

# LEGAL UPDATE

## CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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### EVIDENCE

#### **STATE SECRETS PRIVILEGE ASSERTED; SUIT DISMISSED**

While civil and criminal litigation in the American justice system is best viewed as the ultimate search for truth, there are in fact several broad categories of evidence—that is, evidence subject to a recognized *privilege*—that are never considered by a jury. With longstanding historical support, these categories of evidence (*e.g.*, priest-penitent, doctor-patient, attorney-client) are often fully shielded from jury consideration. The practical effect of such an exclusion on the jury might be softened somewhat by an instruction to not draw any inferences from the fact that such highly desirable evidence was not presented; however, the controlling principle is that even the search for truth can be secondary to the desirability of keeping some things secret.

In the case of *Edmonds v. U.S. Department of Justice*, U.S. Dist.Ct. for D.C. No. 02-1448 (July 6, 2004), the defending governing agency successfully invoked the seldom used *state secrets privilege* to gain dismissal of a contract translator's employment-related suit brought under the Privacy Act, Administrative Procedures Act and the First and Fifth Amendments of the Constitution. The Justice Department argued, in essence, that the lawsuit centered on practices of the agency itself, that disclosure of the agency's practices and records would be a risk to national

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### ESTATE PLANNING

#### **COURT OF APPEALS DENIES ANNUAL EXCLUSION FOR LLC INTERESTS**

In *Hackl v. Commissioner of Internal Revenue*, 335 F.3d 664 (7<sup>th</sup> Cir. 2003), the U.S. Court of Appeals for the Seventh Circuit affirmed a decision of the Tax Court denying the annual gift tax exclusion for gifts of interests in a family Limited Liability Company (LLC). Mr. and Mrs. Albert Hackl began a tree-farming business in 1995 and organized it as an LLC under the laws of Indiana. The LLC had both voting and non-voting interests. Mr. Hackl was the LLC's manager. Under the operating agreement the manager served for life (or until resignation, removal or incapacity), had power to appoint a successor and could dissolve the LLC. He controlled financial distributions, and members needed his approval to withdraw or sell their interests.

If a member transferred his or her shares without the manager's consent, the transferee would only receive the interest's economic rights but no membership or voting rights. Voting members could run the LLC during interim periods between managers, approve salaries and bonuses, and remove a manager and elect a successor. With a supermajority of 80%, voting members could amend the operating agreement and dissolve the LLC, but only after Mr. Hackl's tenure as manager had ended. Both voting and nonvoting members had access to the LLC's books and records and the right to decide whether to continue the business in the event of dissolution.

Shortly after the LLC's formation, the Hackls began annual transfers of the company's interests to their children, their children's spouses, and a trust for grandchildren. After January, 1998, 51% of the company's voting shares were in the hands of the couple's children and their spouses. The Hackls attempted to shield the transfers from gift taxation under the then-\$10,000 annual exclusion for gifts of present interests. The Internal Revenue Service (IRS) deemed the transfers *future interests* and thus ineligible for the annual exclusion. The controversy was elevated to the Tax Court, which sided with the Service. The Hackls appealed, and

the Court of Appeals sided with the IRS. The amount in controversy was substantial, since the Service had assessed a gift tax deficiency of around \$400,000.

The government argued that the transfers did not have any substantial present economic benefit. In its decision the Court reasoned that since the term "future interest" was not defined in the Internal Revenue Code, it was appropriate for the Tax Court to look to Treasury regulations and case law for guidance, a somewhat circular argument that begs the question. In any event, the Court looked to its own jurisprudence and found that the term "present interest" connotes the right to a substantial present economic benefit, which, in the Court's opinion, was not present in the case since the operating agreement foreclosed the donees' ability to transfer their shares. The Court noted that this meant they were essentially without immediate value to the donees. This goes to valuation, however, and certainly the donees were entitled to a *marketability* discount; but, it says nothing about whether the interest is *present* or *future*.

The Hackls argued that their LLC was typical of closely held businesses in our country, most of which have restrictions on alienability of shares (if corporations) or interests (if LLCs). The Court was unmoved by this argument, reasoning that just because a practice is prevalent in the business world the Service does not need to take notice of it. Following this line of reasoning, however, would mean that the only interests eligible for exclusion would be cash or stocks and bonds which can be readily traded publicly. The Court would exclude most of the wealth in this country from the annual exclusion.

