvious potential for environmental legal issues. And that is not limited to real property leases, purchases and sales. Mergers and acquisitions, as Halliburton learned all too late, may involve contingent environmental liabilities for long-ceased activities. Current or historic activities on adjacent property may implicate your client. Trusts and estates may have environmental legal implications, depending on the assets held.

While the risk of environmental legal exposure may be slight in most circumstances, the consequences of such exposure can be catastrophic. This is because liability for personal injury, remediation and property damage can exceed the value of the asset. With respect to remediation obligations, the liability is, in some circumstances, strict. And consider that most general liability and D&O insurance policies exclude from coverage claims arising from pollution conditions.

The concerns relate to good legal

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practice, ensuring that the client's interests are fully protected. Environmental inquiry by counsel will also protect against allegations of malpractice. So what are the warning flags that should alert the transactional attorney that further inquiry is not only appropriate, but necessary to satisfy practice standards?

1. Is there real property involved? If so, what is the history of use at or adjacent to the site, including above and underground storage tanks?
2. Are there assets being exchanged which are associated with industrial activities, now or in the past?
3. Are there in the transaction documents provisions for representations and warranties that extend to environmental issues? Are they limited to the knowledge of the indemnitor or do they extend to facts?
4. Are there now or have there been environmental claims, violations, orders, judgments, or notices that relate to the transaction?

When real property is involved, it is common practice to obtain an environmental assessment of the property, prepared by an environmental engineer. The assessment should satisfy the standards of the American Society for Testing and Materials Standard 1527-00, a standard devised to provide a defense to remediation liability under certain circumstances. The assessment is not necessary in every transaction, but certainly when warning flags are raised the judgment of whether there are environmental risks is best left to the environmental engineer, not the attorney. Identified risks can then be allocated between the parties through representations and warranties, indemnification, specialized insurance products, other risk transfer mechanisms, and escrowed funds. But a failure to recognize the potential of environmental liability will result in a failure to address the risk, with consequent exposure to both attorney and client.

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Know Your Options in Divorce

*By Jennifer Wehrle, Certified Divorce Financial Analyst**

The grant of stock options to key employees is now commonplace as many companies strive to add extra incentive to the overall compensation plan. Traditionally, stock options are used to reward and retain the top tiers of management and other key employees. Particularly in the last decade, however, many companies have opted to include more employees by offering broad-based stock option plans. It is estimated that nearly a third of large domestic companies now have broad-based stock option plans covering all or a majority of their employees. Obviously, stock options will be seen more and more in future divorce cases as a substantial marital asset.

Given the complicated nature of stock options, attorneys specializing in divorce need to understand the basic function of stock options and the unique tax and distribution issues resulting from valuation and division during divorce. When an attorney has a divorcing client where options are part of the matrimonial assets, a copy of the Stock Option Plan document from the issuing company should be requested immediately. Stock options have very specific exercise provisions and the attorney must be aware of these terms to avoid economic loss to one or both divorcing parties or a potential malpractice claim. Typically, this document will define the parameters of how the stock options may be treated – whether they may be transferred or assigned.

Basically, there are two categories of stock options. ISOs, or Incentive Stock Options, are statutory and are not transferable or exercisable by anyone other than the employee. ISOs require more tax planning because it is a preference item for the alternative minimum tax. The second category is NQOs or Non-Qualified Options. NQOs *may* be transferable and exercisable by the non-employee spouse. Again, it is imperative to gain a copy of the company's Stock Option Plan document. Also, it is important to note that if the NQOs are assigned to the non-employee spouse, the employee will be taxed on the income at exercise.

"Deadlines are the mother of invention."

John M. Shanahan

Once you have defined the marital options and taken into consideration the consequential tax treatments and tax effects (income on other areas of the tax return), you can begin stock option valuation. The two most popular methods are the "intrinsic value" and the "Black-Scholes" method. In the intrinsic value method, the value of the stock option is equal to the difference between the option exercise price and the fair market value of the stock. The Black-Scholes method is similar to the intrinsic value method, but is more complex because it incorporates volatility into the calculation. For example, the Black-Scholes method distinguishes between options from a slower growing utility-type company and a faster growing technology-based corporation, whereas intrinsic value will not factor non-numerical data into the equation. Although options analysis software is readily available, it is advisable to consult with a certified divorce financial analyst or a certified public accountant when trying to determine the best options valuation model for your client. Afterwards, when the value is understood and established, the options can be negotiated into the divorce settlement.

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Clients should be educated on the factors relating to stock options, such as investment risk of the underlying stock, time value of assets, and tax issues inherent to options. Considering the complexity of design and exercise, attorneys involved in a case concerning stock options should consider drafting agreements with provisions including compulsion to sell vested options at designated times, payment of strike price, and payment of resulting taxes from exercise.

As you can see, division of stock options during divorce will require more attention to financial detail than is normally required from a retirement plan type of division. As more employees accumulate stock options, divorce attorneys will need an increasing awareness of the effective handling and treatment of this unique marital asset.

