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A Common Estate Planning Pitfall to Avoid: Beware of Inadvertent Transmutations of Separate Property

By Stacey F. Herhusky

Both Nevada and California are community property states. In community property states, assets owned by a party prior to marriage are the separate property of that party. Assets acquired during the marriage are generally treated as community property. Spouses may agree to change the character of any of their property—from

separate property to community property, from community property to separate property, and from separate property of one spouse to separate property of the other. When spouses agree to change the character of property, it is commonly referred to as "transmutation." A transmutation is typically an express written declaration of intent. However, under a

variety of circumstances the lines between separate property and community property can become blurred and spouses can inadvertently transmute their separate property into community property. One of the most common situations where this can occur is in the estate planning process. Often, spouses decide to change the character of separate prop-

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Transfer of Properties to Family Trusts for Married Settlers: A Few Strategies

By Vera Anne Struc

You and your spouse have decided to "get your affairs in order" and establish a revocable living trust as part of your estate plan. You both diligently complete the questionnaire your attorney has given you, which includes an inventory of all your assets. The questionnaire asks you to identify each asset as

"community property" or "separate property." For many happily married couples, this is the first time they have considered the characterization of their marital and separate properties.

When married settlers transfer property to a revocable trust, questions arise concerning the consequences of the transfer with

respect to the settlers' legal rights in the transferred property. Questions also arise about the possible desirability of identifying property as community property or separate property. Sometimes preliminary identification may reveal reasons that the settlers should "transmute" the character of that property, for

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A Common Estate Planning Pitfall to Avoid: Beware of Inadvertent Transmutations of Separate Property

“...under a variety of circumstances the lines between separate property and community property can become blurred and spouses can inadvertently transmute their separate property into community property.”

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erty to community property for estate planning purposes (i.e. to avoid probate and estate taxes upon one of the spouse's death). A typical transmutation for estate planning purposes is one which involves the transfer of property into a revocable living trust. At first glance, the transmutation for estate planning purposes appears to be a good idea. Typically, when the character of property is changed from separate to community property for estate planning purposes, the spouses are on good terms and the marriage is contemplated to last until the death of one of the spouses. However, what happens if the spouses decide to divorce, and the underlying estate planning purpose of the transmutation no longer exists? Does the character of the property revert to separate property?

The Court of Appeals entertained this issue recently in *Marriage of Holtemann* (2008) Cal.App.4th (No. B203089, Second Dist., Div. Six, 5/12/2008). In this case, the parties were married in 2003 and separated in 2006 with Wife filing for divorce in August of 2006. It was a second marriage for both parties and each party had adult children from their

prior marriages. Mr. Holtemann had considerable assets. In 2005, the parties jointly retained an attorney to prepare estate-planning documents in order to minimize death taxes and avoid probate if either one of them died. On March 10, 2005, as part of estate planning, Husband and Wife executed a “Spousal Property Transmutation Agreement” and the “Holtemann Community Property Trust.” The Transmutation agreement stated that Husband agreed that the character of the property listed in Exhibit A, “is hereby transmuted from his separate property to the community property of both parties.” Exhibit A contained a list of Husband's separate property being transmuted to community property, as well as a list of the parties' community property. That document also provided that Husband and Wife intended that transmuted property would be transferred into a community property trust, pursuant to the documents that they had executed. The trust documents declared the parties' intention to have the trust hold their community property, which was created by Husband's execution of the transmutation concurrently with the trust. Those documents also contained

the parties' acknowledgment that transmutation was signed by Husband conditioned on execution of the trust to dispose of his property on his death; another separate provision described character of the trust assets as community property, but emphasized that separate property and quasi-community property of each trust settlor would remain his or her separate property or quasi-community property.

After the parties separated and Wife filed for divorce, Husband gave notice that he had revoked the trust. Husband, of course, contended that transmutation was valid only for estate planning purposes; Wife claimed it was valid for all purposes. The trial court found that the transmutation was valid. The California Appellate Court affirmed the trial court's decision on May 12, 2008, holding that the transmutation document (1) contains clear and effective language of transmutation; (2) expressly states that character of Husband's separate property will be changed to community property; (3) is not made conditional or temporary by having been executed as part of estate planning; and (4)

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A Common Estate Planning Pitfall to Avoid: Beware of Inadvertent Transmutations of Separate Property

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was executed by Husband knowingly and after being advised by counsel.

