

LEGAL Update

Summer 2008

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INSIDE

Finance 101: Know Your Loan Documents	1
Whatever Happened to the "Good Old Days" When Employees ...	2
It Is Safe To Serve.....	4
LEB News & Notes	6



Finance 101: Know Your Loan Documents

By Joel S. Aronson, Esq.

Neither a borrower nor a lender be; For loan oft loses both itself and friend, And borrowing dulls the edge of husbandry. —*Shakespeare's Hamlet, 1603 LORD POLONIUS*

If you followed Shakespeare's advice, this article is not for you. For the vast majority of entrepreneurs and their bankers, the advice is quaint at best, and anachronistic or foolhardy at worst. The question is what should you, as either a borrower or lender, be doing in these unsettled times. In order to answer this question, you must have a firm understanding of what your loan documents say. What are the basic terms? What is the collateral? What are the financial and other covenants, and are they being met? What do you need to do to ensure that the loan can be repaid according to its terms? How can you protect yourself and your institution if the loan cannot be repaid? The answers to these questions are, for the most part, the same whether you are a borrower or lender.

The terms: Is it a fully amortizing loan? When does it mature? Is the interest rate fixed or variable, and if variable, what is the index? Strong borrowers should be looking to lock in fixed rates before the economy strengthens and rates rise. But is there a pre-payment penalty?

The collateral: What assets are pledged as collateral? If there are newly acquired assets, are they additional collateral or are they unencumbered, and a potential source of additional collateral to either further protect the lender or available to collateralize additional credit? Are the liens properly perfected? Have the UCC liens been calendared by the lender for continua-

tion? Are there guarantors?

The covenants: Is the borrower providing the financials as required? Are there financial ratios that must be met? How often do you test to see if the borrower is in compliance? Borrowers can not wait until the end of the fiscal year to find out. If you are not in compliance, what actions are needed to bring you back in line? Do you need to make collection calls because of ballooning receivables? Have you failed to adjust your overhead in a slowing economy? The sooner you spot trouble, the easier it is to repair. Hiding, or worse, lying to your lender, guarantees a poor outcome. Develop a plan and ask for assistance. A lender would rather let you pay interest only for six months so that a plan can be implemented than find out six months from now that you have maximized your credit and capacity for additional debt.

The lender's goal is to be repaid according to the loan documents. The borrower's goal should be to maintain a healthy balance sheet so that the terms are met. If you have a troubled loan, our Creditor's Rights, Workouts and Foreclosure group is here to assist you.

Joel S. Aronson is a principal in the firm's Litigation and Commercial Lending practice groups, and Chair of the Creditor's Rights and Workouts Group. He can be reached at 301-347-1526, or via email at jsaronson@lerchearly.com.



Whatever Happened to the “Good Old Days” When Employees . . .

By Richard G. Vernon, Esq.

. . . simply downloaded pornography from the Internet?

Although the precise origin of the old adage, “No good deed goes unpunished”, may be unknown, employers are all too often aware of its applicability, where employees are involved. This is particularly true where employers try to establish reasonable policies with respect to employee Internet usage at work. Some employers prohibit personal use of their computer systems altogether. Whether this is effective in ensuring that employees only access the Internet for work purposes can only be ascertained by the employers constantly monitoring employee computer usage. Other employers believe that it is not practical or possible to prevent employees from logging onto their personal e-mail accounts or occasionally surfing the web. These employers are more likely to allow some personal Internet use, generally imposing some limitations such as only allowing access during non-work hours or providing only for “reasonable” personal use.

It is difficult to determine which of these approaches is more effective. What is not difficult to discover, however, is the extent of employee misuse of their employers’ Internet connections. In 2005, America Online and Salary.com conducted a survey which disclosed that the average worker frittered away 2.09 hours per 8-hour workday, resulting in an overall cost to American employers of \$759 billion per year on salaries for which real work was expected, but not actually performed. Certainly not all of this was attributable to misuse of employer Internet connections, but nearly 45% of more than 10,000 people polled cited web surfing as their number 1 distraction at work.¹ According to other sources, accessing sexually explicit, gambling, gaming auction, and social networking websites are among the most frequent misuses of employer computer systems.²

Where employees visit and download materials from pornographic or other sexually explicit websites, employers face additional problems, beyond the lost employee time. Sexual harassment claims, for example, may result from employees seeing objectionable materials that are being viewed by other employees, particularly where supervisors are the offending individuals. Similarly, downloaded porn or, for example, offensive cartoons that are seen by unintended viewers may also provide the basis for hostile environment sexual harassment claims.

