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Report From Counsel

Insights and Developments in the Law **Fall 2008**

Get It in Writing

When an Internet executive held a meeting with the chairman of a telecommunications company, the agenda was a new business idea that the Internet executive had. The discussion was transformed into a recruitment when the telecommunications executive suggested that the idea should be pursued within the company he headed. For two men in the upper echelons of high-tech businesses, they then chose a decidedly low-tech way to memorialize their agreement. The end result, however, shows how substance can sometimes triumph over form in the law of contracts formation.

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At the end of their meeting, the telecommunications executive simply wrote out the agreement by hand on two notebook pages, and both men signed it. The writing included specifics as to how the newly hired executive would be compensated, the terms on which he could quit if he became unhappy, and what would happen if intellectual property involved in the deal could not be transferred to the telecommunications firm. It also included the statement that "[t]he parties will complete formal contracts as soon as possible but this is binding." This would turn out to be pivotal language in the litigation that followed.

Unfortunately, the new arrangement quickly went downhill, and after about six months the new employee was fired. The relationship ended with the "formal contracts" never having been drafted and executed. When the former employee sued for breach of contract and other wrongs, more than six years of litigation ensued, with two trials and two appeals.

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Employers: Don't Let Tips Trip You

Employers in service industries are well advised to pay close attention to their practices and policies affecting customers' tips for their employees. There are a variety of ways in which missteps can run afoul of federal or state laws, including the federal Fair Labor Standards Act (FLSA).

Employees might contend, for example, that the employer is effectively reducing their tip income by imposing various fees or other charges on customers. Or, contrary to a requirement in the FLSA, employees who are paid less than the minimum wage might not be getting enough in tip income to make up the difference between their hourly rate and the minimum wage. Recent cases in the news involved yet another alleged violation, sometimes taking place on a very large scale, where employees are made to share tip income with fellow employees who supervise them.

In one of the tip-sharing cases, a state court ruled in favor of a class of plaintiffs consisting of baristas, or coffee counter servers, whose tips were required to be shared with their shift supervisors, in violation of state law. Change left for tips apparently adds up, as the judgment for the tens of thousands of servers, for about an eight-year period, topped $100 million, including interest.

The case was not cut-and-dried, as the supervisors were themselves hourly workers who had customer service duties in addition to the responsibility of scheduling workers and giv-

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Landowner Gets Settlement for "Taking"

When the government takes aim at private property to be taken for some public purpose, more often than not any resulting litigation is a contest over how much the property owner should be paid, rather than whether the exercise of the power of eminent domain was appropriate in the first place.

From the landowner's standpoint, it is important to realize that adequate compensation is not determined simply on the basis of the current use of the property. Instead, the landowner is entitled to the value of the property based on its "highest and best" use (whether that use already exists or is only in the eye of a developer), so long as such a potential use is not too speculative or otherwise foreclosed by applicable laws and regulations.

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The importance to a property owner of negotiating compensation on the basis of a best-case, but realistic, development scenario for the property is illustrated by a recent case in which the owner of a vacant, 22,000-square-foot lot settled with a town for compensation in an amount that was about 27 times higher than the amount initially offered by the town.

The lot was zoned for residential use, although at the time of the condemnation action the owner had no building or development plans. Appraisers hired by the town offered an opinion that the vacant lot's best use was only as open space, or as a buffer for an abutting lot. They reasoned that compliance with the town's lot area and frontage requirements, as well as with its road standards for improving the dirt road on which the lot was located, would be so burdensome as to make any development of the property prohibitively expensive. They also indicated that extensive development costs would preclude development even if the lot was considered to have grandfathered status that would protect it from certain town requirements.

For its part, the landowner retained experts who opined that the lot was, in fact, suitable for residential purposes and should be valued as such when arriving at a compensation figure for the taking. As the town's experts had noted, there were various requirements on the books that, in theory, could be costly to comply with. However, an examination of past rulings by the town's zoning and conservation officials showed that the lot was likely to be exempted from some of the requirements. Moreover, improvement of the dirt road, which would have been an especially big-ticket item, was not likely to be required.

Both sides were necessarily looking into the future to some extent, but the landowner was able to depict a scenario for the lot that was optimistic enough to bring about a favorable monetary settlement with the town.

