

LET THE SELLER BEWARE

(continued from page 2)

enough money to pay your bills if it hadn't bought an \$80,000 luxury car for its president. The president gave nothing of value for the car and is still driving it. Why not sue him?

For one thing, he may not be solvent. More importantly, the trustee has a number of options, including suing either the initial transferee of a fraudulent transfer or the entity for whose benefit the transfer was made. Although the trustee could sue to recover the car, the car is no longer worth what the corporation paid for it and the trustee would rather have \$80,000 in cash than a used car which she or he must auction.

Further, good faith and lack of knowledge of the voidability of the transfer are not defenses. Recent decisions by the Ninth Circuit Court of Appeals and Bankruptcy Appellate Panel make it clear that the car dealership is the initial transferee and the debtor's president is the entity for whose benefit the transfer was made.

Banks, mortgage companies, and anyone who sells goods or property are at risk under fraudulent transfer law whenever an insolvent corporation has paid the personal debts of an officer or shareholder. A simple defense can be to adopt a policy of refusing corporate checks in payment of personal debts of a shareholder of a company. This may not be a practical option for your company, particularly if you are selling or financing small purchases. Rarely, however, will it be cost effective for a trustee to sue you to recover a fraudulent transfer loss of less than \$5,000.

The much broader issue surrounds the complexity and intricacy of bankruptcy law itself. As illustrated by the example in this article, bankruptcy law is indeed a "mine field" for the inexperienced attorney. If you are sued, or think you are in danger of being sued, act promptly and hire an experienced attorney who specializes in bankruptcy law.

Don W. Robinson is a member of Carr, McClellan's Creditor's Rights and Bankruptcy Department.

BRINGING YOUR PHILANTHROPIC DREAMS TO LIFE

(continued from page 5)

so-called contribution base, depending on the type of asset donated. The specific rules are highly technical and dependent on each donor's situation.

Private philanthropy, which is what private foundations are all about, can be exciting and rewarding for those involved. Although numerous and detailed, the legal and accounting rules for establishing and maintaining a private foundation are designed not to discourage this important arm of charitable endeavor, but to insure that it remains true to its calling of focused, personally inspired benevolence.

Penelope C. Greenberg is a member of Carr, McClellan's Corporate and General Business Department.

The area code for our Burlingame office has changed from 415 to 650.

Our numbers are as follows:

Telephone (650) 342-9600
Facsimile (650) 342-7685

All direct dial numbers for the Burlingame office (696-25..) have also changed to the (650) area code.

CARR, McCLELLAN, INGERSOLL, THOMPSON & HORN
PROFESSIONAL CORPORATION

CARR
McCLELLAN
INGERSOLL
THOMPSON
& HORN

San Francisco Bay Area Offices:

216 Park Road
Burlingame, CA 94010
Tel: (650) 342-9600
FAX: (650) 342-7685

Four Embarcadero Center
Suite 1120
San Francisco, CA 94111
Tel: (415) 362-1400
FAX: (415) 362-5149

"PERSPECTIVES ON LAW" IS PUBLISHED BY CARR, McCLELLAN, INGERSOLL, THOMPSON & HORN PROFESSIONAL CORPORATION, MARK A. CASSANEGO, PRESIDENT. OUR GOAL IS TO PROVIDE CLIENTS AND FRIENDS OF THE FIRM WITH MORE THAN JUST UPDATES ON HOW THE LAW IS EVOLVING. WE HOPE TO SHARE OUR PERSPECTIVES SO THAT YOUR BUSINESSES AND FAMILIES CAN MAKE THE MOST OF THE OPPORTUNITIES BEFORE YOU.

CARR, McCLELLAN, FOUNDED IN 1945, HAS OFFICES IN BURLINGAME AND SAN FRANCISCO. THE FIRM PROVIDES FULL-SERVICE LEGAL ADVICE TO MANY CLOSELY-HELD BUSINESSES AND MAJOR CORPORATIONS IN THE BAY AREA'S LEADING INDUSTRIES, AS WELL AS TO INVESTORS AND FAMILIES.

THIS NEWSLETTER IS FOR GENERAL INFORMATION PURPOSES ONLY AND IS NOT INTENDED TO OFFER LEGAL ADVICE ON SPECIFIC CASES. PLEASE CONTACT YOUR CARR, McCLELLAN ATTORNEY TO DETERMINE HOW THIS INFORMATION MIGHT AFFECT YOU.

