

Report From Counsel

Insights and Developments in the Law

Winter 2009/2010

Litigation over Noncompete Agreements

Agreements between employers and their employees prohibiting or restricting competition by a departing employee are nothing new, but their use is growing—and not just for the highest levels of management. This trend makes it all the more important to understand the limits that courts have placed on such agreements, with a view toward balancing employers'

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interests with policies favoring competition and unfettered opportunities for individuals to pursue their livelihoods. While courts have sometimes struck down noncompete agreements in their entirety, occasionally they effectively have rewritten parts of an agreement, a practice known as “blue penciling,” so as to fix offending parts while retaining acceptable provisions.

In employment contracts, restrictive covenants, as they are sometimes called, are from the outset suspect as restraints of trade that are disfavored at law, and they must withstand close scrutiny as to their reasonableness. For the same reason, they generally are not to be construed to extend beyond their proper import, or farther than the contract language absolutely requires. In

cases of ambiguous language, to borrow a term from baseball, the “tie” goes to the former employee.

The requirements for enforcing a noncompete agreement may vary some from state to state, but a typical set of conditions requires that the agreement (1) be necessary for the protection of the employer that is, the employer must have a protectable interest justifying the restriction imposed on the activity of the former employee;

(2) provide a reasonable time limit; (3) provide a reasonable territorial limit; (4) not be harsh or oppressive as to the former employee; and (5) not be contrary to public policy. In keeping with the law’s predisposition against such agreements, generally the employer has the burden of proving the reasonableness of a noncompete clause.

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Tax Breaks for College Costs

Persistently increasing college costs may have joined death and taxes as inevitable facts of life. Still, it is usually possible to soften the blow of escalating costs of higher education by taking advantage of an assortment of income tax breaks provided by the federal government. The options and their ramifications for your tax bill are not as simple as they might be, so it may be prudent to get some professional advice. Given the large sums of money at stake, you do not want to leave any smart moves unmade for lack of information and timely advice.

American Opportunity Tax Credit

This year, the American Opportunity Tax Credit effectively replaces the

Hope Scholarship Credit. Taxpayers spending at least \$2,000 for tuition, fees, books, and materials for higher education can save \$2,000 in taxes with a dollar-for-dollar credit. Expenses over \$2,000 bring an additional tax credit of 25 cents on the dollar, and, if expenses reach \$4,000, there is a maximum credit of \$2,500. The credit is available per student, so that a family with more than one college student can achieve even larger total benefits. Up to 40% of the American Opportunity Tax Credit is refundable, so that some of the tax credit may be received as a tax refund if the credit for which the taxpayer qualifies exceeds his or her income tax liability. This credit phases

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Lender Must Return Debtor's Vehicle

Theodore entered into an installment contract with a corporate creditor for the purchase of a new automobile. A few years later, he defaulted on his installment payments, and the creditor repossessed the vehicle. Not long after that, Theodore filed for bankruptcy in federal bankruptcy court.

Needing his car to commute to work, he requested that the creditor return the vehicle to his bankruptcy estate. When the creditor refused to return the vehicle, absent what it deemed "adequate protection" of its interests, Theodore moved for sanctions under a Bankruptcy Code provision, claiming that the creditor had willfully violated the automatic "stay" provision in the Bankruptcy Code. The stay provision forbids a creditor from committing any act to obtain possession of property from the bankruptcy estate, or to "exercise control" over the property of the estate, once the debtor has filed for bankruptcy.

In Theodore's case, the creditor could not be said to have acted to obtain possession of the vehicle after the bankruptcy filing, because it already possessed the car at that point. Thus, one issue was whether it could be said to have "exercised control" over the vehicle by simply keeping it and refusing to return it to the debtor, as opposed to selling or doing something else with it.

A federal appellate court answered this question in the affirmative. It held that, upon the request of a debtor that has filed for bankruptcy, a creditor must first return an asset in which the debtor has an interest to his or her bankruptcy estate and then, if necessary, seek adequate protection of its interests in the bankruptcy court. To hold that "exercising control" over an asset refers only to selling or otherwise destroying the asset would not be logical, given the central goal of reorganization bankruptcy. That goal is to gather together all of the debtor's property in the bankruptcy estate, so that the debtor may rehabilitate his or her credit and pay off his or her debts. This

applies to all property, even property (such as Theodore's car) that is lawfully seized before the filing of a bankruptcy petition.

The court essentially ruled that the creditor's position had put things in the wrong order. Instead of being permitted to hang on to the vehicle until it felt satisfied that its interests would be protected, the creditor had to first return the

asset to the bankruptcy estate. Then, if the debtor failed to show that he could adequately protect the creditor's interests, the bankruptcy court was empowered to condition the right of the estate to keep possession of the asset on the provision of certain specified adequate protections to the creditor.