Before feeling too sorry for Mr. Holtemann, it is important to know that throughout the opinion, the justices tell us that he was, “fully informed of the legal consequences of his actions.” Moreover, the attorney they jointly retained sent him a letter reminding him that this “transmutation” of separate into community property has clear and potentially irreversible consequences.

However, it is not difficult to see how, despite these admonitions, Mr. Holtemann proceeded as, in his mind, he was planning only for his death. He was short sighted and did not consider the impact of his actions in the event of a divorce or legal separation. This is regrettably a common frame of mind in which happily married people enter estate planning and postmarital agreements or, for those contemplating marriage, the negotiation of premarital agreements.

The Appellate

Court’s opinion in *Marriage of Holtemann* is further evidence of the necessity of competent representation when the issue of changing the character of property arises. The change in the character of property often brings with it unintended consequences. Accordingly, if you are married and are contemplating changing the character of your property for estate planning purposes, or for any other purpose, it is advised that you consult with an experienced attorney.

“The change in the character of property often brings with it unintended consequences.”

Contractor Troubles? The Residential Recovery Fund May Help

By John C. Rogers

Are you having difficulty getting a licensed contractor to perform services under a contract? Have you had to pay a lien because your contractor did not pay a subcontractor or supplier? Regrettably, there are many contractors who are failing to perform agreed services leaving the owner or developer with limited remedies. You should be aware that if you are the owner occupant of a residence, the Contractor’s Board may be able to help.

A number of years ago, NRS Chapter 624 was adopted and a “Residential Recovery Fund” was established to help owners when their licensed contractors fail them. There are many rules applicable to qualifying and actually getting a claim paid, but many claims are regularly made and paid. Usually you must pursue and exhaust all available remedies, even if your contractor files bankruptcy. If you obtain a judgment against the contractor, that simplifies the claims proc-

ess, but it is not always necessary. Currently, the maximum claim that can be paid is \$35,000 per claimant owner, and \$400,000 total against a contractor. So, if you are having difficulty getting your contractor to perform a contract, a punchlist, a warranty or a repair, consider talking to an attorney about exploring your options, or call the Nevada State Contractor’s Board to see what is required to file a claim. Don’t delay pursuing this remedy, there are significant time limits.

“Usually you must pursue and exhaust all available remedies, even if your contractor files bankruptcy.”

Transfer of Properties to Family Trusts for Married Settlers...

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example to increase the basis of both halves of community property under Internal Revenue Code Section 1014(b)(6). The answers to these questions may have important consequences in property distribution rights, taxes, and creditors' rights for each spouse, and may have unintended consequences for a spouse if the parties divorce as noted in the *Marriage of Holtemann* (see article in this newsletter regarding this case).

Complicating matters further, when married settlers hope to discuss and resolve these complex issues amicably with their estate planning attorney, they may find that their attorney is unable to advise them due to "conflicts of interest"—which may mean that each party must engage independent and separate counsel for advice, even though the couple believes all is harmonious between them.

It all sounds so complicated, because it is. An experienced estate planning attorney will always ask her clients to characterize their properties so as to preserve the characterization of property when it is transferred to the revocable trust, and to possibly explore changing the characterization to achieve an estate planning goal. Characterization of properties must be addressed before the trust is drafted, and afterwards when assets are formally transferred to the trust.

Once the married settlers have determined the characterization of their properties, there are various strategies

to deal with the identification issues within the estate plan. No particular approach is always correct. In each case it is necessary to weigh the benefits of property characterization against the problems presented.

Separate Trusts for Separate Property. When one or both settlers own a large amount of separate property, it may be preferable to establish a separate trust for separate property. A separate trust may be the safest strategy for avoiding commingling of separate and community property or inadvertently transmuting separate property into community property. A married couple's estate plan might then include three separate trusts: A community property trust and separate property trusts for each spouse.