Cyber Insurance for Businesses

Businesses have been dependent on computerized information for some time now, but it has been only relatively recently that insurance companies have devised and offered insurance policies specifically tailored to the potential losses from a variety of problems that can affect a computer system.

An early impetus for cyber insurance was anticipation in the late 1990s of losses associated with the coming of "Y2K." That concern turned out to be overblown, but the threats that have spurred cyber insurance offerings since then are real enough, including viruses, hackers, and legal injuries to others from information on a company's website. One study has found that the average annual technology-related financial loss for United States companies more than doubled just from 2006 to 2007.

Another development that prompted more cyber insurance policies was the realization, which sometimes came as a surprise to insured businesses, that general liability policies did not cover computer problems. Cyber insurance is a good idea for all of the usual reasons associated with insuring against business losses. But it also makes sense because of the particular costs associated with responding to a computer data breach, especially now that many states have adopted data breach notification laws.

This kind of postmortem after a breach could include such measures as notifying affected customers, paying for credit monitoring for those customers, replacing compromised credit or debit cards, and undertaking forensic analyses of affected databases. All in all, there are some expensive scenarios to insure against.

Categories of Losses

The losses covered by cyber insurance generally fall into two categories:

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LLC Ruling Favors Taxpayers

Anna was the mother of three children and the widow of the man who invented the heart defibrillator implant. In 1992, she created a trust for each of her daughters and gave a portion of her substantial interests in patent licenses to the trusts. In 2001, she created a limited liability company (LLC), to which she made some large transfers. She then gave a 16% interest in the LLC to each of the trusts, keeping a 52% interest to herself. Only four days later, Anna died suddenly and unexpectedly.

The IRS claimed a deficiency of millions of dollars in estate taxes. It pointed to a part of the Internal Revenue Code that provides that all property is to be included in a decedent's estate to the extent that the decedent has transferred an interest in the property while retaining for life the possession or enjoyment of, or income from, the property. There is an exception to this general rule in cases of a bona fide sale for full and adequate consideration in money, but the IRS argued that the exception did not apply in the case of Anna's estate.

In a somewhat surprising decision, given a recent trend favoring the IRS in such disputes, the United States Tax Court sided with the estate and kept the LLC assets out of the gross estate for estate tax purposes. The court ruled that the bona fide sale exception applied, notwithstanding that the LLC activities were not in the nature of a "business." It was sufficient that Anna had "legitimate and significant nontax reasons" for creating and funding the LLC, including joint management of family assets, pooling family assets to maximize investment opportunities, and providing for each of her daughters on an equal basis.

Some practical lessons for minimizing estate tax liability while using family LLCs emerge from the case of Anna's estate. They include the following: (1) document the legitimate and significant motivations, unrelated to estate taxes, for forming such an entity; (2) continue the entity after the decedent's death, to avoid the appearance of an ordinary trust; (3) if, as in Anna's case, the donor dies unexpectedly a short time after the gifts, be prepared to demonstrate that the death was unexpected; and (4) keep sufficient assets outside of the entity to cover the donor's living expenses, to avoid the possibility that the donor will treat the assets of the entity as her own. The planning, drafting, and advice associated with a family LLC entails resolution of complex issues and requires the guiding hand of a knowledgeable professional.

Federal Estate Tax

The federal estate tax credit, currently at $2 million, is set to increase to $3.5 million in 2009. This means that in 2009 you can leave up to $3.5 million to your heirs without any federal estate tax liability.

If Congress takes no action, the federal estate tax will be repealed altogether in 2010. While this is an unlikely scenario, it does underscore the uncertainty involved in estate planning over the next few years. Make sure to meet with a professional to review your plan.

Cyber Insurance

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first-party losses, meaning those affecting the business itself; and third-party losses, meaning incidents mainly affecting outside parties, including the customers of a business. Of course, the same underlying problem can cause both kinds of losses, such as when unauthorized access to a computer system shuts down the computer system of a company whose customers or clients rely on that system through an extranet.

