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EARNOUTS OFTEN GENERATE LITIGATION

Zenix was a manufacturer of high-frequency microwave components for the defense, aerospace, and telecommunications industries. In 1998, Zenix entered into an asset purchase agreement with EDO under which EDO purchased substantially all of the assets of Zenix for \$800,000, and assumed certain Zenix liabilities. The Asset Purchase Agreement required EDO to pay Zenix a 5% royalty on sales of Zenix products after the closing until such time as the aggregate amount of royalty payments equaled \$1,200,000.

Six months after the closing, EDO closed one of the Zenix plants and moved equipment to another plant that Zenix alleged was not equipped to manufacture Zenix products. Zenix further alleged that EDO changed production formulas and disposed of equipment and inventory necessary for the continued production of Zenix products, resulting in lost sales, and a corresponding reduction in royalties.

In 2005, after EDO did not resume manufacture of Zenix products, Zenix demanded payment of \$1,154,000 in royalty payments. EDO rejected Zenix's demand. Zenix sued EDO alleging, among other things, breach of contract, breach of the implied covenant of good faith and fair dealing, and fraud. EDO filed a motion to dismiss all of Zenix's claims.

As to its claims for breach of contract and breach of the implied duty of good faith and fair dealing, Zenix alleged EDO was required to make royalty payments totaling \$1,200,000, and EDO breached its contractual duties by failing to take steps necessary to generate sales of Zenix products after the closing.

EDO argued that royalty payments were not mandatory and that EDO had no duty to use reasonable efforts to sell the Zenix product line. EDO noted that the Asset Purchase Agreement included no language that EDO must use best or reasonable efforts and that such a duty could not be inferred.

While the court agreed that royalty payments were not mandatory, the court held that under New York law EDO had a duty to use reasonable efforts to sell Zenix products and that Zenix had alleged facts sufficient to state a claim for breach of that duty. The court further noted that if EDO's interpretation of the Asset Purchase Agreement were adopted, EDO could have shut down the Zenix product line immediately after the closing, rendering the royalty provisions illusory.

This case illustrates that in the absence of express provisions in an acquisition agreement governing the parties' obligations with respect to an earnout, actions by the purchaser that allegedly frustrate the seller's ability to receive earnout payments may give the seller a sufficient basis to allege fraud and breach of the implied covenant of good faith and fair dealing.

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ATTACK ADVERTISEMENTS NOT ENOUGH TO RAISE COMMERCIAL DISPARAGEMENT CLAIM

In the recent Illinois Supreme Court case of *Imperial Apparel, Ltd. v. Cosmo's Designer Direct, Inc.*, the court was asked to decide if an advertisement that contained a string of harsh attacks on the quality of the plaintiff's product constituted defamation and commercial disparagement. In a prior case, the Appellate Court held that a cause of action for commercial disparagement was viable where the quality of a business product was wrongfully maligned. On appeal to the Supreme Court, that issue was not decided because the statements were deemed to be privileged under the First Amendment of the Constitution. The Supreme Court found that commercial competitors are privileged to interfere with prospective business relationships so long as their intent is to further their businesses and is not solely motivated by spite or ill will, but that abuse of that privilege can lead to liability, including defamation and commercial disparagement.

Imperial and Cosmo are competitors in the sale of discount menswear. Litigation arose when a newspaper advertisement accused Imperial of copying Cosmo's "3 for 1" sale idea and stated that Imperial "inflate[s] prices and compromise[s] quality." Specifically, the ad described Imperial products as "rags," "flea market style warehouse," "low rent," and "a hooker's come on." It also made comments comparing the owner of Imperial to the Iraqi Information Minister.

Under Illinois law, a statement is defamatory *only* if it can reasonably be interpreted as falsely stating a fact. The Court considered three factors: (1) whether the statement has a precise and readily understood meaning; (2) whether the statement is verifiable; and (3) whether the statement's literary or social context signals that it has factual content. The Court ruled that Cosmo's advertisement statements were merely subjective characterizations and lacked precise and readily understood meaning. The Court reasoned that because the world of discount menswear is highly competitive, no reasonable person would regard them as anything other than colorful hyperbole aimed at capturing the reader's interest and attention.

Likewise, in a recent Appellate Court case, *J. Maki Construction Company v. Chicago Regional Council of Carpenters*, the Court reversed a jury verdict in favor of the plaintiff because the alleged defamatory statement could not be readily verified. In *Maki*, the defendants created a handbill which included a limerick that accused the plaintiff of building "crappy" houses. The Court determined that the term was not actionable because it was imprecise and lacked a method to measure the "crappiness" of the houses.

If you have any questions concerning what constitutes defamation or commercial disparagement, and whether you have a claim for damages, please contact a member of the firm.

