

LEGAL UPDATE

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

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BUSINESS LAW

LEGAL PITFALLS FOR THE UNWARY SMALL-BUSINESS OWNER

In business, as often in life in general, the biggest mistakes may come not from what you do not know, but from what you thought you did know that turns out to be incorrect. In short, it is important to step back, re-evaluate and verify your business, both intra-office (between officers, directors, lenders, vendors and employees) and regarding third-parties and clients on an ongoing basis. Doing so at each and every stage (conception, formation, growth and expansion) will keep you on guard for the following common legal pitfalls affecting businesses of every size, but particularly destructive to small-business. Here is an illustrative list of common legal problems facing small-business and tips on how to avoid them:

1. Starting a business while employed by a potential competitor, or hiring employees without first checking their agreements with their current employers and their knowledge of competitor's trade secrets. From state to state the law is set in stone that when someone is currently employed by a company, particularly if an officer, director, or key employee, that individual cannot run a competing business. Any overt act towards a competing business, even if just incorporating a company for "future" purposes, will likely

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TORTS

TORTIOUS INTERFERENCE WITH CONTRACT OR WITH BUSINESS EXPECTANCY

Background

The Virginia Supreme Court explains that a "party to a contract has property rights in the performance of and anticipated profits from the contract, and these rights are entitled to protection in the courts. Thus, one who intentionally interferes with another's contractual rights is subject to tort liability." *Duggin v. Adams*, 234 Va. 221 (1987). Tortious interference occurs when a third party purposefully interferes or harms a contractual or business relationship between two other individuals. Virginia first recognized this type of case in 1917. By way of background, Judge John Wetzel of the Circuit Court of the City of Winchester explained that tortious interference claims developed:

As the country became more industrialized and more sensitive to the excesses of unregulated competition, the laissez-faire attitudes which had characterized the permissive legal view of business practices in the nineteenth century changed, and the courts gradually became intolerant of what they perceived to be unfair business practices. "As our industrial conditions have developed, we have found that men may be oppressed quite as effectively and disastrously through business methods and practices as by force and violence. The law, therefore, must be invoked for the protection of the individual against the abuse of power." Louis D. Brandeis, 1911, quoted in Alfred Lief, *The Brandeis Guide to the Modern World*, p. 85 (1941). *Simbeck, Inc. v. Dodd-Sisk Whitlock Corp.*, 44 Va. Cir. 54 (1997).

In deciding tortious interference cases courts have to be sensitive to competing interests. "An injury may be of the kind which, in a relatively free economy, a citizen is obliged to suffer, an injury resulting from lawful competition of which he cannot complain... if means of competition are fair, advantage should remain where success has put it, but if acts complained of do not rest on some legitimate interest or if there is sharp dealing or overreaching or

other conduct below the behavior of fair men similarly situated, the ensuing loss should be redressed." *Simbeck, Inc. v. Dodd-Sisk Whitlock Corp.* Business mores, standards and practices change over time and, so to, will the line demarcating permissible and impermissible behavior.

The Basics

Virginia recognizes two forms of this tort: tortious interference with contractual relations and tortious interference with prospective business or economic advantage. The two are very similar but, as their names imply, involve interference at different stages of a contractual or business relationship. To make a claim of tortious interference with a contractual relationship a plaintiff must prove that: (1) a valid contractual relationship existed, (2) the defendant knew of the contract, (3) the defendant intentionally interfered such that the contract was terminated or breached and (4) resulting damage. The elements required to establish tortious interference with a prospective business advantage are similar, but the critical difference is that the plaintiff must also prove that the defendant employed "improper methods." Improper methods include conduct that is illegal or independently tortious such as violations of statutes, regulations or common-law rules. Other forms of interference include violence, threats, intimidation, bribery, unfound litigation, fraud, misrepresentation, misuse of confidential information, unfair competition and other unethical conduct. A defendant is liable if he acted with the purpose of interfering with the performance of a contract. It is not necessary to prove the interferor acted maliciously. The requisite level of intent also exists if the interferor knows that the interference is certain or substantially certain to occur as a result of his or her actions.

Valid Contract or Business Expectancy

The first step in proving tortious interference with a contractual relationship is to produce and prove that there is a valid contract. This may seem like an obvious starting point but one that can be problematic. If a contract has been terminated or is unenforceable it cannot form the basis for this type of claim—for

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ASK A LAWYER, Q&A

Q. All this talk of health care reform has me thinking about insurance. In my small business, we pay the cost for an individual employee's coverage. One employee is covered at no cost by his wife's very generous plan. Now he has demanded that I give him cash equal to what I would otherwise be paying for his insurance? Must I pay him?

