

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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AUGUST-SEPTEMBER 2003

INSURANCE

D.C. COURT WRESTLES WITH UNINSURED MOTORIST ISSUE

Even in this era of mandatory liability insurance, it is not unusual to encounter a negligent driver whose insurance has lapsed—characteristically, just before the driver needs it most. While typically this scenario involves non-payment of premiums, it is also not unusual to find that a borderline insurance carrier is insolvent. In the recent case of *Mosley v. Welch*, D.C. App.No.00-CV-1283 (August 28, 2003), the D.C. Court of Appeals dealt with complications arising from exactly that scenario. In summary, the facts were as follows:

- Taxicab driver Mosley caused an accident in June, 1994;
- Pedestrian Welch sustained an injured leg and brought suit;
- Defendant Mosley had \$25,000 in insurance coverage through Capital Casualty Insurance Company (CCIC), which is a wholly owned subsidiary of Capital Cab.
- In a separate proceeding, CCIC was declared insolvent in order to be liquidated. Welch's suite was stayed to allow the D.C. Insurance Guaranty Association ("DCIGA") to assume CCIC's defense and other obligations

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TAX PLANNING

FINAL REGULATIONS ON TAX SHELTERS ISSUED

On February 27, 2003 the Treasury Department and the Internal Revenue Service (IRS) issued final regulations requiring taxpayers to disclose their participation in potentially abusive tax avoidance transactions, promoters to register certain abusive transactions, and advisors to maintain lists of clients who have entered into potentially abusive tax avoidance transactions. One of the objectives of the new regulations is to put promoters of tax shelters and taxpayers who purchase them on notice. Most of the transactions the IRS is seeking to shut down take advantage of the literal wording of the Internal Revenue Code to achieve ends which are completely at odds with the specific legislative intent of the particular Code provisions involved. Typically, the transactions have no economic substance or business purpose apart from tax avoidance, exalt form over substance, and try to exploit the interstices of the Code by strained yet verbatim interpretations of its provisions.

In the past the IRS has tried to curb the increasing use of tax shelters on a case-by-case basis using the step transaction and form over substance doctrines. However, this casuistic approach has proven unequal to the task, so the Service is now tackling the problem through regulations. Nevertheless, the new regulations are probably just a prelude, and one should expect both more litigation and Congressional legislation plugging a number of perceived loopholes. Of course, all these efforts ensure that in the years ahead the Code and the regulations will increase both in length and complexity. For example, the new regulations contain 98 pages of fine print, so in this article the most the author can do is provide the highlights.

The heart of the new regulations is the definition of "reportable transactions," the six new categories of potential tax avoidance transactions. Taxpayers will be required to disclose to the IRS if they have entered into these transactions and

promoters will be required to maintain lists of investors who have purchased tax shelter packages covered by the six categories. A brief description of each category follows.

Listed Transactions. These are tax shelter that have already been identified by the IRS as tax avoidance transactions. The Service website contains a comprehensive list of these transactions with numerous examples of each for taxpayer guidance. One can expect that the IRS will take a hard line on these transactions since it has put taxpayers on notice that it has determined them to be abusive.

Transactions Marketed Under Conditions Of Confidentiality. As the title of this category indicates, the objective here is to force disclosure of transactions that the promoter has tried to keep secret by calling it "proprietary" or by other means. The theory is that a promoter or taxpayer who takes pains to obfuscate may be engaging in tax evasion. The objective is transparency.

Transactions With Contractual Protection. These are transactions where the promoter is paid a contingency fee based on taxes saved or where the fee is refundable if the tax shelter does not work as advertised. The theory here is that a tax advisor who is giving tax advice in good faith does not need to condition his advice on results. Put another way this type of fee arrangement is supposed to give all the wrong incentives to taxpayers and their advisors. The taxpayer is willing to buy the package since the fee is refundable if the shelter does not work, and the promoter is willing to rely on the audit lottery not catching the scheme.

Transactions Generating Section 165 Losses Exceeding Specified Amounts. Here the IRS is simply trying to apply thresholds to determine whether certain losses seem too large for the taxpayer in question. It is really a materiality filter which will not necessarily yield evidence of tax evasion.

