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Covenants Not to Compete: A Primer for the Business Owner

by Paul B. Calico



Has this ever happened to you? Your “star” sales manager has just handed in her resignation. You hear through the grapevine that she has accepted a position with your fiercest competitor. She knows everything about your company, from sales forecasts and pricing strategy to new product developments and customer lists. And pretty soon, your competitor will know everything she knows — *unless* you had her sign a covenant not to compete.

Business owners really cannot afford to pass up the benefits and protection that covenants not to compete offer. Whether they are called non-compete agreements, restrictive covenants, or covenants not to compete, these contracts are an essential tool for every business owner.

What Is a Covenant Not to Compete?

Very simply, a covenant not to compete is an agreement that prohibits an individual from competing with a former employer. The agreement typically will state that the individual, after leaving his or her employment, may not be employed in the same or a similar line of work for a specified time in a certain geographic area.

For example, an office supply manager who works for ABC Company may sign an agreement that restricts him from taking a management position at other office supply businesses within 50 miles of ABC for two years after he leaves ABC. The agreement may also provide that the former employee cannot disclose or use trade secrets or confidential information obtained by working for the former employer, or that the former employee may not start a competing business within certain geographic and time limitations.

A less restrictive type of non-compete agreement may allow a former employee to continue in the same

type of employment without interruption, but prohibit the former employee from soliciting the former employer’s customers in a specific area for a certain amount of time. This is called a non-solicitation covenant.

Is It Enforceable?

Any agreement in restraint of trade, such as a covenant not to compete, is generally not viewed favorably by courts. However, courts also recognize the importance of protecting a company from unfair competition from the very employees it recruited and trained. These employees may have had access to sensitive pricing and marketing information, as well as strategic business plans, customer lists, or other information that a business wants to keep confidential.

Therefore, courts in a majority of states *do* recognize and enforce covenants not to compete, as long as they are reasonable. (California is an exception; there, by statute, restrictive covenants are not allowed.) Other states have enacted statutes specifically stating what must be included in order for covenants not to compete to be valid and enforceable.

When Is a Covenant Not to Compete Reasonable?

A covenant not to compete should contain restrictions that are no broader than reasonably necessary for the former employer’s protection. In addition, it should not impose an undue hardship on the former employee in making a living, and it should not be injurious to the public.

The question of whether a specific covenant not to compete is enforceable is entirely dependent on the facts of each situation. To determine reasonableness, a court will ask a number of questions. Here are just a few:

- Does the employer have a legitimate business interest that requires protection?
- Are the agreement’s time and geographic restrictions reasonable in light of the business interest to be protected and the employee’s need to make a living?
- Did the employee have access to trade secrets or confidential business information?
- Does the agreement seek to stifle the inherent skill and experience of the employee?

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CLIENT SPOTLIGHT

Complete Petmart

Imagine a store that would not only remember your pet's birthday, but would offer a special treat as well. That dream is a reality at Complete Petmart, the Dayton, Ohio-based retail chain that offers a variety of pet products.

With service and accessibility at the forefront of their philosophy, Complete Petmart is following a course of steady growth in an ever-changing industry.

With 12 stores in the Cincinnati area, as well as multiple stores in Dayton and Columbus, Ohio, Complete Petmart has now branched into the Highland Heights/Alexandria, Kentucky region. At the end of 1997, there were 22 stores in operation. For 1998, four to eight more are planned. This growth represents both the stores' successes as well as their future goals. According to Tim Rogers, merchandising manager, slow, steady, profitable growth is one of the goals of the company. Explains Rogers, "The key to our growth is service and convenience."

Service with a Smile

Complete Petmart stores are designed to make shopping easy. The bright, colorful stores are well-lit and carefully planned. Areas for the different animal sections are clearly marked. Cartoon dogs, cats, fish, birds, and small animals show up throughout the stores and throughout the various flyers and publications the company produces, helping to create company recognition. All the stores have a similar layout, designed to give customers a sense of familiarity so that they can find what they want easily. However, managers have the freedom to make changes in order to cater to the specific markets that exist within each city.

As with any store, knowledgeable salespeople play an important role in gaining customer loyalty. Each month, the staff attends training seminars to learn about products so that they can recommend the best product for each customer.