What is most troubling about this case is that it ignores the meaning and history of the term "future interest" in Anglo-American law. The reason the term is not defined in the Code is that it does not have to be. Every first year law student knows that a future interest is, for example, a remainder interest in a trust; or, if the subject is real property, it is the interest that the remainderman has after the life tenant dies. "Future interests" have little, if anything, to do with the law of business associations, which is much more modern than the law of trusts or real

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## **EMPLOYMENT** **COURT ADDRESSES ‘SAME SEX’ DISCRIMINATION ISSUES**

Ruling on summary judgment motions in a discrimination lawsuit, U.S. District Judge Reggie Walton recently reviewed the fundamental requirements of a sustainable claim of discrimination. In doing so, Judge Walton also explained the differences presented by allegations of “same sex” discrimination.

In *Cromer-Kendall v. D.C.*, U.S. Dist. Ct. for D.C. No. CA-00-1338 (July 9, 2004), the plaintiff sued for “same sex” discrimination, sexual harassment, hostile work environment, retaliation and severe emotional distress. Plaintiff, a female police officer, alleged that a female superior officer had, over a lengthy period, offended her with repeated, unwanted sexual advances and had initiated adverse employment action against her when the advances were rebuffed. Plaintiff further claimed that her efforts to report and thereby stop her superior’s harassment were mishandled. The District of Columbia moved for summary judgment, and it was in that context that Judge Walton addressed the applicable law of sex discrimination.

A party moving for summary judgment must demonstrate that there is no genuine issue of material fact and that judgment is proper as a matter of law. If a reasonable jury *could* return a verdict in favor of the non-moving party, then there remains a genuine issue of fact and summary judgment will not be granted. The court does not act as a jury and decide which side has stronger proof; rather, the *non-moving* party has the benefit of a favorable inference in all issues of disputed fact.

In *Cromer-Kendall*, the Court first recognized that discrimination based on same-sex harassment is in fact actionable under Title VII of the Civil Rights Act of 1964. The plaintiff may prove harassment in either of two forms: *quid pro quo* or hostile working environment. Whichever type of harassment is claimed, the plaintiff must always prove that the conduct at issue actually constituted discrimination because of sex.

The Court explained that there are three ways to prove that same-sex sexual behavior rises to the level of illegal harassment. First, the plaintiff may show that the sexual behavior is motivated by actual homosexual desire. Second, the plaintiff can show that the harassment is framed in such sex-specific and derogatory terms as to make it clear the

harasser is motivated by general hostility toward members of the same gender in the workplace. Finally, the plaintiff may present comparative evidence of how the harasser treated members of both sexes in a mixed-sex workplace. Turning to the specific allegations in this case, the Court was satisfied that the first standard, *i.e.*, evidence of actual desire, had been met.

Once sex discrimination has been proven sufficiently to defeat a summary judgment motion, the Court explained, the remaining challenges of proof are the same in same-sex and opposite-sex discrimination cases. The plaintiff must prove that the sex discrimination was serious enough to constitute *quid pro quo* or hostile work environment harassment. Plaintiff in *Cromer-Kendall* alleged the latter (hostile work environment); and, the Court readily agreed that there was ample proof to defeat the summary judgment motion on that point.

The only issue on which the District of Columbia did prevail was the charge of retaliation. In response to the plaintiff’s administrative complaints, some actions impacting her work status were alleged. The Court explained, though, that changes in work assignments or work-related duties that do not include demotion or pay reduction are not normally actionable adverse employment decisions. The District was granted summary judgment only as to the retaliation claim.

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### **EVIDENCE** *continued from page 1*

security and that, therefore, plaintiff’s claim must fail.

The Court in *Edmonds* explained that the state secrets privilege “is a common law evidentiary rule that permits the United States to ‘block discovery in a lawsuit of any information that, if disclosed, would adversely affect national security.’” (Citation omitted) The Court traces the state secrets privilege in American jurisprudence to the Aaron Burr prosecution in 1807, when a supposedly exculpatory letter from General Wilkinson to President Thomas Jefferson was challenged. The letter was admitted, but the need to suppress sensitive information was recognized. Citing the post-World War II case of *U.S. v. Reynolds*, the Court in *Edmonds* explained that there must be a formal claim of privilege lodged by the head of the department with control over the matter. And the court must

determine itself whether the circumstances are appropriate for the claim of privilege. Eventually, as the Supreme Court explained in *Reynolds*, the court “must be satisfied from all the evidence and circumstances, and from the implications of the question, in the setting in which it is asked, that a responsive answer to the question or an explanation of why it cannot be answered might be dangerous because injurious disclosures could result...[then] the claim of the privilege will be accepted without requiring further disclosure.”