Transactions Resulting In Book-Tax Differences Exceeding Certain Amounts.

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INJUNCTIONS APPELLATE DECISION DEMONSTRATES HIGH THRESHOLD FOR INJUNCTIVE RELIEF

Often in the course of representing commercial clients, a matter will arise which causes the client—in a sense of outrage and frustration—to demand immediate injunctive relief. The factual background which leads to this plea may involve an employment dispute where an employee defects to a competitor, or a claim that a competing business has usurped a proprietary business idea or method of practice, or, perhaps, a business expanding into a territory or product line which the client believes is prohibited or exclusive. Although a lawsuit for monetary damages can also seek ultimate injunctive relief, clients often want to know why they cannot obtain an injunction immediately as opposed to waiting for the outcome of the long and expensive adjudicative process. A recent case decided by the District of Columbia Court of Appeals is helpful in shedding some light on the question of why an injunction is usually unavailable at the inception of litigation.

The case of *Zinkle v. D.C.*, D.C.App. No. 02-CV-310 (Aug. 28, 2003), involved an individual who was employed in a supervisory role by the Office of the Chief Financial Officer of the District of Columbia. The specifics as to why this employee was terminated are really not germane to our analysis of injunctive relief. Suffice it to say that the employee was accused of knowingly violating directives from his superior and as a result was placed on administrative leave pending termination for insubordination.

The employee filed an action in D.C. Superior Court, which included a motion for a temporary restraining order to prevent the District of Columbia from terminating him until a hearing could be held seeking a permanent injunction. A “temporary restraining order” is an interim measure aimed at maintaining the *status quo* until a request for an injunction can be considered—in this case, five days. A preliminary injunction is not of such a limited duration and would stay in place until a final determination after trial. In the *Zirkle* situation, an injunction would delay termination until there had been a full trial on the merits. In *Zirkle* the temporary restraining order was actually extended for approximately five months, after which a

hearing was held and the trial court decided that there was insufficient reason to issue a preliminary injunction. The employee appealed this denial of preliminary injunctive relief.

On appeal the District of Columbia Court of Appeals ruled that the trial court had properly denied the preliminary injunction because the employee suffered no *irreparable injury* and because compensatory damages and reinstatement of employment were available if he ultimately prevailed at trial. The Court explained that a four-part test was to be used to determine if a party seeking an injunction should prevail. The trial court should assess whether the moving party has clearly demonstrated: (1) that there is a substantial likelihood he will prevail on the merits; (2) that he is in danger of suffering irreparable harm during pendency of the action; (3) that more harm will result from denial of the injunction than will result to the defendant from its grant; and in appropriate cases, (4) that the public interest will not be disserved by issuance of the requested order. The Court of Appeals explained that in considering whether to issue a preliminary injunction, the most important inquiry is that concerning *irreparable harm*. The Court further stated that an injunction should not be issued unless the threat of injury is imminent and well-founded and unless the injury itself would not be capable of being redressed after a final hearing on the merits. In this case the Court noted that the employee could only point to the loss of a potential job offer as the basis for immediate harm. The Court then reasoned that this was not an *irreparable injury* because economic and reputation type injury are insufficient to justify prejudgment equitable (*i.e.*, injunctive) relief, since adequate compensatory relief in the way of monetary damages will later be available at trial. The Court cited language of a leading case from the U.S. Court of Appeals for the District of Columbia holding that:

The key word in this consideration is irreparable. Mere injuries, however substantial in terms of money, time and energy necessarily expended in the absence of a stay, are not enough. The possibility that adequate compensatory or other corrective relief will be available at a later date, in the ordinary course of litigation, weighs heavily against a claim of irreparable harm.

For purposes of this article, we are not going to address the other factors which all would have to be met in order to obtain preliminary injunctive relief. The requirement of an *irreparable injury* that cannot later be dealt with at trial through a monetary award or other compensatory damages is sufficient to address the frustrated client who wants to know why an injunction cannot be immediately obtained. This is not to say that occasions will not arise in which injunctive relief is in fact appropriate. However, those times are rare, for this type of relief is, by definition, extraordinary in nature. Or, put more succinctly to our clients, we feel your pain, but without more than money damages, the courts won't restrain.