If a pet wants or needs a product, there is a good chance Complete Petmart has it or can get it. Each store maintains about 5,000 items, but with two distributors, they have access to approximately 40,000 pet items.

Complete Petmart stocks products for dogs, cats, small animals, reptiles, and fish. Fish are the only livestock that Complete Petmart carries, but they account for approximately three to five percent of their overall sales.

Treats for All

To encourage customer loyalty, Complete Petmart invites customers to bring their pets to the stores with them, enabling the owner to pick products that will best fit each pet's requirements. Pets receive a free treat, have their picture taken, and may even be signed up for the birthday club. To celebrate the pet's birthday, the customer receives a coupon worth an Iam's treat for cats and dogs, or a Kaytee treat for small animals or birds.

Other customer incentives include a Frequent Buyer Card. With each food purchase of three pounds or more, the card receives a mark. After 12 purchases, the next order of the same size is free. Complete Petmart also publishes *Pet Care Magazine*, an advertising supplement that runs twice a year in the *Cincinnati Enquirer* and the *Kentucky Post*. Plans are to expand its run into Columbus and Dayton this year. The publication includes coupons as well as tips for owners concerning the care of their pets. The articles cover topics such as grooming, choosing a pet, nutritional needs, as well as stories about pet organizations. Flyers are also sent out to regular customers and run as Sunday inserts, alerting customers to upcoming specials.

Other promotions include a spring and winter event in conjunction with local shelters.



ATTORNEYS ON THE MOVE

William V. Strauss has been named to the Personnel Committee of the Contemporary Arts Center. He also serves on the Facilities Committee, which is working on the new building for the CAC, proposed for the corner of Sixth & Walnut Streets, across from the Aronoff Center for the Arts.



William V. Strauss

Recently **Richard D. Heiser** moderated a course in comparative religion at the Institute for Learning in Retirement at the University of Cincinnati. His undergraduate and graduate degrees are in comparative religion, the study of which has been a life-long avocation. The course offered sessions on Hinduism, Islam, Buddhism, Christianity, Judaism, Taoism, and Confucianism. Each lecture covered the essence, or central ideas and tenets, of each religion. Students were retired people, generally over 60, bright, thoughtful, and interested in continuing their educations.



Richard D. Heiser

local music and community theater scenes. He recently had two guitar solo numbers in a performance with The Klezmer Project, which plays traditional Eastern European Jewish music. In November Steve also played the lead role of the father (played on Broadway by Judd Hirsch) in Herb Gardner's play, "Conversations With My Father." Steve was very excited about that opportunity because this part was his most juicy, dramatic, and largest role to date. Finally, Steve was recently awarded the coveted "Orchid Award" from the local Association of Community Theatres for his portrayal of Merv Kant in the 1996 Stagecrafter's production, "The Sisters Rosensweig."

Mark H. Berliant has accepted an appointment to the Board of Trustees of the Greater Cincinnati Film Commission. The Film Commission has been responsible for major studios coming to the Greater Cincinnati Area to make their films, such as "Little Man Tate," "Milk Money," and "Lost in Yonkers," to name just a few.



Mark H. Berliant

William R. Jacobs will be the speaker for the Estate Planning and Probate Committee of the Cincinnati Bar Association on Tuesday, March 10, 1998 at 12:00 p.m. Bill's topic will be "Issues in Representing Beneficiaries, Heirs, and Spouses in Trust and Estate Litigation" at the Trust & Estate Litigation seminar.



William R. Jacobs

At the request of Sutton G. Landry, the Director of Northern Kentucky University's Small Business Development Center, **Claudia G. Allen** and **Charles H. Melville** have agreed to serve on a task force

charged with exploring the creation of an Entrepreneurship Institute at NKU. For several years, Strauss & Troy has co-sponsored a series of seminars in conjunction with NKU's Small Business Development Center. The seminars cover all aspects of



Claudia G. Allen



Charles H. Melville

managing a small business, from marketing to finance. Strauss & Troy attorneys, who are presenters at the seminars, cover a wide variety of legal issues faced by small business, including deciding on the form of the business, risk management, personnel matters, how to hire and get the most from a lawyer, and intellectual property issues. The proposed Entrepreneurship Institute would build upon the core competencies of the SBDC and add a significantly broader range of programs than are possible under the constraints of the current federal grant guidelines. The task force would be involved primarily in identifying program priorities for such an Entrepreneurship Institute and in developing a



Anthony M. Barlow



Marshall K. Dosker



John G. Parnell

Strauss & Troy is pleased to announce that, effective January 1, 1998, **Anthony M. Barlow** and **Marshall K. Dosker** have become members of the firm; **John G. Parnell** has joined the firm in an "Of Counsel" capacity; and **August T. Janszen** and **Cheryl A. Meyer** have become associated with the firm.