All of these consequences suggest the need for employers to adopt, publish, and implement fair policies under which they may, and do, consistently monitor employee computer use. While some may argue that this smacks of “Big Brother watching”, the “2007 Electronic Monitoring & Surveillance Survey” by the American Management Association (see footnote 2) reflects that a growing majority of American employers are retrieving, recording, and reviewing employee communications to and from their work computers. The economics and potential liability are too great to do otherwise.

If these potential issues were not enough, there is a new danger for employers who do not take effective steps to prevent their employees from downloading on-line materials. The new danger involves employees downloading and frequently, distributing recorded music files. On February 28, 2008, sixteen record label companies filed suit in federal district court in New Jersey. This was, what appears to be, the most recent in a number of similar lawsuits filed by the Recording Industry Association of America (RIAA) and various recording companies against a variety of employers whose employees have downloaded music by means of company computers.³

1 “Wasted Time At Work Costing Companies Billions”, San Francisco Chronicle, July 11, 2005, discussing the findings of the AOL/Salary.com study: <http://www.sfgate.com/cgi-bin/article.cgi?f=/g/a/2005/07/11/wastingtime.TMP>

2 See, for example, “2007 Electronic Monitoring & Surveillance Survey”, press release, American Management Association, February 28, 2008: <http://press.amanet.org/press-releases/177/2007-electronic-monitoring-surveillance-survey>;

see also “Excessive Indulgences: Personal Use of the Internet at the Department of Interior”, a report by the Department of Interior’s Inspector General, September, 2006. (Although the report apparently may not be directly accessed, the reader may Google “amount of time lost personal employee internet usage” and find the report as the seventh listed item on the first page of Google results.)

3 For a discussion of the issue of the rights of on-line users, see the website of the Electronic Frontier Foundation (EFF): <http://www.eff.org/about>. In particular, see: <http://www.eff.org/wp/fial-what-peer-peer-developers-need-know-about-copyright-law>

The original defendants in the New Jersey suit are 26 “John Does”, that is, 26 unidentified individuals who are likely employees at one or more companies. They are accused of violating federal copyright laws by downloading and distributing copyrighted sound recordings owned by the plaintiff companies. The entity that was served with the complaint in this matter was Comcast, which is the Internet Service Provider (ISP) through which all of the downloads in question took place. Once the plaintiffs have learned the names of the offending employees’ employers through the discovery process, the suit will almost certainly be amended to bring in those employers as defendants. In pursuing the employers, the plaintiffs are taking the position that the employers’ failures to have adequate steps in place to prevent the illegal downloads make the employers equally liable for the illegal activity.

In the Electronic Age we live in, the courts are trying to stay current, and they have developed two primary theories of copyright infringement liability that come into play in these kinds of situations. Each is a species of so-called “secondary” copyright liability, where the employee is the primary, or “direct” infringer, and the employer, despite not participating in the direct infringement or requiring it as a function of the employee’s job, is nonetheless held secondarily liable for the infringement on the theory that the employer contributed to the infringement or failed to stop it. These are court-made doctrines, premised on traditional notions of respondeat superior (also called the “Master-Servant Rule”), under which an employer is responsible for the actions of employees performed within the course of their employment. The Copyright Act itself does not contain a cause of action for liability by anyone other than the actual infringer.

One of these theories provides for a cause of action “for contributory liability” which applies to “one who, with knowledge of the infringing activity, induces, causes or materially contributes to the infringing conduct of another, and who thus may be held liable as a contributory infringer.” To assert a claim for contributory copyright infringement, a plaintiff must assert that the defendant (1) knew of, and (2) substantially participated in the alleged infringement. Significantly, the “knowledge” prong includes so-called constructive knowledge of the infringement (the employer knew or should have known about the infringement), and the “participation” prong arguably includes merely supplying the means (i.e., employee computers) to carry out the

infringement. Employers who ignore telltale signs of employees’ file-sharing do so at their own risk, and the ostrich defense is unavailing.