STEPHEN GRAEFF

TAX PLANNING *continued from page 1*

Because U.S. companies report taxable income to the IRS differently than net income before tax under Generally Accepted Accounting Principles (GAAP) for financial reporting purposes, there are always differences between taxable income and accounting income. If those differences are excessive the IRS wants to know why. Again there might be nothing sinister at work.

Transactions Generating A Tax Credit When the Underlying Asset Is Held For A Brief Period Of Time. Abusive tax shelters often rely on foreign transactions which frequently give rise to foreign tax credits. This category is best illustrated by Example 5 of the Regulations. In the example a foreign subsidiary of a U.S. company buys a Euro-denominated bond, sells it six days later, and earns only €100,000 on the transaction. However, the transaction generates a €500,000 foreign tax credit. That is a credit of roughly \$500,000; not bad for six days of work.

The new regulations clearly show that the Service is concerned about shelters and aims to eliminate them. More to the point once a taxpayer and his, her or its advisors are on notice of what the IRS considers abusive, it becomes much harder to defend the continued use of tax shelters thus branded. If you have any questions on the new regulations please call Roy Morris or the author.

NÉSTOR CRUZ

EMPLOYMENT

DOES YOUR EMPLOYMENT MANUAL CREATE A CONTRACT WITH YOUR EMPLOYEES?

Employment Manuals, also known as Employee Personnel Manuals, Employee Handbooks or Employee Policy Manuals, frequently contain language which provides that while the manual may contain the then current operating policies of the employer, the policies contained in the manual are not intended to and shall not be construed as creating a contractual relationship between the employer and employee. Many employers blindly interpret exculpatory provisions such as the one above as negating a contractual relationship. The District of Columbia Court of Appeals recently addressed this issue in the case of *Howard University v. Lacy*, D.C. App. No. 02-CV-464 (July 17, 2003) and held that creation of a contract in an employee manual is determined by the intent of the parties.

The *Howard University* case involved a breach of contract claim by Plaintiff Lacy, who was terminated after allegedly placing a student in an illegal choke hold in April, 1996 (this, of course, begs for the question—what is a *legal* choke hold?). Plaintiff Lacy asserted that his termination violated the contract allegedly created by the employee manual. In sum, Lacy contended that the employee manual, which permitted termination of non-temporary and non-probationary employees only for unsatisfactory work performance, neglect of duty or conduct incompatible with the welfare of the University, was violated in that the University did not comply with specific disciplinary and grievance procedures in its employee manual.

Defendant Howard University denied that the employee manual created a contract between it and its employees. Howard University refused to agree that the employee manual, which specifically provided on the first page that “[t]his document is not to be construed as a contract,” was in fact a binding contractual agreement. In addition to language attempting to specifically negate the creation of a contract, the manual also provided that the University reserves to itself the exclusive discretion to exercise traditional management prerogatives, which include the sole authority to “select, hire, promote, demote, suspend [and] terminate ... employees.”

Prior to trial in October, 2001 (more than five years after the incident which led to the termination) in the Superior Court of the District of Columbia, Judge Susan R. Winfield ruled as a matter of law that the manual constituted an employment agreement. Defendant Howard University was not permitted to offer evidence to the contrary at trial; and, a jury held that Plaintiff Lacy was terminated in violation of the contract created in the employee manual. Howard University appealed, asserting that the manual did not create a binding contract in light of (i) the statement that the manual was not a contract and (ii) its retention of authority to terminate employees notwithstanding the stated grievance and disciplinary policy.

The appellate court held that the manual was ambiguous with respect to the critical question whether the parties had entered into an employment contract, given the statement refuting the creation of a binding contract. The court further held that, where an ambiguity is present, the intent and understanding of the parties is of critical importance. Thus, the case was remanded to the trial court to permit Howard University to present evidence of its intent when it issued the manual in order to determine whether the manual in fact created a binding and enforceable contract.