CHARLIE IN SPRINGFIELD

A. Charlie, your employee is gaming you. There is no requirement that an employer pay an employee the value of an employee benefit when the employee elects not to participate in the benefit. What's next, an employee demanding reimbursement for transportation expenses when he walks to work? Regardless, if the employee wants to make it more "painful" for the employer, he could elect to be covered by the employer sponsored health insurance and cause you to pay the premium. In the current scenario, since he is covered by his wife's employer's generous plan, the coverage you provide would be secondary coverage and of very little benefit to your employee. Of course, while the coverage is of little benefit to your employee, you are footing the bill. For this reason, it is often advisable that the employer require that employees contribute to the cost of the premium. Even a small employee contribution will weed out employees who are electing to participate in employer sponsored health insurance when they have no real need for the coverage, including situations where the employee has access to coverage through a spouse's plan or even coverage provided to certain retirees.

Q. I work in an auto repair shop. The boss announced recently that we were no longer employees, that from now on we were independent contractors. He explained that he would pay less in taxes, which is good, and that nothing else would change. I imagine that's

OK. Even if it isn't, it's the employer's problem, not mine, right?

DALE IN OAKTON

A. Dale, your boss is leaking oil. I'd need to know more about your job. Since you say nothing except your employment status changed, though, I assume you still basically perform your job as directed by the man. While there are a few different tests to determine if a worker can be properly classified as an independent contractor (1099), you must look at the specifics of the position to determine proper classification. Does your boss tell you when to be at work? Does he provide you with tools? Who bears the risk if a customer does not pay? These are but a few of the factors which must be reviewed to determine if classification as an independent contractor is proper. As you noted, there are tax consequences to the classification, but these consequences benefit the employer. In an employer-employee relationship the employer and the employee each pay equal amounts in taxes for FICA (Social Security) and Medicare. However, an independent contractor would pay the equivalent of the employee's share and the employer's share, thus, doubling the tax burden on the worker. This is before we even factor into the equation the costs associated unemployment taxes and worker's compensation insurance.

PHILIP SCHWARTZ**TORTS**

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example, a non-compete clause that is void because it is impermissibly broad and/or the term is too long. Additionally, "tortious interference claims lie only against a party that is a stranger to the relationship." *Childers Oil Co., Inc. v. Exxon Corp.*, 960 F.2d 1265 (4th Cir. 1992). The defendant cannot be a party to the underlying contract.

In the case of tortious interference with a business expectancy, a plaintiff must prove, as a starting point, that there was a legitimate

expectation of a business relationship. This is more complicated than proving the existence of a contract and is more fact specific. A plaintiff must prove that there is a "particular expectancy which is reasonably certain will be realized." *Masco Contractor Services East, Inc. v. Beals*, 279 F. Supp 2d 699 (E.D. Va. 2003). It is not enough for the plaintiff to hope or believe that a business relationship will develop. There must be a probability, not possibility, of future economic benefit.

At-will Contracts

Interference with an at-will contract is more difficult to prove and, accordingly, must meet the same standard as interference with a prospective business advantage – that is, a plaintiff must prove the interference occurred by "improper methods." In *Duggin v. Adams*, the Virginia Supreme Court explains that:

Unlike a party to a contract for a definite term, however, an individual's interest in a contract terminable at will is essentially only an expectancy of future economic gain, and he has no legal assurance that he will realize the expected gain. Thus, the cause of action for interference with contractual rights provides no protection from the mere intentional interference with a contract terminable at will. In short, the extent of permissible third-party interference increases as the degree of enforceability of a business relationship decreases. Nevertheless, the fact that a contract is terminable at the will of the parties does not make it terminable at the will of others. (*internal citations excluded*).

Affirmative defenses

An interferer may escape liability by proving that the interference was justified or privileged. The Virginia Supreme Court has specifically provided five grounds for use of the affirmative defense of justification or privilege: legitimate business competition, financial interest, responsibility for the welfare of another, directing business policy and the giving of requested advice. *Commerce Funding Corp. v. Worldwide Sec. Servs. Corp.*, 249 F.3d 204 (4th Cir. 2001).

DANA THERIOT

Trivia answer: Justin Banford traces his roots to Canada.

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trigger litigation. When employed, an individual owes common law duties to his or her employer. If someone intends to leave their employment to open a competing business, the first justifiable step is to resign.

Every employee, regardless of position, learns certain information concerning the operations of his employer. Under federal law, "A trade secret, as defined under 18 U.S.C. §1839(3)(A), has three parts: (1) information; (2) reasonable measures taken to protect the information; and (3) which derives independent economic value from not being publicly known." An employee may leave an employer, but that does not release his duty to protect the trade secrets of his former employer.

When recruiting new employees, inquire into any covenants the candidate holds to previous employers (non-competes, non-solicitations, non-disclosures, etc.). Violation of such covenants will land both the new employee and his new employer in court.

