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OFFICERS AND DIRECTORS MAY SEEK NEW EMPLOYMENT

WITH A COMPETITOR, BUT MUST PROCEED CAUTIOUSLY

In previous issues, we have discussed the fiduciary duties of officers, shareholders, and directors, and the liabilities that may arise when they attempt to break away and establish businesses that compete with their current employers. A recent Illinois Appellate Court opinion provides guidance in this highly fact-sensitive area of the law.

In 1993, Don Linse and Lori Cooper founded Hallman Capital Management, Inc., an investment advisory firm ("HCM"). In 1994, HCM hired Thomas Hallman, who purchased 20% of the voting shares of HCM, and who was named chief financial officer and vice president. In 1996, HCM hired James McQuinn. Hallman was a director and officer and McQuinn was an officer of HCM.

In April 2000, Hallman and McQuinn began steps to establish a competing firm. In June and July 2000, Hallman and McQuinn executed a lease for office space, bought office equipment, and filed articles of incorporation for a new company. Hallman copied HCM prospect lists, customer account spreadsheets and customer mailing labels, among other documents. Hallman and McQuinn resigned on September 1, 2000, taking the copied documents with them. Shortly thereafter, they completed necessary regulatory filings and then announced their departure to HCM clients.

In September 2000, HCM filed suit against Hallman and McQuinn, alleging corporate misconduct. The trial court ruled in favor of HCM on several counts, but against it on counts alleging Hallman and McQuinn had breached fiduciary duties arising from their respective status as an officer, director, and shareholder of HCM. HCM appealed.

The Appellate Court ruled that Hallman and McQuinn owed a "heightened" fiduciary duty because they were each officers of HCM. (All employees of Illinois companies owe a duty of loyalty to their employers.) Notwithstanding this "heightened duty," the trial court correctly found that their actions did not constitute a breach of that duty.

Generally, employees may compete with a former employer and solicit former customers as long as they do not do so before the termination of their employment. They may plan, form, and outfit a competing business so long as they do not compete while still employed. Officers and directors have a heightened (or a greater) fiduciary duty of loyalty, and may not exploit their corporate positions for their own personal benefit or hinder a corporation's business operations.

A breach of this heightened duty occurs if, during the course of their employment, officers or directors: fail to disclose that employees are forming a rival company or engaging in other fiduciary breaches; solicit the business of a customer before leaving employment; use company facilities or equipment in developing their new business; or solicit fellow employees to join a rival business. A breach also occurs when confidential information is used for the new business, or a mass exodus of employees is coordinated shortly after their resignations.

Hallman and McQuinn began planning and, in fact, incorporated a competing business while still employed. However, they did not solicit clients for their new business or begin competing with HCM until after they had resigned. Although they did not inform HCM of their intentions, and may have typed their new business plan and experimented with advertisement fonts on HCM's computers, their conduct did not rise to the level of a breach of their fiduciary duties, because they neither exploited their positions for their personal benefit and to HCM's detriment, nor impeded HCM's ability to do business. They did not actively invest in a rival company, taking advantage of benefits to which they, as fiduciaries, were entitled, to insure the success of that rival company; nor did they mislead HCM about their actions, impeding its ability to do business.

Hallman and McQuinn did not use or steal HCM's property to operate their rival business, nor did they actually begin business while still employed. According to the Appellate Court, while the record reflected Hallman and McQuinn did engage in certain prohibited conduct, they simply did not participate in the "monkey business" referenced in other Illinois cases in which liability was imposed on officers and directors. It concluded that to construe their actions as a breach of their heightened fiduciary duties would virtually prevent all officers and directors of Illinois companies from seeking new employment prior to resigning from an existing position.

Any officer or director seeking to engage in a competitive business with a former employer should carefully analyze the many Illinois cases which address fiduciary duties in order to avoid conduct that may come back to haunt them. We are available to assist such an analysis.

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**A RECITAL OF CONSIDERATION IS NOT NECESSARY
TO ESTABLISH AN ENFORCEABLE CONTRACT**

All contracts must be supported by consideration. "For \$1.00 in hand paid" was the traditional recital of consideration that appeared in most contracts. The modern approach is to omit the traditional recital. This new style is based on the belief that a traditional recital of consideration is ineffective, and therefore should be omitted. This approach leads to a contract that is easier to read and understand.

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YOUR IRA AND 401k MAY INVEST IN REAL ESTATE

Millions of Americans have taken advantage of the ability to contribute money to an Individual Retirement Account (“IRA”) on a tax deductible and tax deferred basis and to delay the required distributions until their retirement years. While most Americans invest the assets of their IRAs in stocks and bonds, there are many other investments available to them through their IRAs, including investment in real estate.