August T. Janszen



Cheryl A. Meyer

An article appeared in the January 8 issue of The American Israelite covering a speech by **Steven F. Stuhlbarg** which he delivered at a meeting of the Greater Cincinnati Chapter of Women's American ORT. Steve discussed the basics of the dilemma presented by the separation of church and state and then focused on recent developments in school districts. Steve also continues to be very involved with the



Steven F. Stuhlbarg

- Is the benefit to the employer disproportionate to the burden on the employee?
- Did the employer spend considerable time and money in training the employee?
- Does the agreement seek to eliminate unfair competition or merely ordinary competition?

Also, like any contract, a covenant not to compete must be supported by consideration (something of value). The best approach is to have key employees sign a covenant not to compete as a condition of their employment when they first start their jobs. An employer who has an employee sign a covenant later in the employment relationship runs the risk that a court will refuse to enforce the agreement for lack of consideration.

While some states recognize *continued* employment as consideration in these situations, others do not. To be on the safe side, employers who have employees sign restrictive covenants after they have already started to work should, in return, offer something of value to the employees other than merely continued employment — additional compensation or extra benefits, for example.

The departure of a key employee is a situation that every business owner will face at one time or another. Having a covenant not to compete in place helps ensure that your key employee does not become a key employee for your competitor. If you would like more information or you need advice about a particular situation, feel free to contact Paul B. Calico at Strauss & Troy.

How to Avoid Trademark Infringement Claims

by Charles H. Melville

A lawsuit for trademark infringement is the last thing a business wants to encounter. After all, a company usually makes a major investment of time and money to develop and market a product or service and choose a name for that product. No business wants to spend even more time and money defending its right to use a trademark, and to run the risk of having to change the mark if a court finds it infringes another company's trademark. So, how can you avoid this situation?



What Is a Trademark?

A trademark is simply a word, phrase, symbol, or design used to identify the source of a product; similarly, a service mark is a word, phrase, symbol, or design used to identify the source of a service. For example, **TYLENOL®** and **EXCEDRIN®** are well known trademarks for over-the-counter pain medications. Virtually everyone immediately recognizes both these trademarks. However, do you know the name of the company that produces them? Very few people actually do, which is really the essence of a trademark. Through extensive advertising, the public recognizes the mark, and associates that mark with certain standards of quality and performance, even though they probably do not know the name of the company that produces the product. In other words, the trademark becomes the commercial signature of the producer.

Sources of Trademark Protection

First, let's take a look at the sources of trademark protection. A trademark may be protected under the federal (Lanham Act) or state statutes,

or under the common law. To qualify for federal trademark protection, a trademark must be registered with the U.S. Patent and Trademark Office. Once federally registered, a trademark is entitled to nationwide protection.

A state trademark registration is effective only in the state of registration. A Cincinnati company that does business in Ohio, Kentucky, and Indiana would thus have to file three state applications to cover its area of business. From the dollar and cents standpoint, it is generally cheaper and more effective to file a single federal application rather than multiple state applications.

Common law trademark protection provides rights in a trademark to the "senior," or first user of a trademark in a particular geographic area. Common law trademark protection is limited to the geographic area where the mark is actually used, along with a zone of reasonable expansion surrounding this area.

Strength of a Trademark

Strength of a trademark depends on two main factors: (1) the nature and extent of use of the mark, and (2) the distinctiveness of the mark itself. The nature and extent of use in turn depends on the time of use, as well as the amount of advertising using the mark (**IVORY®** has been used by Procter & Gamble for many years, and hence is now a very strong trademark).