The second cause of action is vicarious liability, which also has a two-prong test. It must be shown that the defendant employer has both: (1) “the right and ability to supervise the infringing conduct,” and (2) “a direct financial interest in such activities.” While it is difficult to imagine that an employer would reap a financial benefit from an employee who downloads music rather than doing his or her job, there is an argument to be made (and some supporting case law) that when an employee-employer relationship exists, the employer is responsible for the employee’s direct infringement under traditional notions of respondeat superior discussed above, regardless of whether a financial benefit can be shown. Under this approach, an employer could be on the hook for an employee’s violation of copyright law, even if it did not benefit from the infringement.⁴

In the good old days, then, it was internal concerns -- economic necessity and a desire to avoid internal sexual harassment and related claims -- that prompted employers to take steps to prevent their employees’ misuse of company computers. More recently, employers are facing outside threats from record label companies, the RIAA, and others which are seeking to impose an even greater obligation on employers, that is, to prevent downloading and peer-to-peer (P2P) file sharing by employees using company computers.

Rick Vernon directs Lerch, Early & Brewer’s Employment and Labor Law practice. In recent years, he has been named by the Washington Business Journal as 1 of 5 finalists in its “Top Washington Lawyers”, Employment Law category, and also named by Washington SmartCEO Magazine as one of 35 members of the Greater Washington Legal Elite. Mr. Vernon can be reached at 301-907-2818, or via email at rgvernon@lercheearly.com.

⁴ A great deal of credit (and my thanks) is owed to two attorneys R. Bruce Rich and Todd Larson of Weil, Gotshal & Manges, New York, New York. Bruce heads Weil Gotshal’s Intellectual Property and Media practice, is a nationally recognized expert in intellectual property law, and helped found the Firm’s pre-eminent music licensing practice. Todd is an associate in the Firm’s Litigation and Regulatory Departments and works with Bruce. I thank them both for providing the information in this and the preceding two paragraphs and for walking me through the complex IP area in which they work.



It Is Safe To Serve

Liability of a Community Association Director and Officer

By Jeremy M. Tucker, Esq.

Serving on the Board of Directors of your association can be a rewarding experience, depending on whom you ask. Many people who would otherwise be willing to serve shy away because of the fear of being sued for decisions that the Board makes. Fortunately, Maryland law provides significant legal protection for directors and officers of a community association from liability when making decisions or taking action that falls within the scope of the directors' or officers' duties.

Immunity

Under §14-118 of the Maryland Real Property Article and §5-422 of the Maryland Courts and Judicial Procedures Article, directors and officers of a community association cannot be held liable for injuries to a third-party if the director or officer:

- 1) acted within the scope of the director's or officer's duties;
- 2) acted in good faith; and
- 3) did not act in a reckless, wanton or grossly negligent manner.

This standard affords directors of community associations greater protection than that afforded directors of corporations generally. The Maryland Code provides that a director of a corporation is generally immune from liability for his or her actions if the director acted:

- 1) in good faith;
- 2) in a manner he or she reasonably believes to be in the best interests of the corporation; and
- 3) with the care that an ordinarily prudent person in a like position would use under similar circumstances.

Maryland law further provides that when the damages are covered by insurance, the plaintiff may recover damages from the association only to the extent of the applicable limit of insurance coverage, including any amount for which the association is responsible as a result of any deductible or coinsurance provisions of such insurance coverage.