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EMPLOYERS CANNOT MODIFY EMPLOYMENT CONTRACTS

BY SUBSEQUENT EMPLOYEE HANDBOOK DISCLAIMERS

Plaintiff-employee Gary Ross (“Ross”) argued that the defendant-employer, May Company d/b/a Marshall Field’s and Company (“Marshall Field’s”), breached his employment contract when it wrongfully terminated him from the job he held for almost 40 years by failing to discharge him in accordance with certain terms set forth in Marshall Field’s 1968 employee handbook.

In this case, the trial court determined that the promissory language set forth in the 1968 employee handbook issued to Ross, together with oral assurances of job security by Marshall Field’s agent, created an employment contract between Ross and Marshall Field’s, thereby altering Ross’s prior at-will status and binding Marshall Field’s to certain procedures before it could terminate his employment. (If Ross was an at-will employee, he would be deemed to have assented to a unilateral modification of the terms and conditions of his employment by Marshall Field’s if he continued his employment following the issuance of a later handbook.)

Marshall Field’s maintained that disclaimers set forth in employee handbooks issued to Ross in the late 1980s, together with new benefits, modified Ross’s 1968 employment contract, converting him to an at-will employee, and, thus, they were not obligated to follow the termination procedure set forth in the 1968 employee handbook. The new benefits consisted of paid personal days, short, and long-term disability, an insurance reimbursement plan, and a supplemental retirement savings plan. Ross accepted the new benefits and enrolled in the new long-term disability plan and in the enhanced supplemental retirement savings plan.

Ross countered that the disclaimers in the 1980 handbook did not modify his employment status because they were not supported by consideration. Ross acknowledged that he received a benefit from the enhanced pension and other new benefits; however, he maintained that such benefits from Marshall Field’s did not serve as consideration supporting the unilateral modification of his employment contract because they were offered to all eligible employees and there was never any bargained-for exchange between him and Marshall Field’s in which he agreed to modify or terminate his prior contract rights in exchange for the benefits.

The Appellate Court in this case agreed with Ross and concluded the disclaimers in revised handbooks issued after 1968 did not modify Ross’s employment contract because he received no consideration. The court stated that, in the employer-employee context, “consideration will be found when an employer and its employees make a bargained-for exchange to support [the employees’] relinquishment of the protections they were entitled to under the existing contract.”

Here, Marshall Field’s did not contend that it bargained for Ross to modify his employment status and become an at-will employee. In this case, there was no bargained-for exchange, nor did Marshall Field’s make any promises in exchange for Ross’s agreement to relinquish his contractual rights with respect to the new benefits. The additional benefits, which were offered in 1990, were in no way related to, bargained for, or referenced to any preexisting contractual rights; the benefits were offered to all eligible employees whether or not they possessed contractual rights.

Thus, Marshall Field's acted unilaterally when it offered the additional benefits to its employees. Accordingly, no consideration flowed from Marshall Field's to Ross to compensate him for relinquishing the protections he enjoyed under the 1968 employee handbook.

Please do not hesitate to contact us if you have a question about modification of any employment relationship.

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BASEBALL AND GOLF: CAVEAT SPECTATORS

Spectators at golf and baseball events should be aware (read: beware) of the law as it pertains to injuries sustained by them at such events. The Illinois Baseball Act, enacted in 1996, provides:

The owner or operator of a baseball facility shall not be liable for any injury to the person or property of any person as a result of that person being hit by a ball or bat unless: (1) the person is situated behind a screen, backstop, or similar device at a baseball facility and the screen, backstop, or similar device is defective (in a manner other than in width or height) because of the negligence of the owner or operator of the baseball facility; or (2) the injury is caused by willful and wanton conduct, in connection with the game of baseball, of the owner or operator or any baseball player, coach or manager employed by the owner or operator.

In the face of a challenge to the Act as special legislation favoring the owners of major league baseball parks, the Act was found to be constitutional three years after it was enacted.

Similarly, spectators and fellow players at golfing events have little to complain about when injured by errant golf balls. A golfer who was hit and injured by another golfer's hooked ball complained the other golfer either failed to properly swing his club, failed to maintain a proper outlook or failed to give her proper warning of his misguided shot by yelling "Fore!" The Illinois Appellate Court reasoned since:

...even the best professional golfers cannot avoid an occasional 'hook' or 'slice' it cannot be said that the risk of a mishit golf ball is a fully preventable occurrence. To the contrary, even with the utmost concentration and 'tedious preparation' that often accompanies a golfer's shot, there is no guarantee that the ball will be lofted onto the correct path. For that reason, we have held that the mere fact that a golf ball did not travel in the intended direction does not establish a viable negligence claim. To provide an actionable theory of liability, a person injured by a mishit golf ball must affirmatively show that the golfer failed to exercise due care by adducing proof, for example, that the golfer 'aimed so inaccurately as to unreasonably increase the risk of harm'. It is common knowledge, at least among players, that many bad shots must result although every stroke is delivered with the best possible intention and without any negligence whatever.