This case highlights three important points with regard to employment manuals. First, every manual should contain a provision negating the creation of a contractual relationship. Second, the manual should not include policies which are not routinely followed (in this instance, grievance and disciplinary procedures when they are not necessary given an employment at-will environment). Third, manuals should be reviewed regularly to ensure consistency with recent statutes and case law.

As an aside, it is interesting to note the speed at which the judicial wheels turn. The instant case was initially tried before a jury more than five years after the incident which resulted in Plaintiff Lacy’s termination. The appeal was decided approximately nineteen months later, and the case was then remanded to the Superior Court (trial court) for further proceedings. Thus, seven and one-half years after Plaintiff Lacy was terminated, he is still unsure of the outcome of his claim.

PHILIP SCHWARTZ

INSURANCE

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under the Property and Liability Insurance Guaranty Association Act of 1993 (“the IGA Act”).

- When the stay was lifted, trial proceeded. The jury found Mosley liable and awarded Welch \$75,000.

After damages were awarded, the procedural fun began. Defendant/appellant Mosley filed a post-trial motion for partial relief, arguing that the IGA Act applied to Welch’s claim and that Welch should be required to exhaust his own uninsured motorist coverage before enforcing the judgment against Mosley. In other words Mosley asked that Welch use his own UM coverage before he began collection efforts against Mosley personally. This presented a practical problem for Welch, because he could not even identify his carrier from several years earlier. But more significantly, Welch contended that the IGA Act did not give Mosley rights against him and did not oblige Welch to exhaust his UM coverage before enforcing his \$75,000 judgment against Mosley’s assets.

Because no stay was in effect during the post-trial phase, Welch took enforcement action, and the court entered judgment of condemnation for Welch against \$27,488 in Mosley’s bank account. Subsequently, the trial court denied Mosley’s post-trial motions, leading to the appeal.

The focus of the appeal was on the question whether Mosley could compel Welch to turn to his own UM coverage before enforcing his judgment against Mosley directly. The IGA Act functions by allowing DCIGA to honor claims against insurers that become insolvent. Essentially, DCIGA steps into the shoes of the insolvent carrier to provide defense and/or honor valid claims. In this instance DCIGA assumed CCIC’s obligation to insure Mosley to a stated limit of \$25,000.

The IGA Act also seeks to preclude duplicate insurance recoveries by requiring claimants to use other sources of insurance coverage first. In this case DCIGA, before paying CCIC’s coverage to Mosley, *could* have insisted that Welch pursue a claim against his own vehicle insurer on his uninsured/underinsured motorist coverage. The DCIGA could have credited any UM payments Welch received; and, if they had already paid Mosley, DCIGA could have sought reimbursement. Appellant

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CARR, MORRIS & GRAEFF, P.C.

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial Litigation; Alternative Dispute Resolution; Employment/Labor; Discrimination; and Wage-Hour.

The firm maintains its office in the Metro Center region of downtown Washington. It has attorneys admitted to all of the local judicial jurisdictions—the District of Columbia, Maryland and Virginia.

STAFF NOTES

Congratulations. On September 3rd, Dana Theriot gave birth to Aidan Robert Theriot—a robust 7 lb., 12 oz., and 21 inches (or 1' 9"—which in boyspeak means “about 6 ft.”). Dana and Bart are adjusting well, but the Theriot herd of cats is unimpressed. September 3, coincidentally, is also Bart Theriot’s birthday.

* * *

Néstor Cruz has been elected President of the Cornell Graduate School of Management alumni club of the Washington metropolitan area.

INSURANCE

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Mosley’s arguments failed, however, because the court declined to equate his position to that of DCIGA. The purpose of the act, the court noted, “is to avoid duplicate insurance recoveries and protect the funds of the DCIGA, not to reduce the liability of the insured or provide them with more asset protection than if their insurers had not become insolvent.” When DCIGA paid Welch \$25,000, its obligation

was satisfied. Mosley would then be in exactly the position he would have been in if his insurer had not become insolvent. If CCIC had not been insolvent and had paid Welch \$25,000, Mosley would not have had reason to insist that Welch exhaust his UM coverage before pursuing Mosley directly. Only DCIGA had the right to insist on such exhaustion.

LAWRENCE CARR

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