An IRA is a trust or custodial account set up for the exclusive benefit of the taxpayer or his or her beneficiaries. The trustee or custodian of the IRA must be a bank, a federally insured credit union, a savings and loan association, trust company, or other entity approved by the IRS. The Internal Revenue Code prohibits the following as investments for IRAs: life insurance and collectibles (art, antiques, gems, coins, stamps, wine, etc.), commodities, and S corporation stock. Thus, individuals may direct the trustees to invest their IRAs in many different assets other than the traditional stocks and bonds. Among the assets the IRA owner may direct the trustee to invest in is real estate, including vacant land, commercial buildings, apartment buildings, condominiums, and the like. The advantage of ownership of real estate in an IRA is that both the income generated by the asset and any gains on the sale of the asset are deferred until required distributions begin. On the other hand, losses from operations, depreciation or other deductible items, will remain in the IRA and will not benefit the taxpayer individually.

Because contributions to an IRA must be in the form of cash, a taxpayer cannot contribute a real estate asset directly to the IRA – the taxpayer must contribute cash to the IRA and then direct the trustee to purchase the real estate. There are other restrictions as well. For example, an IRA cannot purchase real estate from the taxpayer, nor can the taxpayer use the real estate personally at any time or lease the property to a related person. Thus, the IRA could not lease space in an office building owned by the IRA to a business owned by the taxpayer, purchase a condominium to be used by the taxpayer’s child while the child is attending college, or own a vacation home that the IRA owner “rents” from his or her IRA.

Further, the IRA owner cannot manage the real estate – it must be managed by an independent third party. Also, one must keep in mind that no beneficiary of the IRA can be the manager or otherwise receive a benefit, such as a brokerage commission, in connection with a real estate owned by the IRA. Some of these issues can be overcome by forming a limited liability company to operate the business for the IRA, but the taxpayer must be aware of the issue of unrelated business taxable income, or UBIT. This issue can arise if one attempts to invest in real estate through a limited partnership or limited liability company. The IRS treats income from such entities as business income rather than investment income and imposes a tax on the profits. Considering that depreciation, mortgage interest expense, and operating expenses may reduce the taxable income, a taxpayer may decide the tax deferral benefit is enough to outweigh the small amount of UBIT that may result. UBIT can also be an issue if part of the acquisition cost of the real estate owned by the IRA is financed. If the property is financed, the IRS will claim the income from the financed part of the real estate is taxable.

There are fairly onerous penalties for failure to observe the rules. The IRS may treat a non-qualifying investment as an early withdrawal from the IRA, taxing it as ordinary income and imposing a 10% penalty.

If you desire to discuss the investment by your IRA in real estate or other specialized assets, please do not hesitate to contact us.

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AT-WILL PROVISION IN EMPLOYMENT AGREEMENTS PROVIDES EMPLOYERS WITH DISCRETION TO ADJUST COMMISSION RATES

As employers continue to use written employment agreements, a question often arises regarding what discretion, if any, an employer has to adjust the compensation, especially commissions, set forth in the employment agreement. So long as the employment agreement identifies the employment relationship as “at-will,” the employer has complete discretion to adjust the employee’s commission rate, as is demonstrated in the Illinois case of *Geary v. Telular Corporation*.

Kevin Geary (“Geary”) was employed by Telular Corporation (“Telular”) as a regional sales manager. Shortly after beginning his employment, Geary executed an employment agreement which stated that his employment was at-will. Thereafter, Geary became a part of the Motorola Account Team which was responsible for sales to Motorola, Inc. (“Motorola”). During Geary’s employment, Telular adopted a compensation plan for the Motorola Account Team which modified Geary’s employment agreement to include monthly commissions equal to .5% “of all Motorola revenues generated by the Motorola Account Team.”

Several months after implementing the compensation plan, Telular underwent a reorganization in which the employment of all members of the Motorola Account Team, except Geary, was terminated. Geary was, instead, promoted to director of business development for Motorola. Geary’s compensation as director consisted of a base salary of \$65,000 and quarterly commissions based on a percentage of a target sales figure achieved rather than a percentage of revenues generated. Thereafter, Telular paid Geary according to the new compensation plan. While Geary continued his employment, he objected to the modification in his commission rate. Several months later, after his termination, Geary filed suit against Telular, alleging a breach of contract.

In entering judgment in favor of Telular, the court explained that when an employment agreement is terminable at will, the employment agreement may be modified by the employer as a condition of its continuance. The employer’s unilateral right to modify at-will employment terms applies to the compensation provisions, including commissions set forth in the employment agreement. If the at-will employee continues to work after a modification, he is deemed to have accepted the modification to the employment agreement.