Applying the *Reynolds* standard, the Court in *Edmonds* reviewed the government’s efforts to exercise its privilege. The Court was satisfied that the Attorney General’s assertion of the privilege met the necessary prerequisites for formal invocation. Once proper invocation was established, the Court turned to the issue of whether the case should be dismissed. The government need only demonstrate a “reasonable danger” that harm will ensue from the contested disclosures. Exercise of the privilege, the Court reasoned, can lead to three results: (1) continuation of the case without the disputed evidence, (2) summary judgment for defendant if the excluded evidence would otherwise have given that defendant a valid defense to the claim, (3) if the very subject matter of the action is a state secret, then dismissal based solely on invocation of the privilege is appropriate.

The Court determined that the plaintiff’s case could not survive exclusion of the privileged evidence. The plaintiff’s Constitutional and underlying whistleblower claims would necessarily involve disclosure of the sensitive conduct complained of. Improper disclosure of records had been alleged, so the content of those confidential record systems would necessarily be an issue. The Court explained, “Without access to the information covered by the privilege or the ability to depose witnesses who may have knowledge of the events, the Court is unable to fathom how the plaintiff could prove that the defendants acted in a ‘patently egregious and unlawful’ manner.” The Court concludes that, “[B]ecause the Court finds that the plaintiff is unable to establish her First Amendment, Fifth Amendment and Privacy Act claims without the disclosure of privileged information, nor would the defendants be able to defend against these claims without the same disclosures, the plaintiff’s case must be dismissed, albeit with great consternation, in the interests of national security.”

**LAWRENCE CARR**

## **WAGE-HOUR NEW FLSA OVERTIME PAY REGULATIONS**

The U.S. Department of Labor has issued new regulations regarding overtime pay, effective August 23, 2004. Overtime pay regulations are contained in the Fair Labor Standards Act (FLSA) and, prior to this recent revision, had not been updated since the 1950's. The FLSA generally requires covered employers to pay employees at least the federal minimum wage (\$5.15 per hour) for all hours worked, and overtime premium pay of time-and-one-half the regular rate of pay for all hours worked over 40 in a single work-week. However, the FLSA includes a number of exemptions from the minimum wage and overtime requirements. There has been a great deal of debate regarding the new regulations, and, depending on your perspective, the new regulations can either help or hurt workers. The regulations appear to increase the number of workers entitled to overtime pay while also expanding the categories of workers exempt from overtime pay.

Under the new regulations almost all workers paid less than \$455 per week on a salary basis (or \$23,600 a year) are entitled to overtime pay regardless of his or her job duties. (The exception for this rule is teachers, doctors and lawyers; they are never eligible for overtime.) This is a significant increase from the \$8,060 threshold under the old rules and, according to the Labor Department, 1.3 million additional new workers will be able to receive overtime pay. The new regulations also provide that if a white-collar worker makes over \$100,000 a year, he is ineligible for overtime. (The Labor Department concedes 107,000 "highly compensated" workers could lose their overtime pay under the new rules.) Thus, the debate surrounding the new rules and, more specifically, the exemptions, tends to focus on those who earn between \$23,600 and \$100,000 per year.

In order to determine who is exempt or not eligible for overtime, employers must perform a three-part analysis. The new regulations provide that a worker who (1) earns between \$23,600 and \$100,000 per year ("salary-level test"), (2) on a salary basis ("salary-basis test") and (3) performs administrative, professional, executive, certain computer and outside sales duties may be ineligible for overtime ("duties test"). These exemptions are often referred to as the "white collar" exemptions. The confusing aspect of this analysis is the third prong or the "duties" test. For purposes of this article we will focus only on the duties performed by administrative, professional or executive employees.

