

“Good Guy” Guaranties

WHEN SIGNING A NEW LEASE, LANDLORDS WILL seek a minimum two month security deposit from most tenants. In addition, if the landlord is doing work or providing a free rent period and, especially if the tenant is a subsidiary or a shell corporation, the landlord will want additional security. This could be in the form of an additional security deposit or a guaranty.

Wary individuals will not sign a guaranty that exposes them to substantial liability; corporations must disclose their contingent liability under a guaranty in their financial statements. These issues have led to various forms of limited guaranties. The limitation can be a maximum dollar amount or a certain number of years of the lease term, in each case allowing the landlord to recoup its renting expenses. But what has become most popular is the “good guy” guaranty. In this form of guaranty, the guarantor agrees to pay the rent from the time the tenant goes into default until the date the tenant surrenders the leased space to the landlord. The guarantor has no liability if the tenant vacates its space when it stops paying rent. The landlord benefits by avoiding months spent to evict a tenant who continues to operate with no ability or intention to pay any rent during that period of time. The surrender enables the landlord to immediately re-rent the space and minimize its damages, while avoiding potentially expensive litigation.

The individual owner of a tenant corporation is in a position to control the actions of the tenant and determine when to surrender the premises.

This guaranty forces him to be a “good guy” and promptly turn over the premises. It would seem difficult to make a case for an individual to refuse to sign this form of limited guaranty; however, there are some dangers in signing, and, in addition, most good guy guaranties today are somewhat more comprehensive than the simple and previously employed guaranty forms.

The good guy guaranty continues as long as the lease is in effect. This means that if the tenant subleases the premises, the guarantor now has to be concerned whether the subtenant will surrender the premises if it is unable to pay rent, because the guarantor is still responsible now for both the subtenant’s occupancy and the tenant’s. If the tenant assigns the lease, the guarantor has no control over the assignee in occupancy. The tenant must make provision for this possibility in the lease or guaranty or resolve these issues at the time of the assignment. For example, as part of the landlord’s approval, the tenant could negotiate a termination of the guaranty with a principal of the assignee substituted as guarantor. In the case of a sublease, the concept of a substitute guarantor does not work since the tenant could remain in occupancy or resume occupancy. However, an additional security deposit may be provided by the subtenant to the tenant, who in turn would deliver a further security deposit to the landlord. Another solution is for the tenant to accept a good guy guaranty from a principal of the subtenant.

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Landlords and their attorneys have embellished the good guy guaranty, seeking to improve it in many ways. The individual guarantying the lease should not merely accept a good guy guaranty, but should carefully examine exactly what is guaranteed. The first expansion seen has been to guaranty all rent due from the execution of the lease until the tenant vacates. If the tenant has been paying the rent on a regular basis until the final default, this language should not create any additional burden on the guarantor. However, in many cases, the landlord has given the tenant a rent concession or abatement at the beginning of the lease term with a provision that provides that if the tenant defaults, the landlord is entitled to recover the rent concession as additional rent. This sum would then be encompassed by the good guy guaranty.

Leases usually have non-waiver provisions so that the landlord does not waive any rent due, even if the landlord does not collect it or bill for it. If, for example, the landlord did not bill for an operating expense escalation or for real estate taxes, either because the amount was small or the landlord overlooked it, the good guy guaranty would require the payment of these sums if the landlord later sought to collect them.

Some forms of guaranty provide that the individual is guarantying rent, but others include all obligations of the tenant from the date of the lease execution. Now the guarantor is responsible for matters other than rent, such as provisions requiring compliance with law, repairs and maintenance. A careful reading of the lease is necessary to determine the obligations of the tenant. Sometimes a lease provides that a defaulting tenant is liable for the unamortized portion of brokerage commissions, legal expenses or construction costs paid for by the landlord as part of its leasing of the space.

In some instances, you do not even have to look in the lease. One form of good guy guaranty expressly states that the guarantor guarantees these items in addition to the rent.

Expanding the good guy guaranty even further, some landlords have provided that the surrender of the premises must be by a written surrender agreement accompanied by the keys and actual possession. Some have gone even further and provided that the tenant must give several months notice before delivery of this surrender agreement and possession. The argument is that the tenant generally plans in advance to cease business. If the tenant notifies the landlord three or four months in advance, the landlord has ample time to prepare for a transition. Most individuals will find this an unacceptable burden, but many may agree to a one or two month notice provision.

Finally, the parties should consider what happens in the event of the tenant's bankruptcy. Some good guy guaranties provide that the guarantor is liable in the event of the tenant's bankruptcy from the time of the bankruptcy until the surrender. Under the Bankruptcy Code, the rejection of the lease and surrender of the space may take up to ninety days, which would be covered by this guaranty. It may also change the guarantor's thinking about whether to file bankruptcy voluntarily on behalf of the tenant, since the guarantor will be personally responsible for the tenant's indebtedness. The good guy guarantor also knows that if the tenant pays the landlord past due rent, that money may be considered a preferential payment to a creditor requiring the money to be paid to the bankruptcy trustee. The good guy guarantor again becomes liable for those preferential payments.