Applying the above principles to Geary’s case, the court noted the sales at issue were completed after the modification in his compensation plan. The court held that a sale was complete upon Telular’s receipt of a purchase order from Motorola, which did not occur until after the modification in Geary’s compensation plan. Thus, since Geary had accepted the modification to the prior compensation plan by his continued employment, he was not entitled to the larger commissions allowed by the prior compensation plan.

If you have a question about at-will employment or compensation, including commissions, please telephone a member of the firm.

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EQUITABLE APPORTIONMENT IS AN IMPORTANT CONSIDERATION IN ESTATE PLANNING

A properly-prepared estate plan must be based on a thorough analysis of the client's needs and desires as well as the effect local laws may have on the estate taxes assessed against the estate. The language of one's will and trust must be clear and unambiguous so as to avoid potential unintended consequences.

Assume the following facts: Mr. Smith, a widower, created a living trust which at the time of his death had a value of \$4,000,000. At his death in 2006, he also had \$1,000,000 of assets in his own name, so probate administration of those assets was required. Mr. Smith's will bequeathed one-half of the probate estate to his friend, Ms. Jones. The balance of his probate estate was to be transferred to the trustee of his living trust. Mr. Smith's will provided that all estate taxes were to be paid by the trustee of his living trust, but made no mention of how the estate taxes would be allocated, or *apportioned*, between his probate estate and his trust. Mr. Smith's living trust provided for distribution of the assets to his children.

Absent any specific language relating to the apportionment of the estate taxes between the legatee under Mr. Smith's will (Ms. Jones) and the beneficiaries of his living trust (his children), the effect of Mr. Smith's plan is that Ms. Jones would receive \$500,000 (one-half of his probate estate) without any reduction for the estate taxes to be paid on the amount Ms. Jones received. The total estate taxes would be paid from the living trust, with the result that the Smith children bear the entire tax burden of their father's bequest to Ms. Jones.

To avoid this result, Illinois follows the doctrine of "equitable apportionment." This rule applies only if the decedent's intent is not clearly stated in his or her estate planning documents. By this doctrine, if there is no clear intent, federal estate taxes will be apportioned between probate and nonprobate assets. By following the doctrine of equitable apportionment, the executor and trustee of Mr. Smith's estate and trust would be entitled to deduct from Ms. Jones' bequest an amount equal to her proportionate share of the estate taxes paid with respect to Mr. Smith's taxable estate.

The issue of apportionment can also arise when the decedent and another person hold title to property as joint tenants with right of survivorship. When the value of joint tenancy property is included in the decedent's gross estate, it can generate a federal estate tax. Because federal estate tax law is silent on the apportionment of whether a surviving joint tenant is liable for the estate tax attributable to property interests received by the surviving joint tenant, state law will determine whether apportionment will apply. Some states would require the *estate* to pay the tax. Under Illinois law, the tax would be equitably apportioned and the surviving joint tenant would be liable to pay a proportionate share of the estate taxes.

As demonstrated above, equitable apportionment will fairly charge estate taxes among the recipients of one's assets. The effect of the language in one's will and trust agreements, as well as the extent of joint tenancy arrangements, must be carefully considered so that the apportionment issues are understood by the client and consistent with the client's intent. There is no substitute for careful and thorough estate planning. Please telephone us if you have any questions regarding your estate plan.

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WHAT IS THE IMPACT OF OUT-OF-STATE CASE LAW ON ILLINOIS LITIGATION?

It is not unusual for clients to inquire during the course of a litigation about the importance of a court's ruling in a case with similar facts to those of the client's case, especially if the opinion is not from an Illinois court. Generally speaking, all rulings by the Illinois Supreme Court on an issue are considered "precedential authority" which must be followed by the Illinois courts which are subsequently asked to consider the same issue involving a substantially similar set of facts. Such a precedent must be followed in order for Illinois law, especially case law, to be applied consistently.

Conversely, the opinions of out-of-state courts are not given *precedential* status. In fact, Illinois courts are not bound by decisions from another state's court. This does not mean, however, that Illinois courts will not consider the opinion of an out-of-state court when deciding a similar issue. To the extent that facts in the out-of-state opinion are similar to the facts being considered by the Illinois court and the Illinois court is unable to locate an Illinois court's opinion that speaks to the issue raised, the Illinois court may consider the out-of-state opinion as "persuasive authority." The Illinois court may choose to follow the out-of-state opinion if it agrees with the reasoning set forth in the opinion.

The persuasiveness of out-of-court case law may also depend on the history of the development of a particular area of case law within the state whose opinion is being considered. The best example of this is the development of corporate law in the State of Delaware. As a result of a well developed corporate statutory scheme and the resulting case law interpreting the same, the Delaware courts' opinions regarding most issues involving corporate law from formation to governance to dissolution are not only persuasive but often set the standard on how such issues will be ruled upon by the courts of other states.