PERSPECTIVES ON

LAW

Vol. 8 No. 1
Spring 1998



ABOUT OUR PEOPLE
7 IN OUR PROFESSION
AND NEW ATTORNEYS

FAMILIES AND
INDIVIDUALS
3 AFTER THE
EARTHQUAKE, WILL
YOUR INSURANCE
CARRIER COME
THROUGH?

4 BRINGING YOUR
PHILANTHROPIC
DREAMS TO LIFE

6 NEW TRUSTEE
NOTIFICATION STATUTE:
PRIVACY NO MORE

STRATEGIES
FOR BUSINESS
1 PROTECT YOUR
CORPORATE VEIL

2 LET THE SELLER
BEWARE

CARR
McCLELLAN
INGERSOLL
THOMPSON
& HORN

STRATEGIES
FOR
BUSINESS

PROTECT YOUR CORPORATE VEIL

By L. Michael Telleen, Esq.

One of the most important advantages of operating a business in corporate form is the protection shareholders receive from exposure to the corporation's liabilities. This shield from liability, often referred to as the "corporate veil," protects a shareholder's individual assets from claims by the corporation's creditors.

Protecting this veil requires care and attention. Obviously, the courts may disregard a corporate veil when it is used to perpetrate fraud, circumvent a statute, or accomplish other wrongful or inequitable purposes. Equally important, the corporation's veil can be damaged if the business is not properly organized and carefully operated.

The case law of California and other states determines when a corporation will not be treated as an entity (a person) separate from its shareholders. The courts check many factors in making this determination. For example, the courts will look for co-mingling of funds between the corporation and its shareholders or the diversion of corporate funds to other than corporate uses.

Other important factors considered by the courts are whether or not the corporation is observing proper corporate formalities. The following questions may be asked:

- Was the corporation properly organized?
- Was the issuance of corporate stock properly authorized by the directors and the stock actually issued?
- Was the corporation adequately capitalized?
- Is the corporation observing legal formalities such as holding shareholder and director meetings and maintaining minutes and adequate corporate records?

Whether a business is large or small, the proper organization of a corporation requires more than just filing articles of incorporation. It requires

electing directors and holding an initial meeting of directors to elect officers, adopt bylaws, authorize the issuance of stock, and deal with related elections and approvals. It also means adequately capitalizing the corporation and arranging for sensible insurance coverage.

Proper maintenance of a corporation as a separate entity includes complying with corporate formalities such as holding regular shareholder and director meetings. Those meetings and the actions taken should be documented with appropriate minutes or written consents. If meetings are not held, written consents should be executed in lieu of meetings – even if the corporation has only a few shareholders, directors and officers. Indeed, this holds true even if there is only one shareholder who serves as the only director and the only officer.

With assistance from professional advisors, maintenance of corporate records need not be a complicated process. Ask your accountant to check the corporation's financial records, your insurance advisor to periodically review insurance coverage, and your attorney to maintain minute and stock records.

At least once a year – at a minimum – an annual shareholders meeting should be held to elect new or reelect the old directors and an annual directors meeting should be held to elect new or reelect the old officers. These annual meetings should occur even if the directors and officers remain the same from year to year. In addition, directors meetings should be held or consents should be prepared to approve significant transactions such as loans, leases and certain contracts.

The Internal Revenue Service may ask to see the corporation's minutes in connection with an audit. Properly prepared minutes will provide evidence for the treatment of the corporation as a separate entity. They can also back up certain tax elections or the corporation's tax treatment of particular items of income, deduction or credit.

We find it helpful to meet with a corporation's officers periodically to discuss the activities of the corporation and the proper documentation of those activities. If a personal meeting is inconvenient, these matters can be discussed by telephone or dealt with in correspondence, facsimile or by electronic mail. For assistance, please contact us.

L. Michael Telleen is a member of Carr, McClellan's Corporate and General Business Department.

LET THE SELLER BEWARE

By Don W. Robinson, Esq.

Learning that a debtor has filed for bankruptcy can ruin your day. Suddenly, the collectability of a receivable that your company has been carrying is in great doubt, claims must be filed, and payments, if any, will not occur for months or years.