Separate Schedules For Community Property, Separate Property of Husband, Separate Property of Wife. If the couple decides that it is not necessary to establish three separate trusts, the revocable trust may be drafted to hold, as distinct trust estates, the couple's community property and their respective separate property. In this case, separate trust asset schedules can be prepared, which would serve to identify and characterize the properties while such properties are held by the trust. Typically such schedules are executed by both parties, and in the case of the separate property schedules, are formally acknowledged by the non-owning spouse, who waives his community property rights to his spouse's separate property.

Marital Property Agreement. Many couples do not know that joint tenancy property, even when acquired by "husband and wife" during their marriage, is not community property. Care must be taken when conveying joint tenancy property to a revocable trust to properly characterize it. If the couple wishes their joint tenancy property to be characterized as community property, it is possible to do so prior to the conveyance into the trust by a written agreement between the parties. If, on the other hand, the couple decides that the joint tenancy property is really each spouse's respective separate property (because, for example, they each used separate property to acquire the property and no community property was used to purchase the property), the parties can document that as well prior to the conveyance of the property into the trust.

Separate Counsel for Each Spouse. While a typical couple together engages an attorney to prepare an estate plan for both of them, to better preserve separate property, even in the absence of conflict between the parties, the couple might consider engaging separate counsel to advise each of them regarding their respective property rights.

When engaging in the estate planning process, a married couple will find many challenges in characterizing their community property and their respective separate property. When developing their estate

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plan, a married couple is best served by carefully considering all issues with an experienced estate planning counsel.

If you already have an estate plan, the recent Holtemann ruling, explained on page one, makes it advisable for couples to review their existing estate plan with estate planning

counsel to assure that they have characterized property as they intended. If not, an amendment can be drafted to correct any mischaracterizations.

What Is ADR?

By Cassell von Baeyer

Alternative Dispute Resolution (ADR) is the name used to define methods of resolving legal disputes outside of the courtroom. Unfortunately, with attorneys defining the issue, litigation becomes the “norm” and all other ways of resolving disputes become the “alternative”. Why is this unfortunate? Because often ADR methods can resolve issues quickly, with less cost and often with more durable and elegant solutions than litigation. Of course, there are some disputes which are best suited for litigation and for which ADR will not be more effective.

ADR spans the gamut from informal negotiation to, settlement conferences to mediation and arbitration. Informal negotiation often means the parties, with or without the assistance of an attorney, attempt to settle a dispute between themselves.

Mediation is the process by which parties in a dispute voluntarily submit a dispute to a neutral third party who can help facilitate the negotiations between the parties. The process is private, volun-

tary, informal and non-binding. The mediator has no power to impose a settlement.

Arbitration, like mediation, involves a third party intervention in the dispute process, however, in arbitration the neutral third party arbitrator has the power to impose a decision. Arbitration may be court-annexed or private and voluntary between the parties. Arbitration awards may be binding or non-binding (i.e. enforceable in court or not). With both mediation and arbitration the process, the rules and the level of formality are often governed by the parties.

Unlike litigation, ADR may provide a forum in which the parties can develop solutions that go beyond a monetary award. For example, in a recent California case, mediation provided the forum for a wrongful death case to settle with a more meaningful settlement than a monetary award. The case involved a family that was on vacation at a California State Park. While bike riding their two children were killed by a State Park worker who was driving drunk. After years of negotiation, the parties were

ready to walk away from the mediation table, unable to bridge a \$400,000 gap between their monetary positions. As the mother pushed her chair back from the table she said, “I just want my children remembered”. Luckily, someone from the State heard this. The State’s ability to hear this underlying concern, that could not truly be addressed with money, lead to a successful settlement under which the State erected a monument to the children at the State Park at which they were killed. There was an additional monetary settlement that was easily reached after addressing the underlying interests of the parents. All parties walked away from the dispute with a satisfying solution that could not have been reached in court with a jury trial.

While litigation does have its place, ADR can often address underlying interests in a way that make for more durable and more satisfying settlements. If you would like more information about the ADR process, or the mediation services that we provide, please feel free to call Cassell von Baeyer.

“...ADR methods can resolve issues quickly, with less cost and often with more durable and elegant solutions than litigation.”