Naming a Director or Officer in a Lawsuit

Individual Board members or officers of a community association, in such capacity, cannot be named as defendants in a complaint for injuries. In other words, if a member of the association sues the association over a decision of the Board, that member may not name individual directors, personally, in the lawsuit. Only the community association, as an entity, may be named in the Complaint. Specifically, MD Code, Courts and Judicial Procedures, §5-422(d)(1) provides:

- (d)(1) Except as provided in paragraph (2) of this subsection, a claimant shall name only the governing body as a party defendant.
- (2) An officer or director of a governing body may be named individually only when the governing body for which the officer or director was acting cannot be determined at the time an action is instituted under this section.
- (3) If an officer or director is named as an individual defendant under this section, the governing body for which the officer or director

If the association maintains a D & O Policy and the Board or officers are named as defendants in a lawsuit in which monetary damages are sought, the D & O Policy, in most circumstances, will cover the cost of the defense and the attorneys' fees; the officer or director will not be personally liable for damages.

was acting shall be substituted as the party defendant when its identity reasonably can be determined.

In practice, however, officers and directors are routinely named in lawsuits notwithstanding the above, but generally will be dismissed from the case under section (d)(3) above.

Limitation of Recovery

Even if someone were to sue the association for tortious actions of a director (e.g. negligence or defamation), Maryland law limits the amount of damages that a person can recover. Specifically, MD Code, Real Property, §14-118(b) provides that a person who sustains damage from the tortious act of an officer or director, while the director or officer is acting within the scope of his or her duty, may only recover in an action brought against the governing body for actual damages. This limitation on recovery applies only to tort actions and not contract claims.

Insurance Implications

Additional levels of protection are provided to directors and officers through the association's directors and officers liability insurance policy ("D & O Policy"). If the association maintains a D & O Policy and the Board or officers are named as defendants in a lawsuit in which monetary damages are sought, the D & O Policy, in most circum-

stances, will cover the cost of the defense and the attorneys' fees; the officer or director will not be personally liable for damages. Interestingly, if the complaint fails to request the award of monetary damages, most D & O Policies will not cover the cost of the defense.

Maryland law further provides that when the damages are covered by insurance, the plaintiff may recover damages from the association only to the extent of the applicable limit of insurance coverage, including any amount for which the association is responsible as a result of any deductible or coinsurance provisions of such insurance coverage. MD Code, Courts and Judicial Proceedings §5-406(c).

In short, if a director or officer acts in good faith to comply with the governing documents of the association in making decisions, acts in a conscientious manner while performing his/her duties, and does not steal or misappropriate funds, the risk of personal liability for serving as a director or officer is minimal.

Jeremy M. Tucker is an associate in the firm's Community Association and Litigation departments. He can be reached at 301-657-0157, or via email at jmtucker@lercbearly.com.

News & Notes – Summer 2008

Congratulations



Harry Lerch, a Principal in our Land Use and Zoning practice group, and the Ironman of Swimming, completed a streak of 3,668 straight days of swimming a mile in his pool. Harry's streak was broken when he was recently prescribed 24 hours of rest after minor surgery. However, he has returned to the pool and hopes to beat his 10-year record.

Raymond J. Sherbill, a principal in the firm's Business and Taxation group, has been elected President of the National Capital Area Chapter of ORT America.



Patrick L. O'Neil, a principal in Land Use and Zoning, graduated with the Leadership Montgomery Class of 2008. Also, Mr. O'Neil has been installed as the Vice-President of Economic Development & Government Relations for the Bethesda-Chevy Chase Chamber of Commerce.

Robert G. Brewer Jr., a Principal in the Land Use and Zoning practice group, has been installed as Counsel to the Bethesda-Chevy Chase Chamber of Commerce.



Alison W. Rind, a principal in the firm's Commercial Lending and Real Estate Transactions practice areas, won a President's Citation from the Bar Association of Montgomery County, Maryland, for Outstanding Service for her work with the Fall Outing Committee. In addition, Ms. Rind will be co-chairing the Montgomery County Bar Foundation annual golf outing for the fifth year in a row. The event will be held on Columbus Day.



Jeremy M. Tucker was appointed by the Rockville City Mayor and Council to the Rockville Historic District Commission.

Arnold D. Spevack and **Jeremy M. Tucker** won The Jewish Foundation for Group Homes' "Rock the Law Award" for Outstanding Achievement for Pro Bono Causes.