Unfortunately, things can and sometimes do get worse. Just as you are contemplating the likely loss of your receivable, you may learn that your company has now been sued by the trustee of the bankrupt company to return one or more payments that you had previously received. The suit arises from something called “preferential transfers.”

This plus the many other complex issues that arise under bankruptcy law are not only complex, they can sometimes be counter-intuitive and seemingly illogical. Thus, if you learn that a debtor of your business has gone bankrupt, or you fear that one might be at risk of doing so, you are well advised to seek the counsel of an experienced attorney who specializes in bankruptcy law. To paraphrase a local judge, bankruptcy law is a “mine field” for the inexperienced attorney.

Take just one example. Imagine that you own a car dealership that sells a luxury automobile for \$80,000, the market price, to the president of a prominent local company. The company owns a fleet of cars, which your dealership services under contract, but the president registers the new car in his own name and pays with a corporate check.

The company later fails to pay outstanding invoices for repairs and servicing of the company cars. When the outstanding invoices reach \$25,000, you contact an attorney who sends a letter terminating the contract and threatening to sue. In response, the car dealership pays you \$15,000 and agrees to pay the balance of \$10,000 over two months.

“**B**ANKRUPTCY
LAW IS A
‘MINE FIELD’
FOR THE
INEXPERIENCED
ATTORNEY.”

A month later, the company files a Chapter 7 bankruptcy petition and a trustee is appointed to liquidate the assets of the corporation for the benefit of the creditors. You file a claim for \$10,000, hope for the best, and expect the worst. Shortly thereafter, the trustee threatens to sue *you* on the grounds that the \$15,000 you received within 90 days of the bankruptcy filing was a “preferential transfer.” You turn the matter over to the same attorney who handled the matter before.

Your attorney knows enough about bankruptcy law to realize that a debtor isn’t supposed to favor one creditor over another during the slide into bankruptcy. The payment wasn’t a matter of favoritism, he or she explains, since the debtor refused to pay anything until you terminated the contract and threatened to file a state court complaint. “Anyway,” adds the attorney, “why are you going after my client when the debtor’s president is driving around in a luxury automobile that he bought from my client with corporate funds?”

Unfortunately, your attorney has just made matters worse. He or she has just destroyed a possible defense to the trustee’s demand for the return of the \$15,000. The Ninth Circuit Court of Appeals holds that a creditor who terminates its contract with a struggling debtor is using economic pressure to modify payment terms, and this is not in the “ordinary course of business.” In addition, payments made in settlement of litigation are not considered to be in the “ordinary course of business” by the Bankruptcy Court for the Northern District of California.

Worse yet, in calling attention to the fact that your car dealership was paid with a corporate check for a car registered to the debtor’s president, your attorney may have set you up to be sued for a fraudulent transfer of \$80,000. Granted, you did not defraud anyone. If anything, you feel defrauded. After all, the corporate debtor would have had more than
(continued on page 8)

ABOUT OUR PEOPLE

IN OUR PROFESSION. . .

DENNY S. ROJA

Denny Roja has been elected President of the Silicon Valley chapter of the Association for Corporate Growth, an international organization with chapters throughout the U.S. and Europe.

CAROL B. SCHWARTZ

Carol Schwartz was recently appointed to the Board of Trustees of the Peninsula Association for Retarded Children and Adults.

NICHOLAS J. SPYROS, JR.

Nick Spyros has joined the Board of Directors of the Burlingame Chamber of Commerce.

L. MICHAEL TELLEEN

Mike Telleen is Secretary and a Director of the Day School Foundation, and has been elected as President of the St. Andrews Lutheran Church Council for 1998. On July 1, 1998, Mike will again be serving as a Director of the Rotary Club of Belmont.

W. GEORGE WAILES

George Wailes has been elected President of the Hillsborough Schools Foundation. Mr. Wailes also serves on the board of the San Mateo County Bar Association.

MOIRA C. WALSH

Moira Walsh has been elected as a Vice President and member of the Board of Directors of the San Francisco Court Appointed Special Advocate Program.

“**M**ANY WILL
WANT TO REVISIT
THE TERMS OF
THEIR TRUST
PLANNING
DOCUMENTS.”

NEW ATTORNEYS. . .

The firm is pleased to announce that **Daniel R. Morris** and **Elise C. Jacques** have joined Carr, McClellan.