Child Support Responsibilities When Parents Share Joint Physical Custody But Have an Unequal Timeshare

By Jamie L. Winter

The Nevada Supreme Court recently addressed two important family law questions previously left unanswered by the State's highest court. See *Rivero v. Rivero*, 124 Nev. Adv. Op. 84 (October 30, 2008). The first question undertaken by the Court was whether an unequal custody timeshare arrangement should be considered joint physical custody. Relying on the definition of "joint physical custody" as found in the Missouri statutes, the Nevada Supreme Court answered the question in the affirmative. The State's highest court determined that a joint physical custody order denotes an order awarding each of the parents "significant, but not necessarily equal" periods of time during which a child resides with or is under the care and supervision of each of the parents. The Court went on to say that joint physical custody shall be shared by the parents in such a way as to assure the child of frequent, continuing and meaningful contact with both parents.

The second question answered by the Court was what formula should be used to determine child support payments to apply in cases where parents share joint physical custody but have an unequal time share. The Nevada Supreme Court relied upon a child support formula adopted by the Court for cases of equal time

share, see *Wright v. Osburn*, 114 Nev. 1367 (1998), and modified it to apply in cases involving an unequal time share. The modified formula consists of the following:

1. Calculating the amount of child support each parent must pay pursuant to NRS 125B.070;
2. Considering any support-able adjustments under NRS 125B.080(9);
3. Calculating the percentage of time each parent has with the child(ren);
4. Determining the difference in the percentage of time each parent has with the child(ren);
5. Multiplying each parent's calculated child support by the time difference;
6. Subtracting the adjusted child support amount from the parent who has the child(ren) more of the time and adding the adjusted child support amount to the parent who has the child (ren) less of the time;
7. Subtracting the smaller number from the larger number; and
8. Applying the statutory caps.

The Court underscored the value of the modified *Wright* formula which the Court believes, "accounts for the differences in both income and the financial consequences of caring for the child...works

equally well if the parents' incomes are equivalent but the time share is unequal . . . [and] furthers the best interest of the child by equalizing the standard of living between the parents." The Court warned, however, that, "when applying the modified *Wright* formula, courts should exercise considerable caution before reducing the formula amounts." In sum, from the Court's perspective the new guidelines will provide district courts and parents greater flexibility in creating joint custody arrangements and require the courts to determine the true nature of a custodial arrangement by considering whether each parent's time with the child is significant, frequent, continuous, and meaningful.

So what does all this mean to Nevada litigants and practitioners? *Rivero* is important in that the decision has provided guidance in two areas of family law previously unanswered in the State's statutory and case law. Practically speaking, however, it is anticipated that *Rivero* will result in a proliferation of litigation regarding custody and child support matters as the consequence of being designated a joint physical custodian cannot be understated. Moreover, legal analysts expect a deluge of motions to modify existing arrangements involving unequal timeshare into joint physical custody awards.

"...the new guidelines will provide district courts and parents greater flexibility in creating joint custody arrangements and require the courts to determine the true nature of a custodial arrangement..."

Boilerplate Stuff you Don't Read – Part 2

By Andrew N. Wolf

In the last newsletter issue, I described techniques that can make your contracts more useful (to your side of the case) if you are in a dispute. I promised you additional information on the use of warranties, indemnity and insurance provisions.

Warranties

A warranty is an agreement that the item sold, or some other subject matter related to your contract, conforms to a certain description. The effect of a warranty is a contractual allocation of financial risk if the item sold (or other subject matter of your agreement) does not conform to the specified warranty. A warranty is violated when the thing sold doesn't satisfy the warranted condition. When this happens, the party who made the warranty is liable to the other party for the cost to repair or correct the issue -- *without regard to fault*. Thus, warranties produce liability without fault, sometimes called "strict liability." When a warranty is breached, it may also provide a basis for rescission and restitution -- this means unwinding the contract.

Including warranties in contracts is an ef-

fective way to make sure your assumptions about what you are buying are included in the paperwork. Requesting warranties during negotiation and drafting of documents is a good way to find out whether each party has the same understanding of what is being bought and sold. Signing an agreement that contains warranties that you did not agree to make can produce bad results; likewise, failing to include warranties in an agreement to reflect what has been promised to you is also a bad idea.