A New York court recently ruled that a landlord could not collect accelerated rent under a good

The principal of a tenant should carefully examine a "good guy" guaranty to determine what it encompasses.

New Developments Affecting Family Limited Partnerships

FOR THE PAST FEW YEARS, THE IRS HAS BEEN aggressively attacking the use of family limited partnerships and family limited liability companies ("FLPs") in the gift tax and estate tax context. The IRS has had its greatest successes in challenging cases in which the taxpayers violated many of the basic "do's and don'ts" of FLP planning.

Typical FLP planning involves the contribution of assets by the older generation to an FLP in exchange for all, or nearly all, of the limited partner interests. The creator also retains control (as general partner or managing member), whether solely or with other family members. The creator then makes gifts of FLP interests (which have little or no voting rights) to other family members. On the gift tax return, the gifted FLP interests are reported net of a discount (sometimes reaching over 50%) to reflect lack of marketability and minority interest. On the creator's death, the FLP interests reported on the estate tax return are similarly discounted.

Most of the cases that the IRS has chosen to challenge have the following "bad facts" in common:

- The creators were elderly and in many cases had been diagnosed with a terminal illness.
- The creators transferred to the FLP virtually all of their assets and means of support. The assets typically transferred to the FLP were passive investments and the family home.
- The creators continued to reside in the home (now owned by the FLP), deposited income from the FLP assets into their personal bank accounts, used FLP funds to pay personal expenses, and generally did not administer and operate the FLP as a separate entity.

Not surprisingly, the IRS has taken the position, which has been successful in court, that there was an implied agreement among the partners for the creator of the FLP to retain the economic benefits of the underlying property. As a result, the underlying assets attributable to the interests in the FLP that were retained by the creator were included in the estate at the undiscounted fair market value of the underlying assets. In addition, the underlying assets attributable to the FLP interests that had been previously gifted to family members were included in the creator's estate at the full fair market value of the underlying assets at the creator's date of death.

Moreover, a recent Tax Court decision raises some troublesome issues that affect nearly all FLPs and raises estate and gift tax concerns even for long-established active family businesses without "bad facts."

In this case, known as "Strangi II" (the second case involving the same taxpayer), the Tax Court's reasoning in favor of the IRS went further than any of the prior cases and has resulted in a re-examination of what were thought to be the basic acceptable rules of FLP planning.

Strangi II appeared to be a typical "bad facts" case:

Two months before he died, Mr. Strangi transferred 98% of his wealth (including his house) to an FLP in exchange for a 99% limited partner interest and 47% of the stock of the 1% corporate general partner. His children contributed assets in return for the remaining 53% of the general partner. The children then gave a 1% interest in the general partner to a local charity. The general

The IRS is aggressively examining the use of family limited partnerships.

partner could unilaterally determine FLP distributions, and, together with the other partners, could liquidate and dissolve the FLP.

Mr. Strangi continued to occupy his residence without the payment of rent, and distributions were made from the FLP for his benefit and, after his death, for the benefit of his estate. When Mr. Strangi died, his interests in the FLP were reported on his estate tax return, and the IRS challenged the substantial discount that the estate claimed for the interests (presumably, for lack of marketability). The Tax Court first determined that the facts supported the existence of an implied agreement for Mr. Strangi to retain the possession or enjoyment of the underlying assets. As a result, the underlying assets in respect of his FLP interests, including those in respect of his 47% interest in the general partner, were included in his estate, without any discount. This result was not surprising, given the “bad facts” of the case.

But then, although not necessary to its decision, the Court went on to discuss a second theory: that the assets of the FLP should be includible in Mr. Strangi’s estate solely on the basis of his retained control.

The Tax Court referred to the following factors supporting its decision:

- The general partner, which had the sole power to make distributions, was controlled by Mr. Strangi and his son-in-law, who was also his attorney and his attorney-in-fact.
- Mr. Strangi retained the right, together with the other partners and shareholders of the general partner, to liquidate the partnership and receive the assets owned by the FLP.
- Because the FLP owned investment assets rather than a business, FLP distributions under the control of Mr. Strangi would not

be affected by business concerns e.g., working capital needs, expansion.

- All of the owners of the FLP (except for a charity, which had a 1% interest in the general partner) were Mr. Strangi and members of his family. Thus, there was no meaningful independent oversight over the activities of the FLP.
- The arrangement was created primarily for estate planning purposes rather than a business purpose.

The Tax Court’s opinion is a cause for concern because it is potentially far-reaching. Taken to its extreme, the literal language of the case possibly could apply even if at death the creator held only 1% of the voting power and economic interest in the FLP and his children or others held the remaining 99%.