2. Choosing the Wrong Ownership Structure. The decision you make will affect whether or not you will be able to accept outside investors, the number and nature of outside investors, tax treatment, liability, and how you may be able to sell your company in the future. The two dominant forms of business entities are corporations and limited liability companies (LLC). For businesses owned and operated by a small group of related individuals, the LLC is generally considered a better option. However, if you expect to have investors and partners come and go, and expect to up-scale your business into a larger organization, you likely want to incorporate. LLC's and subchapter S corporations are not subject to tax at the organizational level, called pass-through taxation, whereas subchapter C corporations are taxed at the corporate level. The decision really turns on the facts and circumstances of your particular business.
3. Failing to Clearly Document Owners' Rights and Responsibilities. This mistake is almost always made at formation. As time passes, people's recollections always change and allegations of "oral

agreements" compound. The company founders should address: How much capital is each person to contribute? What happens if the company needs additional capital? How much time should each founder be expected to contribute? What happens when someone wants to leave the business? What if one of the founders dies or is disabled? In a corporation ownership is documented by issuing stock certificates, and the above issues can be addressed in a Shareholders' Agreement. In an LLC the Operating Agreement usually controls ownership, management and the foregoing issues.

4. Failing to Document Expectations and Rules for Employees. To ensure that your employees meet your expectations, it is important to set clear and consistent expectations and rules. An Employee Handbook is the clearest way of spelling out what is and what is not acceptable. All employees, including at-will employees, should acknowledge receipt and review of the Employee Handbook.

Companies often mishandle employee issues. Improper documentation of the relationship may turn independent contractors into employees and at-will employees into employees with special rights concerning termination. Additionally, to ensure enforceability, non-competes, non-solicitations, confidentiality and intellectual property agreements should be negotiated at the time of hiring. Lastly, if ever having to terminate an employee, say as little as possible – less is more.

5. Avoiding Litigation. Litigation is a favorable outcome – for litigation attorneys. The costs of litigation are immense, not just in terms of money, but also time and focus. Do your best to avoid litigation by: 1) seeking legal advice before entering into an uncertain relationship, 2) insisting on favorable alternative dispute resolution mechanisms, mediation & arbitration, in your contracts, and 3) addressing the issue immediately and directly with the other party at initial onset. Once the relationship breaks down and counsel is involved, it is much more difficult and costly to extricate yourself.
6. Ignoring Intellectual Property. You worked hard to build your brand; yet,

many small companies, particularly non-technology companies, mistakenly believe they have no intellectual property worthy of protection. Ignoring intellectual property can open the door for competitors and employees, both current and former, to infringe on your business. You can protect yourself by ensuring intellectual property protection provisions are included in all of your contracts, both in-house through employee handbooks and confidentiality agreements and with any counterparties, particularly so if your company ever grants an intellectual property license to another party.

7. Weak or Lacking Vendor/Client Written Agreements. A handshake is rarely sufficient; as is the contract you likely signed ten years ago with your biggest client and haven't looked at since. Business relationships are ever growing and evolving, and written agreements must be periodically amended or restated to address changing circumstances. A valuable simple exercise is to pull the contracts you have with your five largest clients, if you can find them, and read them again. Business is all about relationships, and when the relationship changes, so should your written agreement.
8. Asleep at the Wheel. The most important thing to remember, and really the culmination of the foregoing, is to make it a practice to periodically review all your company's procedures and relationships, and to stay vigilant in protecting your business. Too often small-business owners become engrossed in day-to-day operations to see the larger picture. Allowing simple tasks to go undone creates costly future remediation efforts. Make it a point to review: your employment policies and employee contracts, your contract status with your largest customer, the missing or unsigned corporate documents that you and your partner have been meaning to review and sign, the threat of infringement on your intellectual property, etc. Addressing these issues routinely will keep your eyes on horizon, allowing you and your company to plot a path to circumvent these pitfalls or in the event you fall into one, to have legal protections in place to resume course without costly delay.

JUSTIN BANFORD

**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; Employment/Labor; Discrimination and Wage-Hour; Criminal; and Alternative Dispute Resolution.

The firm maintains its office in Tysons Corner, Virginia—the business hub of the metropolitan region. It has attorneys admitted to all of the local judicial jurisdictions.

STAFF NOTES

CMG Trivia. Which CMG attorney was half-upset, half-proud when Canada struck Olympic gold in men's hockey, beating the American team 3-2 in overtime? Answer on page 2.

* * *

Margarita and Néstor Cruz spent spring break in New York attending a performance of *Attila* at the Metropolitan Opera and visiting art museums.

* * *

Happy Anniversary. March 1 marked CMG's 28th anniversary—and first anniversary in Virginia.

NEGLIGENCE

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