Many of us can vouch for the wisdom of such reasoning.

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**IRA TIP: A BENEFICIARY DESIGNATION FORM
CANNOT BE COMPLETED POST-MORTEM**

The benefit of designating a successor or contingent beneficiary if the primary beneficiary of the IRA is deceased is that the distribution can be stretched over the life expectancy of the designated beneficiary, and the distribution avoids probate. These benefits may be lost if no contingent beneficiary is designated. The courts and the IRS may be of little or no help to assist the beneficiary in his effort to obtain the benefit of a lengthier distributive scheme, as exemplified by a recent Private Letter Ruling.

In this specific situation, Husband died in 2004, after the date he was required to start taking minimum distributions from his IRA. Husband's wife had predeceased him. His daughter was his sole heir. Prior to his death, Husband named his wife as the primary beneficiary of his IRA and his daughter as the secondary beneficiary. Later, because he changed custodians of his IRA, Husband completed a new beneficiary designation form in which he designated his wife as the primary beneficiary, but he neglected to name his daughter as the contingent beneficiary of the IRA so she could stretch out distributions from the IRA based upon her own life expectancy.

After his wife died, the custodian sent Husband a new beneficiary designation form so he could name a new primary beneficiary, presumably his daughter. Unfortunately, Husband did not complete and return the beneficiary designation form. Upon Husband's death, then, his estate was the beneficiary of his IRA. As a result, the IRS ruled the required minimum distributions from his IRA had to be made over the life expectancy of the Husband remaining at the time of his death, to be sure a much shorter period of time than his daughter's life expectancy, thereby resulting in an acceleration of income taxes.

The attorneys for Husband's estate sought and obtained an order from a local court that Husband never intended to eliminate his daughter as contingent beneficiary of the IRA, and that his daughter should be treated as if Husband had named her as the beneficiary of his IRA prior to his death. Based on this court order, the attorneys sought a Private Letter Ruling from the IRS that Husband's daughter would be treated as the designated beneficiary of Husband's IRA so that the required minimum distributions could be calculated based upon the daughter's life expectancy.

The IRS refused to recognize this post-mortem reformation of the IRA designation form. The IRS, contrary to two previous rulings with similar facts, determined it was not bound by a state trial court's determination of a property interest. The IRS opined that the income tax statute and regulations clearly describe the procedures to be followed so that a beneficiary can achieve a post-required beginning date payout period longer than the IRA owner's remaining life expectancy. The burden is on the owner of the IRA to follow the proper procedures, and if he or she fails to do so, he or she should not look to the IRS to correct the error.

IRA beneficiary forms should be reviewed frequently and contingent IRA beneficiaries should always be named. Please do not hesitate to call us if you have any questions regarding IRA beneficiary designations.

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PARENTS MUST USE CAUTION WHEN MAKING GIFTS TO CHILDREN

IF THEY WANT TO PRESERVE THE GIFT'S NON-MARITAL STATUS

Jack and Roma Walker had been married for 35 years when Roma filed for a divorce. During their marriage, Jack worked for his father's company. When Jack's father started the company, all 500 shares of stock of the company were issued to Jack's father, who then gave Jack 100 shares as a gift. Jack subsequently purchased shares from his sisters at a purchase price of \$200 per share.

Years later and several years prior to Roma filing for divorce, Jack acquired an additional 235 shares of his father's stock for \$47,000 (\$200 per share), which was substantially less, according to Jack's father's attorney, than the fair market value of the shares, \$117,500 (\$500 per share.) When the sale of the shares closed, Jack's father's attorney recommended that Jack's father file a gift tax return for 141 shares, as he viewed the transaction as a purchase of 94 shares at \$500 per share (\$47,000) and a gift of the remaining 141 shares (\$70,500). Jack's father, however, never filed a gift tax return.

A dispute arose whether the 235 shares were marital or non-marital property. There was apparently no dispute that the initial 100 share gift to Jack was non-marital property. Roma asserted the 235 shares were marital property and part of the marital estate subject to division by the court. Jack argued that 141 shares should be treated as non-marital property and not subject to division because he paid less than the fair market value of those shares, which shares he maintained were a gift from his father.

In determining whether the shares were marital or non-marital property, the court was confronted with the following two contradictory presumptions which arose under Illinois law: all property acquired during the marriage is considered marital property; and the transfer of property from a parent to a child is considered a gift and is non-marital property, unless the gift is made to both the child and the child's spouse.