Bradford J. McCullough, a principal in the firm's Litigation group, was recently installed as Chairman of the Board of Interfaith Works (formerly known as Community Ministry of Montgomery County), a non-profit organization comprised of congregations of various faiths that engages in both direct service to the poor (e.g., shelter programs, housing, mentoring, etc.) and education and advocacy efforts.



On May 2, Mr. McCullough was a panelist at a presentation concerning representing clients in mediation. The presentation was part of the Bar Association of Montgomery County's Annual Law Day.

On June 5 and 6, Mr. McCullough was a faculty member at the National Institute for Trial Advocacy program on Trial Advocacy Skills held at Georgetown University Law Center.

Jeff Van Grack and **Paul E. Alpuche**, were recently recognized by Northwest High School for their contributions to the Athletics Department over the past 10 years. Mr. Van Grack, the Founder and Co-Chair of the firm's Community Associations practice, and Mr. Alpuche, Chair of the firm's Business and Taxation group, have served in a variety of ways to the football program as well as organized academic programs for students of the school.

Speak Up

Jason E. Fisher, co-chair of the firm's Community Associations group, led a one-day workshop on "The Essentials of Community Association Volunteer Leadership". The workshop provided all that you need to know about the role and obligations of developers, reading financial statements, sources of income for associations, the scope of an association's control, and more.



Lawrence G. Lerman, Chair of the Commercial Lending practice group, hosted a seminar on May 13 entitled "Like Kind Exchanges of Real Property". The seminar provided strategies to property owners on a variety of property exchanges.

Richard G. Vernon, a principal in the firm's Employment and Labor practice group, spoke at the Annual Meeting of the Maryland Association of Community College Human Resources Officers in Ocean City on June 5. He discussed significant employment issues that are likely to confront colleges in 2008 and 2009.

Beth J. Weisberg, Of-Counsel within the Family Law group, co-presented a seminar on Collaborative Law to the D.C. Psychological Association at their annual meeting on May 17, in Washington, D.C. Her co-presenter was psychologist Suzan Stafford, Ph.D.

On April 16, as part of National Advance Directives Day, **Sigrid C. Haines** gave a talk at the Rockville Senior Center on advance healthcare initiatives.



Arnold D. Spevack, Joel S. Aronson, and **Cindi E. Cohen** from the firm's Commercial Lending practice group, hosted a seminar titled "Dealing With The Troubled Loan". The seminar dealt with what lenders need to know in reviewing

loan credit and documentation files in connection with the defaulting borrower, workout strategies, collection proceedings, foreclosure, and the bankruptcy process.

Family Matters

Congratulations to **Lawrence G. Lerman's** family, as his son Michael Lerman married Tova Brooks of Haifa, Israel.

Jeremy I. Goldman, an associate with the firm who practices in the Real Estate Transactions and Commercial Lending groups, and his wife added a third member to their family as daughter Shifra Gittel Goldman was born on Monday, April 7, 2008.

Michael D. Smith, an associate with the firm's Commercial Lending and Real Estate Transactions groups, is the proud father of Audrey Lane, born May 2, 2008.



Deborah L. Webb, a principal in the Family Law practice, gave a lecture for NBI (National Business Institute) titled "Child Custody Evaluations" on May 15, 2008. Shortly thereafter, Ms. Webb married David Rycke on the beach in St. Lucia on May 24.

Comings & Goings

Deborah Cook has joined the firm as a Secretary/Legal Assistant within the Litigation practice group.

Joining the firm as a Summer Law Clerk with the Litigation practice group is **Adam Dunn**, a second year law student at the University of Maryland.

Denise Fleming has joined the firm as a Secretary/Legal Assistant.

Jaelyn Hensley, Certified Paralegal, joined the Community Association's collection practice.

William Melchior joined the firm as Marketing Coordinator.

Jimma Merchant has re-joined the firm as Secretary/Legal Assistant with the Commercial Lending practice group.

Lucero Navarro has joined the firm as a Secretary/Legal Assistant with the Community Associations practice group.

Jennifer Nicholson has joined the firm as an Administrative Assistant.

Regretfully, the firm announces the departures of **Michele Beach, Mamie Brown, Robin Dierbeck, Larisa Misulic** and **Porcha Snowden**.

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