An example can be found in the Delaware court's opinion in the case of *In Re The Walt Disney Co.*, in which the shareholders tried to recover the \$130 million severance paid to Walt Disney Co.'s ("Walt Disney") former President, Michael Ovitz, from Walt Disney's directors. The shareholders alleged the directors breached their fiduciary duty to the company by approving the payment. In an opinion issued in August 2005, the Delaware court criticized Michael Eisner and the Walt Disney Board for a series of actions which fell "significantly short of the best practices of ideal corporate governance." The court went on to hold, however, that Walt Disney's Board members did not breach their fiduciary duty to Walt Disney and thus were not personally liable for their bad judgment because they were protected by the business judgment rule. This rule prevents directors from being held personally liable for decisions which, while in error, were made in good faith with the company's interest in mind.

Because of the depth of the Delaware's court's analysis of issues ruled upon in the *Walt Disney* opinion, courts throughout the United States will almost certainly rely on the Delaware court's opinion when ruling on similar corporate governance and compensation issues.

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HOW SHOULD EMPLOYERS MONITOR EMPLOYEE COMPUTER USE TO AVOID LIABILITY?

A recent ruling imposed liability on an employer in a suit filed by the victim of an employee who used company computers for criminal activities. To avoid such liability, employers should carefully monitor their employees' computer use and report criminal activity to authorities. Monitoring, however, could result in a violation of the Electronic Communications Privacy Act ("Act") which prohibits the interception, disclosure, and intentional use of wire, oral, and electronic communications, including those of employees. Thus, how do employers monitor employees' computer use to ensure it is not being used for criminal (or other non-permissible employer) activity without violating the Act?

The Act provides an employer may monitor computer use if the employee consents to the monitoring. The most efficient manner in which to obtain a consent is for the employer to institute a written computer privacy policy which does the following:

- Advises all employees that company computer use is not private and e-mail will be monitored without prior notice.
- States computer and Internet access and use are for business purposes only and not for personal use.
- States inappropriate communications, such as sexist, racist, or obscene material, will not be tolerated, and will lead to disciplinary action up to and including termination.
- Advises employees how company confidential information must be transmitted by e-mail, including advising the recipient that all information is confidential and should be treated the same by the recipient.
- Acknowledges the employee's consent to be monitored and requires the signed privacy policy be returned to the employer or the employee will be terminated.

Once a written privacy policy is implemented by an employer, the employer should routinely monitor e-mails so that its employees are aware that the monitoring policy is being enforced. If a violation of the privacy policy is discovered, the employer should uniformly and consistently exercise discipline for violations of the policy. Courts have held that an employer's failure to enforce its own computer usage or email communication policy may inadvertently lull employees into a "false sense of security," thereby vitiating the effectiveness of the policy, especially if there is a court proceeding and the employee asserts his or her reasonable expectation of privacy right. Even the best written policy is ineffective if the policy is rarely enforced.

If you have a question about a privacy policy or would like to add a privacy policy to your company's employment manual, please telephone a member of the firm.

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From Nolo.com:

A defendant was on trial for murder in Oklahoma. There was strong evidence indicating guilt, but there was no corpse.

In a defense's closing statement the lawyer, knowing that his client would probably be convicted, resorted to a trick.

"Ladies and gentlemen of the jury, I have a surprise for you all," the lawyer said as he looked at his watch. "Within one minute, the person presumed dead in this case will walk into this courtroom."

He looked toward the courtroom door. The jurors, somewhat stunned, all looked on eagerly. A minute passed. Nothing happened.

Finally, the lawyer said, "Actually, I made up the previous statement. But you all looked on with anticipation. I therefore, put it to you that there is reasonable doubt in this case as to whether anyone was killed and insist that you return a verdict of not guilty."

The jury, clearly confused, retired to deliberate. A few minutes later, the jury returned and pronounced a verdict of guilty.

"But how?" inquired the lawyer. "You must have had some doubt; I saw all of you stare at the door."

Answered the jury foreman: "Oh, we did look. But your client didn't."

* * *

A young lawyer with her first big case held forth to the jury hour after hour, straying far from the point of the case.

When she finally sat down, her more experienced adversary rose and, turning to the jury, said, "I'll follow the example set by the learned opponent and submit this case to you without argument."

* * *

"Your Honor, in the first place, as they say, I am going to say it. I was going to say what you said and the reason I am going to say it, is not because you just said it. If you had not said it, I was going to say it first."

– A lawyer speaking to a judge

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