Distinctiveness of a trademark depends on the relationship between the mark and the goods with which it is used. For analytical purposes, trademarks can be divided into three classes. (1) The most distinctive mark is one which is "arbitrary" — for example, **KODAK®**. (2) A "suggestive" trademark is one which requires some imagination or thought to reach a conclusion as to the nature of the goods. All things being equal, a "suggestive" mark is registrable and can become a very strong trademark. (3) A "descriptive" mark is a word or phrase which simply describes the product, such as "OVEN-FRESH" for bakery products. In general, a mark which is "merely descriptive" is not protectible. Anyone should be able to use any set of words which simply describes their product.

Likelihood of Confusion

The test for trademark infringement under both statutory and common law is "likelihood of confusion" by the public concerning the source of goods or services. In other words, would an ordinary consumer be confused as to the origin of a product marketed under the allegedly infringing mark? In common law, many trademark infringement cases are based on a theory of "palming off" its goods or services as a competitor's by appropriating the competitor's trademark.

A business might be found liable if its mark is confusingly similar to one already being used by another company. For example, in an unusual case, McDonald's, the fast food chain, successfully prevented the use of the name "McSleep" for a chain of economy hotels. In that case, McDonald's presented survey results that showed a significant number of people erroneously thought that the fast food chain might have some connection to a hotel chain named "McSleep."

Tips to Prevent Infringement Claims

Avoiding a potentially infringing situation is always the best course for a business to follow. By taking a few precautions at the outset, a company may save many thousands of dollars — or more — in time-consuming trademark litigation down the road. Here are some suggestions:

- ✓ Choose a trademark that is distinctive, but not confusingly similar to others that you are familiar with. This is particularly true if the similar mark is used to identify goods or services that are identical or similar to those you will be marketing.

- ✓ Before making a final decision on a trademark and investing marketing dollars in it, conduct a trademark search for potentially conflicting marks already registered or in use.
- ✓ Make sure your trademark search includes both federal and state registered marks and those protected by common law in the areas in which your company does business.
- ✓ Trademark disputes regarding domain names for web sites on the Internet have proliferated. So, you should register your trademark as a domain name as soon as possible.
- ✓ If your trademark search does not turn up any conflicting marks, you should register your trademark with the U.S. Patent and Trademark Office. This will give you maximum protection against the possibility of someone infringing on your trademark.

Estate Tax “Windfall” Gets U.S. Supreme Court’s Nod of Approval

by Marilyn J. Maag

Two dissenting justices called it a “tax boondoggle.” However, seven justices of the U.S. Supreme Court disagreed and handed in what has been called a victory for taxpayers.

The issue in *Commissioner v. Estate of Hubert* involved the marital and charitable deductions from federal estate tax liability. Generally, the value of assets transferred by will to a spouse or charity qualifies for the federal marital and charitable deductions. This means that these transfers are exempt from federal estate taxes.



When an executor (the person who oversees the administration of an estate) pays estate administration expenses out of the estate’s *principal*, the marital and charitable deductions are reduced dollar-for-dollar by a corresponding amount. This is because the amount that the spouse or charity actually receives from an estate is reduced when expenses are paid from principal. The issue in this case, however, was whether the federal marital and charitable deductions must be reduced when an estate’s executor pays administration expenses from *income* that the estate’s assets earn during the period of administration.

The Facts

Otis Hubert died leaving a gross estate of more than \$30 million. The administration of his estate was governed by the Georgia Probate Code and the Georgia Principal and Income Act. Under both Georgia law and Hubert’s will, the executor had discretion to pay administration expenses from either the estate’s principal or income earned on estate assets after Hubert’s death.

Following a will contest, a settlement agreement was entered into that provided that Hubert’s widow would receive, in trust, about half the estate, while the other half would be given to several charities. Like the will, the settlement agreement also allowed the executor to pay administration expenses from either principal or income.

The estate’s administration expenses totaled over \$2 million. The executor paid over \$500,000 of expenses from principal, while income was used to pay about \$1.5 million in expenses. The \$1.5 million of expenses paid from income was claimed as a deduction on the estate’s federal *income tax return*.

However, on the estate’s federal *estate tax return*, the executor reduced the marital and charitable deductions only by the amount of *principal*, but not income, that was used to pay administration expenses. The IRS then stepped in and demanded that the marital and charitable deductions be reduced further to reflect administration expenses that were paid out of *income*. This would have made more of the estate’s assets subject to federal estate taxes.