A comprehensive cyber insurance policy should encompass both kinds of risks. These are the typical categories of coverage:

- First-party business interruption, covering lost revenue experienced during downtime due to accidents or security breaches (but typically not losses due to catastrophic regional power outages);
- First-party electronic data damage, such as the compromise of data from a virus infection;
- First-party extortion, including the demands made by hackers;
- Third-party network security liability, arising from compromise and misuse of data stemming from identity theft and credit-card fraud;
- Third-party network liability in the form of court judgments obtained by persons harmed by problems originating with a business's computer system; and
- Third-party media liability, aimed at the full range of potential liability from matter published in interactive online communications.

Bicycle Safety

When a car or truck has a collision with a bicycle, the bicycle rider usually loses, no matter who legally had the right of way. Bicycle riders should take extra care to obey the following safety tips:

Remember: Bikes Are Vehicles, Too

Legally, bicycles traveling on a road are required to be treated in the same way as any other vehicle traveling on the road would be. This means that, as a bicyclist, you must obey the same laws as other drivers do. Do not run red lights, change lanes without signaling, or commit other infractions. If you would not do it in a car, don't do it on a bike.

Wear a Helmet

The easiest way to protect yourself is to always wear a helmet when you ride. Some jurisdictions require all riders to wear helmets, but even where it is not required, wearing an approved helmet can significantly reduce the chance of serious head injuries in the event of an accident.

Be Visible

Because bicycles are so much smaller than cars and trucks, it is important to make sure that others using the road can see you. Make sure that your bicycle has reflectors on the front and back and even on the wheels. When riding at night, wear light-colored clothing and use a light.

Be Aware

The best safety advice is to be aware of the conditions around you and be careful when riding. Always look both ways when entering a street and stay on the correct side of the street when riding. Keep a lookout for drivers who may not be looking out for you. Like other drivers, bike riders should ride defensively.

Get It in Writing

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However, a jury eventually ruled that the agreement was valid, and that the telecommunications firm had breached the terms of the contract represented by the two notebook pages.

Four factors are usually considered in determining whether a "preliminary agreement" is binding. In this case, the first two clearly favored the fired executive: There was no explicit reservation of a right not to be bound (in fact, the handwritten agreement said the opposite) and the executive had partially performed the contract. The third factor is whether all of the terms of the alleged contract were agreed upon. On that point, the agreement, although it may have lacked some details, addressed all of the essentials for a binding contract.

The final factor is whether the agreement was a type of contract that is usually committed to writing in a formal manner. When millions are at stake, as was the case here, it may be unusual to seal the deal with a handwritten document, in outline form, and drafted on the spot by one of the principals without benefit of legal counsel. The agreement was not much to look at, barely surpassing in formality the proverbial agreement scribbled on a cocktail napkin. Still, that it was unorthodox did not mean that the method was unprecedented. In the end, this factor, balanced against the other three, was not enough to discard the agreement and deprive the departed executive of the benefits of his bargain.

Tips

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ing directions to the baristas. It was not a case of highly paid bosses dipping into the tip jars filled by customers they never saw in person.

When a shift supervisor hands a customer his latte and muffin, and the customer responds with a tip, the customer may assume that the money, or at least part of it, goes to the supervisor. Instead, under the ruling, the supervisors must now keep their hands off the tips, and the employers must ensure such an outcome.

In the wake of this case, similar lawsuits have been filed against the same employer, a national chain, and against other employers in other states. Companies in the restaurant, hotel, gaming, transportation, and delivery businesses face the largest risks for mishandling the treatment of tips. There is another pending case in which casino dealers have complained that an employer's new policy illegally requires them to share tips with floor supervisors.

The legal issues surrounding the treatment of tips are murky enough in any one state, but further complicating the matter is the fact that there are variations among the states and between the statutes for a state and for the federal government. This makes it especially risky for national employers to assume that a one-size-fits-all policy on tips will be sufficient for all of their locations.

"Back-room" personnel, shift supervisors, hostesses, greeters, drink servers, and other similar positions could be treated differently depending on what state you are in. Employers should regularly assess their job descriptions and tip-sharing policies against applicable state and federal laws. This kind of audit is useful not only for detecting or avoiding possible violations, but for laying the groundwork for a potential "good-faith" defense under the FLSA if litigation ensues.