The opinion has been widely criticized and many commentators have taken the position that it should be limited to its bad facts. It is a Tax Court “Memorandum” decision, which means that it represents the opinion of a single judge, and not necessarily that of the entire Tax Court. The case is on appeal to the Fifth Circuit Court of Appeals. Although that court has a pro-taxpayer reputation, it is impossible to predict the result of the appeal.

Given the present state of uncertainty in this area, there is a risk that the IRS will try to apply the Strangi II analysis to any closely-held business whose creator retains some measure of control over the entity, whether alone or with other family members. Especially at risk are FLPs whose assets consist of passive investments (such as marketable securities) and personal assets (such as a home or a boat) that continue to be used by the creator. If the IRS is successful, the full fair market value of the FLP assets, including that attributable to previously-gifted interests, may be included in the creator’s taxable estate (without any discount). Even if

A New Method for Appointing a Guardian for Your Minor Children

THE DESIGNATION OF A GUARDIAN FOR MINOR children in a will is effective only at death and only after the process of petitioning the Court to probate the will and to appoint the Guardian is completed.

What happens if you do not have a will? What happens if you become unable to care for your children while you are alive but become incapacitated or contract a debilitating illness? What happens if you want to avoid what could be a lengthy delay petitioning the Court to appoint a Guardian? What can be done to assure that your children will be in the hands of those whom you know will best care for them?

There is a document that is less intimidating than a will that provides a solution to the situation described above. Moreover, due to recent statutory amendments that became effective January 1 of this year, the authority granted in the document now can be made to take effect upon the parent's death. It is called a Designation of Standby Guardian. This document allows a parent, legal guardian or primary caretaker (all of whom are collectively referred to as "parent") to designate a person to be the Guardian of his or her minor children. It further permits for alternate designations, if the primary choice is unavailable or unwilling to act.

A parent may nominate the person or persons to become Guardian upon the parent's death, or upon the parent's incapacity or upon the parent's debilitation and consent. The parent's ability to make the choice effective at death is one of the most significant changes in the

statute. Before the statute was amended, a parent would have to designate a Standby Guardian in the event that the parent became incapacitated or debilitated and also appoint a Guardian in case of death.

The Guardian's authority to act begins immediately, without Court action, when he or she receives: (1) a copy of the determination of the parent's incapacity; (2) a copy of the determination of the parent's debilitation and a copy of the parent's written consent to the Guardian's authority; or (3) a death certificate or any other document proving the parent's death. The Guardian then has sixty days to file a petition with the Court to continue his or her authority. In the meantime, the children are provided for in the absence of the parent's ability to do so.

The ultimate decision of who will be appointed Guardian rests with the Court which is required to consider the best interests of the child. However, signing a Designation of Standby Guardian allows the parent to nominate someone he or she believes that the Court should and normally will consider.

It is difficult and painful to conceive of something happening to us before our children are grown, rendering us unable to care for them ourselves. Executing a Designation of Standby Guardian can help alleviate some of the concern surrounding the care of our children. If you have further questions about a Designation of Standby Guardian, please contact Edward S. Schlesinger or one of the other partners of our firm.* ■

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** We thank Marilyn A. Filingeri, MSW, for her assistance with this article.*



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the gifts of the FLP interests are adequately disclosed on gift tax returns, the IRS will not be precluded from challenging the estate tax return upon audit.

In the meantime, the following are some suggested guidelines to be considered:

- The creator should consider giving up all vestiges of “control” over the FLP and possibly giving away any remaining economic interests before death.
- The creator should retain sufficient assets to maintain his or her standard of living without accessing the FLP assets.
- “Deathbed” transfers are suspect.
- Transfers of “personal” assets are suspect. If personal assets are transferred, rent should be paid to the FLP for their use.
- The ownership of significant interests by non-family members should be considered.
- All distributions to partners should be proportional to their percentage interests in the FLP.
- FLP assets must not be commingled with personal assets. Do not pay the creator’s personal expenses from the FLP bank account.
- Comply with the formalities of the transaction. Create a separate FLP bank account, keep accurate books and records, etc.
- Some practitioners have advocated a “wait and see” approach. We believe that clients should actively review the issues. We recommend that clients conduct a thorough review of the ownership, administration and operation of their existing FLPs. For those who wish to create new FLPs, we believe that

the recent developments require more planning in order to have a reasonable degree of assurance that the goals can be achieved.

Each situation must be evaluated on its own.

If you would like to discuss these recent developments and their potential application to your estate and business planning, please call Bob Howard or Mary DeMarco Lee, or your partner at the firm. ■

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guy guaranty where the landlord blocked the tenant from moving out of the space.

If a landlord does not offer a simple good guy guaranty then reaching a fair guaranty will be a matter of negotiation. It should be discussed as soon as it appears as part of the proposed lease terms. If you have any questions about a good guy guaranty or would like one drawn up as part of a commercial lease, please contact Gerald Morganstern or one of the other partners of the firm. ■

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- general business and commercial law
- cooperative and condominium matters
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- trust and estate administration
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- taxation
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