- *Administrative duties test* – to be exempt as an administrative employee the employee must meet criteria 1 and 2 above and have as his or her primary duty the "performance of office or non-manual work directly related to the management of the general business operations of the employer or its customers." Further, the employee's primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.
- *Professional duties test* – the Labor Department distinguishes between "learned professionals" and "creative professionals." To be exempt as a "learned professional" the employee must meet criteria 1 and 2 above and have as his or her primary duty "the performance of work requiring advanced knowledge, defined as work which is predominantly intellectual in character and which includes work requiring the consistent exercise of discretion and judgment... The advanced knowledge must be in a field of science or learning... The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction." See U.S. Department of Labor website [www.dol.gov/esa](http://www.dol.gov/esa).
- *Executive duties test* – to be exempt as an executive the employee must meet criteria 1 and 2 above and "have the authority to hire or fire other employees" or recommend that someone be hired or fired. Further, the employee's primary duty must be to manage a business or manage a recognized department or subdivision. The employee must also customarily and regularly direct the work of at least two or more other full-time employees or their equivalent. (There is a special rule for business owners: an employee who owns at least a bona fide 20% equity interest in the business in which he or she is employed and who is actively engaged in its management, is considered an exempt executive.)

The new rules also state that police officers, firefighters, paramedics and other so-called "first responders" are entitled to overtime pay. The old regulations did not provide this guarantee. Further, "blue collar" workers—including carpenters, electricians, construction workers and mechanics—are guaranteed overtime.

The key to determining whether an employee is eligible for overtime is to focus on the actual *duties* performed by the employee—as opposed to the job title. The Labor Department urges employers to conduct an internal audit and review employee job descriptions so that it can

properly pay (or not pay as the case may be) overtime wages. The Labor Department recognizes that complying with the rules is difficult and provides a "safe harbor" for employers who make mistakes regarding overtime pay. To qualify for this "safe harbor" employers must include a provision in the company employment manual regarding FLSA compliance and the detailed procedure by which an aggrieved employee may complain and investigate any complaints (much like a sexual harassment policy).

Finally, if state law differs from federal law, an employer must comply with the laws or regulations that are most favorable to the employee. Employers are not prohibited from entering into collective bargaining agreements that provide greater protections or benefits to workers.

### **DANA THERIOT**

*Note: As we go to press, the House of Representatives has taken action to block enforcement of the overtime changes discussed above. Employers should check with counsel before implementing any changes.*

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## **ESTATE PLANNING**

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property. To graft a medieval concept like "future interests" onto a modern entity such as an LLC, which is designed to give business people the flexibility needed to operate in a business-like fashion, only serves to justify the perception that the government in general and the IRS in particular are not in tune with the real world. One would have expected, however, that a Federal court of appeals would have been more aware of its surroundings.

In any case, it seems that, in the states covered by the Seventh Circuit, the annual gift tax exclusion for business interests, no matter what the form of the business, is dead, if there are restrictions on transferability. Whether this issue ever reaches the Supreme Court will depend on conflicts with other circuits and on whether the Supreme Court deems the issue important enough to grant *certiorari*. Our advice to business people who are contemplating a similar gifting program is to review their operating agreements or bylaws carefully, check the state of the law in their circuit, and amend the operating agreement or bylaws if necessary. The Hackls were presented with a \$400,000 tax bill, which they will now have to pay since they have exhausted all their appeals. That is a very uncomfortable situation in which to find oneself but can be remedied by some preventive work.

If you have any questions on this important topic, please call Roy Morris or the author.

**NÉSTOR CRUZ**

**CARR, MORRIS  
& GRAEFF, P.C.**

**STAFF NOTES**

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial Litigation; Alternative Dispute Resolution; Employment/Labor; Discrimination; and Wage-Hour.

The firm maintains its office in the Metro Center region of downtown Washington. It has attorneys admitted to all of the local judicial jurisdictions—the District of Columbia, Maryland and Virginia.

Congratulations to Scott and Angela Cummings on the birth of their first child. Ainsley Cummings was born on August 22<sup>nd</sup>, checking in at 7 lb., 14 oz. Mother and daughter are doing well. Scott is shopping for baby running shoes.

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Néstor Cruz has been elected to the Virginia Opera Board of Trustees for Northern Virginia.

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*Time flies.* Roy and Marie Morris's son Robert has completed boot camp at Ft. Benning and is moving on to officer candidate school, also at Ft. Benning. Meanwhile, Mom and Dad are motorcycling across Yellowstone National Park...sort of *Easy Rider* meets *Stripes*...

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