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Medicaid Benefits and Special Needs Trusts

A permanently disabled Medicaid recipient residing in a nursing home challenged an informal rule issued by the federal Department of Health and Human Services which requires that, for purposes of determining the benefits due to a Medicaid-eligible individual, states must consider income placed in a Special Needs Trust for that individual's benefit. (Medicaid provides joint federal and state funding of medical care for individuals who cannot afford to pay their own medical costs.) The challenged rule effectively prevents Medicaid recipients from using Special Needs Trusts to shelter their monthly Social Security Disability Insurance (SSDI) income from certain Medicaid determinations. In the case before the court, the plaintiff's legal guardian had created a Special Needs Trust on the plaintiff's behalf and had been depositing into it the plaintiff's monthly SSDI benefits, minus some income deductions that were not at issue.

The end result of applying the challenged agency rule is that income placed in a Special Needs Trust is not considered in making the first determination of *eligibility* for Medicaid, but is considered in making the second determination of the *extent of benefits* to which an eligible individual is entitled. Relying on the agency rule, appropriate officials may count the income that an institutionalized individual places in a Special Needs Trust when determining how much of the individual's income he or she must contribute to the cost of his or her care.

In his class action lawsuit, the Medicaid recipient, on his behalf and that of similarly situated persons, unsuccessfully argued that the rule conflicts with the express language of a part of the Medicaid laws. A federal appeals court rejected the plaintiff's reading of the pertinent statute, instead concluding that Congress did not speak to the precise question presented by his claim. Under accepted principles of administrative law, this meant that the federal agency was free to "fill the gap" left by Congress. When it did so, that was an appropriate exercise of the agency's authority, to which the court deferred.

Golfer Can't Be Sued for Errant Shot

Azad and Anoop were friends and frequent golf partners. The friendship was no doubt strained when they became adversaries in litigation arising from an injury to Azad during a golf outing. A shot struck by Anoop hit Azad in the eye, causing a serious injury. There was a factual dispute as to whether, when he saw his wayward shot heading for Azad, Anoop yelled "fore" or some other warning, as golf etiquette would dictate. Anoop said he

Ironically, you could say that the worse the shot (and, thus, the more unexpected the path that the ball takes), the less likely it is that there could be a duty to warn.

did call out something, while Azad and another witness said they heard no warning at all.

In the end, whether or not a verbal warning had occurred made little difference in the case, because the court ruled that Anoop had no legal duty to give such a warning under the circumstances. Anoop did not owe his fellow golfer a duty to give a warning about a shot, where Azad was out ahead of Anoop but at least 50 degrees away from the intended line of flight. Some courts have spoken of a duty to warn those within the "foreseeable danger zone" of a golf shot, but even they recognize that, at some point, the distance and angle are great enough to take the injured person out of the danger zone. Ironically, you could say that the worse the shot (and, thus, the more

unexpected the path that the ball takes), the less likely it is that there could be a duty to warn.

An even more basic flaw in the lawsuit stemmed from the court's conclusion that, from the time he stepped onto the first tee, Azad had assumed the commonly appreciated risks of playing golf, one of which is that golfers hit lots of misdirected shots. The risks that participants in sporting or recreational activities are deemed to have consented to are those which are inherent in participation in the sport. Relieving a participant from liability

further a policy of facilitating free and vigorous participation in sporting and recreational activities. While Azad's case was unsuccessful, this should not be taken to mean that a golf course is lawless terrain, where golfers can do whatever they please with impunity. Reckless or intentional conduct, or concealed or unreasonably increased risks, can still result in liability for injuries, but hitting a lousy shot and not yelling "fore" is not enough to make a duffer pay damages to another golfer unlucky enough to be in the line of fire.

Debtor's Vehicle Returned

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Some other considerations also weighed in favor of placing the onus on the creditor, rather than on Theodore, to seek relief from the court if it believed that its interests were not adequately protected. First, the whole purpose of reorganization bankruptcy, be it corporate or personal, and of the stay in particular, is to allow the debtor to regain his financial foothold and repay his or her creditors. Properly implemented, a stay allows a debtor free use of his or her assets while the court works with both the debtor and the creditors to establish a rehabilitation and repayment plan. In theory at least, these assets generate money that could contribute to paying down the debtor's obligations. In Theodore's case, if his car remained in the hands of the creditor, it could hamper him from going to

work (or, in other cases, from finding work), which is crucial for getting the funds necessary to pay off his debts.