The argument ended up in court, of course. Both the Tax Court and the Eleventh Circuit Court of Appeals sided with the estate, and the parties eventually ended up before the U.S. Supreme Court.

The Decision

This case ended up as a victory for the estate, but the nine justices were badly divided. While most cases result in a majority opinion, this one did not. Seven of the justices sided with the estate, but nearly all had different reasons. Two of the justices sided with the IRS.

The amount allowed for the tax-exempt marital deduction generally equals the value of the property that is transferred to the spouse. The result in this case turned on an interpretation of a treasury regulation which states that, when determining the amount of the marital deduction, an executor must consider any *material limitations* on the spouse’s right to income from the property. (For purposes of this litigation, all agreed that the same requirement applied to the charitable deduction.)

The IRS argued that, because the executor had discretion to pay expenses out of income and the spouse (and the charities) did not receive all the estate’s income (some of it was used to pay expenses), there was a limitation on the right to the income. Therefore, the amount of the marital and charitable deductions should be reduced dollar-for-dollar by the amount of income used to pay administration expenses.

However, seven justices disagreed, noting the regulation states that a limitation on the right to the income must be “material” in order to reduce the amount allowed for the marital deduction. Unfortunately, neither the regulations nor this case provides much guidance on the meaning of “material.” The justices merely gave some examples where payment of expenses from income *might* be material. One is where the amount of the principal and expected income are small when compared to the amount of administrative expenses paid out of income. Another is when the value of the asset to the spouse (or charity) comes solely from the expected income.

Four of the seven justices who sided with the estate believed that the income used to pay administrative expenses in this case was not a material limitation, in light of the amount of income the estate’s substantial assets most likely earned. The other three thought that the amount of expenses paid from income *might* have been a material limitation, but could not decide this issue since the IRS never presented any evidence regarding the amount of income earned by the estate.

Final Thoughts

While the case of *Estate of Hubert* has been hailed as a taxpayer victory, an executor must use a great deal of caution before taking advantage of the result in this case. Here are some things to keep in mind:

- An executor may only charge administrative expenses to estate income if both state law *and* the will allow it.
- If expenses are charged to estate *principal*, the federal marital and charitable deductions must be reduced dollar-for-dollar.
- Before charging expenses to income, an executor should carefully examine whether such charges are a “material limitation” on a spouse’s or charity’s right to the income. If so, this may reduce the marital or charitable deduction, and increase the federal estate taxes. Executors should seek competent, legal advice before taking any action on this issue.



We're Just Mad About Our MAD Team

Once again we would like to sing the praises of our **MAD (Make A Difference) Team**. The funds for our MAD Team projects are generated in several ways. Throughout the year we all "pay up" to "dress down" on Fridays and from time to time in-kind donations are sought for specific projects. Additionally, the staff sponsors an annual baking contest and sale, and publishes and sells a recipe book, with all funds going into the Team's coffers.

This holiday season the MAD Team had two projects. The first of these was a contribution which allowed residents of Golden Towers Senior Citizens Home who had no plans for Christmas day, to have a holiday dinner. The second was the Team's "adoption" of 10 families during the holidays, two more families than last year, thanks to the generosity of all at Strauss & Troy. Prior to the holidays a lighted white "giving tree" (hung with stars, each bearing the name and gift wishes of an "adoptee") was placed in our lobby. Those stars were chosen by Strauss & Troy personnel, who then purchased and wrapped the gifts. The MAD Team provided each mother with gifts of food, clothing, and household supplies, and Santa surprised each child with gifts of clothing, coats, gloves, and three toys. Each family was also provided with Kroger gift certificates.

Our MAD Team has brightened the lives of so many since its inception several years ago and has received several awards acknowledging its efforts. No one could be more proud than Strauss & Troy of the generosity of its staff and the continuing year-long efforts of Team members — **Marsha Bowen, Marsha Butler, Dorothy Elder, Becky Epperson, Robert Harper, Elizabeth Mason, Julie Numbers, Marita Owen, and Karen Stegeman**.

Certain states, including KY, do not certify specialties of legal practice. Certain states, including OH, do not provide for recognition as a specialist in any area or field of law, except for patent, trademark or admiralty. IMPACT is published quarterly to provide information of general interest and not to provide legal advice concerning any specific situation. If you wish additional or more specific information, please contact one of the attorneys at Strauss & Troy.

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