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Breaching Client Confidentiality – Duh?

The cornerstone of the legal profession is the fiduciary duty of client confidentiality. Lawyers are quite sensitive to this obligation when "on duty" – such as during trial proceedings, discovery, and while investigating the matter. Unfortunately, too many lawyers let their guard down during breaks in the action, on social occasions, and in informal settings. Just think of the things you have heard when a person near you in an airport uses their cell phone to discuss business details and sometime rather personal matters.

Gerald Skoning in his article "*Loose lips sink ships and other timeless truths*" points out these situations in which lawyers get careless and live to regret it:

- Talking on a cell phone in airports, commuter trains, etc.
- Talking in elevators with strangers on board.
- Conversing with other lawyers in courthouse and law office restrooms not knowing who, if anyone was in a nearby stall (think of the movie "The Witness").
- Doing work on airline flights on a laptop computer easily seen by other passengers nearby.
- Doing work on airline flights using the seat-back pocket to store papers as you work (and drink).
- Using discoverable office e-mail to vent your spleen about clients, partners, loved ones, *et al.*
- Failing to double check e-mail addresses before hitting the send button with the result that your indiscreet and confidentiality busting comments go to the universe at large.

Skoning advises: "Here are a few black letter rules to learn … and stick to: Concentrate on nonlegal business in restrooms; use your cell phone discreetly or not at all; be wary of video voyeurs; never leave a top secret memorandum on airplanes (or maybe have just one glass of wine); and don't vent in e-mails."

By the way if this all seems just common sense to you, always remember the odd thing about common sense is that it is not very common.

> ***"Common sense is perhaps the most equally divided, but surely the most underemployed, talent in the world."***
>
> *Christiane Collange*

Source: Skoning, "Loose lips sink ships, and other timeless truths," The National Law Journal, p. S3, 9/6/2004.

If Old Age Isn't for Sissies, Representing Older Adults Isn't for Wimps

One clear national trend is that lawyers are encountering more problems when representing older adults. The obvious reason for this is that older adults are increasing in number at a record pace – they constitute a growing part of the client base and as they live longer are bringing more complex matters for resolution. What follows are three recent older adult sensitive cases considered in other jurisdictions:

- **Wyoming:** An older adult died while his divorce action was pending with the result that the estranged wife was able to claim a 25% elective share of a $3 million dollar estate. A daughter sued the lawyer representing her father in the divorce for failing to complete the divorce action before his death knowing that her father was in fragile health and had executed a new will leaving her the bulk of his estate. Held: The father had intended to benefit only himself when retaining the lawyer to represent him in the divorce action; therefore, the lawyer had no duty to protect the daughter's interests by expediting the divorce action. (*In Re Estate of Drwenski, Wyo., No. 03-29, 1/28/04; ABA/BNA Lawyers' Manual On Professional Conduct, Current Reports, Vol. 20, No.3, page 58 (2/11/04).*)
- **New York:** A lawyer holding a will of a client asked for guidance from the New York State Bar Ethics Committee when he received a letter requesting return of the will signed by the client, but apparently drafted by someone else. The lawyer suspected that the client was incapacitated and was being unduly influenced by a family member. Opinion: A lawyer holding a will has a duty to return it upon request, but under these circumstances may contact the client to ascertain the client's intent without violating rules concerning

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contact with represented parties and solicitation. If unable to resolve the question by contact, the lawyer may seek judicial guidance. (*New York State Bar Ass'n Committee on Professional Ethics, Op.775, 5/4/04. Opinion is available on the NY State. Bar Ass'n web site.*)

> *"Communication is a measurable asset."*
>
> *Susan Sampsell*

- **Massachusetts:** A lawyer received a fax of a letter signed by an elderly client he had represented for years discharging him and instructing him to turn the file over to a successor lawyer. The lawyer feared this was the result of an abusive child living with the client who appeared to be taking over the father's affairs against the father's wishes. While the lawyer did not think the client was incompetent, he thought the client was exposed to considerable harm including physical, mental, and financial. The Massachusetts Committee on Professional Ethics opined that under the circumstances the lawyer may take action to verify that the client was discharging him of his own free will before turning the file over to the successor lawyer. One way of accomplishing this is to write the successor lawyer and ask for a private meeting with the elderly client. The lawyer may also confer with other family members to inform them of his concerns "only to the extent necessary to protect the client's interests" without violating client confidentiality requirements. (*Mass. Bar Ass'n Committee on Professional Ethics Opinion 04-1, 1/22/04. Opinion is available on the Mass. Bar Ass'n web site.*)

If you find yourself in a delicate situation when representing an older adult, use the KBA Ethics Hotline as a first line of defense. For more on professional responsibility and older adult representation read the KBA *Bench & Bar* article "*Golden Oldies, The Graying of Professional Responsibility*" available on our web site, www.lmick.com, in the Risk Management section.

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