Often, a seller will attempt to disclaim liability for any breach of warranties by requesting an "AS-IS" provision. The words "AS-IS" and similar terms generally trigger a legally enforceable disclaimer of all express and implied warranties, except for warranties set forth elsewhere in the agreement or imposed by law.

Parties relying on warranties will often want a "survival clause" in the agreement to be sure that any important warranties continue in effect after close of escrow.

Indemnity

Indemnity or "hold harmless" clauses are another way of allocat-

ing financial risk to a particular party in a transaction. Indemnity clauses require one party to bear the cost of certain risks defined in the contract, which can range from particular losses, lawsuits, or even non-conformance with prescribed warranties. Most commercial agreements should have some form of indemnity clause, in which one party agrees to defend (i.e., hire a lawyer) and indemnify (reimburse) the other party for the risks described. We find that indemnity clauses are often one-sided, and sometimes taken from unrelated contracts, so that the risks which ought to be negotiated and indemnified are overlooked, while the indemnity clause as written produces results which the parties never contemplated. For example, Party A would not expect to find a clause that lays the costs of Party B's fault back upon Party A. Yet that kind of result can happen when indemnity clauses are not carefully negotiated and drafted.

Indemnity clauses can be quite complex, including provisions regarding the selection and control of the attorneys who will defend the claim. A

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"The words 'AS-IS' and similar terms generally trigger a legally enforceable disclaimer of all express and implied warranties, except for warranties set forth elsewhere in the agreement or imposed by law."

Boilerplate Stuff you Don't Read – Part 2

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well drafted indemnity clause will include a provision that the benefited party will be entitled to their reasonable expenses incurred to pay the indemnified loss, and any settlement, judgment and defense costs.

Losses are not always caused by one person or one discrete act or omission. Events like construction site accidents and other industrial accidents are often the result of a combination of factors. Environmental contamination can have multiple causes spread over decades. In such cases, the wording of an indemnity clause can make a big difference.

The legal effect of an indemnity clause is usually a question of state law. Different states have varying rules for interpreting and enforcing indemnity clauses. Therefore, the state law selected in the agreement can have a major effect on the results produced by the indemnity clause. Some states require particular wording in an indemnity clause before a court will shift the risk of a loss from one party to another. If the contracting parties intend to shift the risk of one party's "active" negligence to the other,

such an intent will often need to be specifically spelled out or the indemnity clause will not be given that effect.

Most or all states have limitations on the kinds of liabilities that may be indemnified, and some even have special statutes that change the rules in particular settings, such as construction contracts, for example. Indeed, California courts have at times distinguished between "Type I," "Type II" and "Type III" indemnity clauses. (I will spare you those details.)

Ultimately, the effect of an indemnity clause will turn on the state law chosen in the contract, the subject matter of the contract, the words used in the indemnification provision, the circumstances of the loss to be indemnified, and the different parties' roles in producing the loss.

Insurance

I can already hear it -- you *know* what insurance is. However, did you know that a promise to procure insurance for another party can sometimes equal an obligation to cover the loss the insurance would have provided if you don't procure it? In other words, if you prom-

ise to insure another party in conjunction with a commercial agreement, you become the insurer if the agreed-to coverage is not purchased. For this reason, insurance provisions in commercial agreements can have enormous financial consequences, particularly when a loss occurs which would have been covered by insurance required by the agreement. As is often the case with indemnity provisions, insurance clauses are sometimes drawn from old, unrelated agreements, and your contract might wind up with unfair or insufficient insurance provisions. Make sure the insurance clause fits the deal.

Conclusion

Next time you negotiate a commercial agreement, make sure that you are best protecting yourself and avoiding unintended financial risks by including appropriate warranty, indemnity and insurance provisions that reflect your intentions and are enforceable under the state law selected in the agreement. Happy contracting.

"As is often the case with indemnity provisions, insurance clauses are sometimes drawn from old, unrelated agreements, and your contract might wind up with unfair or insufficient insurance provisions."

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