Second, allowing a creditor to maintain possession of an asset until it decides on its own that adequate protection is in place, or until the debtor moves for the asset's return, gives the creditor an unfair bargaining advantage over other secured creditors.

Finally, requiring the debtor, rather than the creditor, to bear the costs of seeking court relief hurts not only the debtor but all of the debtor's other creditors by draining the value of the bankruptcy estate. The court reasoned that it makes more sense for all creditors to move before the court in a consolidated proceeding to have their assets adequately protected than for a debtor to file multiple motions piecemeal in an attempt to recover assets that may be scattered among many creditors.

Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects, but rather to provide insight into legal developments and issues. The reader should always consult with legal counsel before taking action on matters covered by this newsletter.

Noncompete Agreements

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In a recent case involving a company that distributed novelty items to convenience stores and similar businesses, a noncompete clause that prohibited a route salesperson from interfering with or attempting to entice away customers—who were customers of the employer during a one-year period before the employee's termination, and whom the employee had serviced, dealt with, or obtained special knowledge about during his employment—was found by a court to be reasonably necessary and enforceable to protect the employer's business. The employer had a legitimate interest in prohibiting solicitation of its recent past customers and in winning back their business, and, as to such customers, the former employee would be in a far better position than an ordinary competitor, with a distinct advantage were it not for the noncompete restriction.

The case of the novelty items business resulted in a split decision for the employer. A separate clause in the agreement, referred to as the "business" clause, prohibited a former employee, for 24 months following his or her termination, from engaging "in any business which is substantially similar to" the employer's business. The court concluded that this provision went too far. It did not protect a legitimate business interest and was thus unenforceable. The engagement of a former employee in a similar, but non-competitive, enterprise posed little, if any, additional danger to the employer.

When a tax return preparation firm sued a former employee for breach of a noncompete agreement, the court used a standard providing that an agreement of that kind will be enforced only if the business interests the employer seeks to protect and the effect the covenants have are reasonable as to (1) duration; (2) the capacity in which the former employee is prohibited from competing against his or her for-

mer employer; and (3) the geographic territory in which the former employee is restricted from working. The court held that the noncompetition clause in the tax preparer's employment contract was overbroad for failing to properly limit the territory to which it applied, making the entire covenant unenforceable. The clause purported to limit the former employee from working for any employer whose business included the preparation and electronic filing of income tax returns, if that

employer was located, conducted business, or solicited business in the geographic district where the former employee had previously worked or within 10 miles of the district's borders, even if the former employee did not propose to work in or near that district. Such a clause cannot stand, because, as the court put it, it "overprotects" the employer at the expense of a former employee's right to earn a living.

College Tax Breaks

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out for taxpayers with a modified adjusted gross income between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married couples filing jointly).

Lifetime Learning Credit

While the American Opportunity Tax Credit is limited to the first four years of education after high school, the Lifetime Learning Credit, as the name suggests, may be claimed for any year of higher education, such as years spent in graduate or professional schools. Another distinction between the two credits is that the Lifetime Learning Credit is available for any course of study relating to job skills at an accredited school, whereas the American Opportunity Tax Credit requires that the student be enrolled at least on a half-time basis. The phaseout income ranges are lower than for the American Opportunity Tax Credit, by margins of \$30,000 for individuals and \$60,000 for married couples filing jointly.

Calculated at 20 cents on the dollar, the Lifetime Learning Credit maxes out at \$2,000, for \$10,000 in tuition and related expenses. It is not refundable. Unlike the American Opportunity Tax Credit, which is determined per student, the Lifetime Learning Credit is calculated per taxpayer, so

any one taxpayer has the above maximum no matter how many individuals in a family are studying at the postsecondary level. A taxpayer may not use both credits for the same student in the same year, but different credits may be used for different students' expenses in the same year.

Tuition and Fees Deduction

A tax credit, by shaving off the actual tax bill, does more for a taxpayer's bottom line than a deduction, which only reduces the income on which the tax will be imposed. Still, there is a third option in the form of a tax deduction for tuition and related fees, although it cannot be used in the same year for the same student as either of the tax credits previously described. This deduction, which is available even for taxpayers who do not itemize deductions, can be as large as \$4,000 for modified adjusted gross incomes up to \$65,000 (\$130,000 for married couples filing jointly). The deduction is cut in half for even one dollar above those incomes, and disappears altogether when the income levels top \$80,000 (\$160,000 for married couples filing jointly). Another limitation on this deduction is that it cannot be claimed for expenses paid with money from a Section 529 plan or withdrawals from a Coverdell Education Savings Account.