In finding that the entire 235 shares were marital property, the court stated that when two presumptions appear to "cancel each other out," the court must look to the facts of the case to determine whether the property is to be considered marital or non-marital property. The court then noted that the stock was purchased with marital funds, i.e., funds acquired during the marriage; Jack's father never demonstrated an intent by filing a gift tax return with respect to the 141 shares; Illinois law provides that property must be either marital property or non-marital property, not partially marital and partially non-marital; and Illinois law also requires that non-marital property commingled with marital property be designated marital property. Thus, the court ruled that the 235 shares were marital property, and were subject to division between Jack and Roma in the divorce proceeding.

If you are a parent considering the transfer of property, such as a family business or real estate, to a child and would like to prevent the transfer from being considered marital property so the property will remain in the family and/or not be subject to a division in the event of the child's divorce, please contact a member of the firm so that the transfer can be properly completed.

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TAX COURT APPROVES AGGRESSIVE VALUATION DISCOUNTS

At the time of Josephine Thompson's death in 1998, she owned approximately 20% of the common shares of Thompson Publishing Co., Inc., a closely-held business, which was a publisher of business-to-business directories. At the time of Thompson's death, the company was profitable, but faced significant challenges from the market due to the growth of Internet-based directories. The taxpayer's estate calculated the value of Thompson's common shares at approximately \$1.75 million, using a capitalization rate of 30.5%, which included a 12% management and Internet-component risk. After determining that the company's total value was \$25.3 million and the estate's share of the company was \$5.3 million, the estate applied discounts for minority interest and marketability of 40% and 45%, respectively, or 85% in the aggregate.

Conversely, the IRS determined that the total value of the company was \$225 million, by comparing the company to public companies and also by reference to discounted cash flows (similar to capitalization of income). The estate's share of the total value was \$46 million, to which the IRS applied no minority interest discount and a 30% marketability discount to arrive at the final value of \$32 million.

The Tax Court, however, found no basis for the estate's 12% management and Internet risk component of the capitalization rate, and determined the minority interest and marketability discounts were too aggressive; and also disagreed with the IRS's valuation, indicating that the public company "comparables" were too dissimilar to be of any use in the valuation and that there were significant errors in the IRS's discounted cash flow analysis.

The Tax Court used the estate's capitalization rate of 30.5% less the 12% management and Internet-component risk, or 18.5%, and applied it to the company's average earnings to which it added the value of non-operating assets. The estate's share of this amount was \$22.7 million, to which the Tax Court applied a minority interest discount of 15% and a marketability discount of 30%, or an aggregate discount of 45%, resulting in the final value of \$13.5 million. The positions of the taxpayer, the IRS, and the Tax Court are summarized in the following table:

Party	Estate Tax Value	Capitalization Rate	Minority Interest	Marketability Discount	Final Value
Taxpayer	\$5,300,000	30.5%	40%	45%	\$1,750,000
IRS	\$46,000,000	3.5%	0%	30%	\$32,000,000
Tax Court	\$22,700,000	18.5%	15%	30%	\$13,500,000

The lesson for taxpayers is that the Tax Court is willing to apply relatively high capitalization rates and minority and marketability discounts aggregating 45% to arrive at an estate tax value for a company.

A substantial part of our practice is dedicated to assisting business owners and families of significant wealth with respect to issues such as those raised in the Thompson case. Please do not hesitate to telephone us if you have any questions regarding valuation issues in your estate plan.

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TOP TEN BUSINESS AND ESTATE PLANNING MISTAKES

(According to RIA Practice Alert dated April 11, 2008, excerpting from an article that recently appeared in the December 2007 issue of Practical Tax Strategies.)

- Mistake #1 Forgetting to name successor agents, proxies, executors, and trustees in estate planning documents.
- Mistake #2 Neglecting to properly structure a business venture to protect personal assets from business creditors.
- Mistake #3 A married couple not taking advantage of both estate tax exemption amounts (\$2 million in 2008) that are available to them, due to inadequate wills and assets owned the wrong way.
- Mistake #4 For businesses owned by more than one individual, neglecting to have an owners' agreement and a binding buy-sell arrangement (with funding).
- Mistake #5 Having inadequate beneficiary designations for retirement plans and IRAs that do not coordinate with the rest of the estate plan (aka "having all your ducks in a row").
- Mistake #6 Neglecting to hold regular shareholder/member/partner and board of director meetings for a business entity, failing to prepare written minutes based on each meeting to include in the entity's records, and ignoring other formalities to assure that the entity is respected for all purposes.
- Mistake #7 Failing to properly plan for family business succession.
- Mistake #8 Failing to consider the income tax ramifications of each personal, investment, or business decision; and failing to take advantage of all available deductions, credits, and opportunities.
- Mistake #9 Failing to incorporate trusts adequately for asset protection purposes (i.e., inability, disability, creditors, and predators of beneficiaries) in the estate plan.
- Mistake #10 Failing to consider the options available to finance long-term care needs.

This is a list of the issues that we address daily in our business practice. Please do not hesitate to contact us if we can assist you in preparing your plan so as to avoid these costly mistakes.

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