Daniel Morris has joined the Estate, Trust and Fiduciary Litigation Group of Carr, McClellan’s Litigation Department as Special Counsel. Mr. Morris is an experienced practitioner and most recently had been a partner at Lakin-Spears in Palo Alto. He is a graduate of the University of San Francisco School of Law.

Elise Jacques has also joined Carr, McClellan’s Litigation Department. Ms. Jacques received her J.D. from Stanford Law School. Elise has litigation experience in the areas of environmental, insurance, employment and business law. Before attending law school, Elise spent ten years directing non-profit public interest organizations.

NEW TRUSTEE
NOTIFICATION
STATUTE:
PRIVACY NO MORE

By Steven D. Anderson, Esq.

Living trusts are a popular estate planning vehicle, and one of their principal attractions has been the fact that these trusts can be administered on a completely private basis. Unfortunately, this changed as of January 1, 1998, and individuals need to be aware of and consider the ramifications of these changes on their personal estate planning documents and goals.

Until this year, when the creator of a revocable living trust died, the successor trustees named in the trust instrument were authorized to administer the trust according to its terms without involving the court. Absent special circumstances, the trust administration could proceed on a completely private basis.

Historically, individuals have been able to transfer property at death using a trust as the vehicle without complicated notice procedures and without divulging every term of the trust. This process provided an appropriate alternative to the very public process required when a will is probated.

Unfortunately, as the use of living trusts has proliferated, so, apparently, have problems. In some circumstances, dishonest trustees acting without court or beneficiary supervision have circumvented trust terms, thus defeating the deceased trustor's wishes.

The California legislature responded with a sweeping new statute, which applies in two instances:

- When a revocable trust becomes irrevocable for any reason (including the death of the trustor)
- When there is a change in the trustees of an irrevocable trust.

Under the provisions of new Probate Code Sections 16061.5 *et. seq.*,

“THE NEW LAW
MAY ENCOURAGE
DECEDENTS
DESIRING TO
MAKE PRIVATE
GIFTS TO DO SO
IN WAYS OTHER
THAN THROUGH
A LIVING TRUST.”

a trustee administering a trust under such circumstances has 60 days in which to send a notice to:

- All persons who would be “heirs at law” of the deceased person, regardless of whether they are named in the trust document; and
- All persons named as beneficiaries under the terms of the new trust agreement, regardless of the amount of the gift to the beneficiary.

The new code provisions require trustees to prove that beneficiaries and heirs actually receive a copy of the statutory notice. Following receipt of the notice, each beneficiary or heir has a right to receive a **full copy of the trust agreement**. A special 120-day period applies for purposes of contesting the provisions of the trust. If an action to contest the trust provisions is not brought within that time, the contestant is barred from later disputing the terms of the trust.

The enactment of the new statute has been controversial, and it is anticipated that the new law may encourage decedents desiring to make private gifts to do so in ways other than through a trust. For instance, they may wish to make life insurance or individual retirement account designations or to create joint tenancy titling arrangements during lifetimes with the intended beneficiary.

The new law will almost certainly result in fewer “minor” trust gifts, such as monetary gifts to housekeepers, gardeners and others to whom the deceased person would not want to give the entire trust document. In addition, the new statute may cause many individuals to reconsider “unequal” gifts to children or others who might be offended (or worse) if the full terms of a trust were made known to them.

Certainly, in view of the new law, many will want to revisit the terms of their trust planning documents to determine whether alternative means of gift-giving are now more appropriate.

Steven D. Anderson is a member of Carr, McClellan's Estate Planning and Probate Department.

FAMILIES
&
INDIVIDUALS

AFTER THE EARTHQUAKE,
WILL YOUR INSURANCE
CARRIER COME
THROUGH?

By Lori A. Lutzker, Esq.

When the Northridge earthquake hit the Los Angeles area the morning of Jan. 17, 1994, Orenzo Cheeks was one of thousands whose home suffered damage from the 6.7 temblor. Afterward, he expected his insurance carrier to pay the fair market value of his loss. When it refused, he sued.

For anyone who has ever wondered if their insurance company would stand behind them after an earthquake, Cheeks v. California Fair Plan Association may be good news.

Cheeks had purchased an indemnity policy from CalFair covering damage to his home, including damage caused by earthquake. The policy provided that covered property losses would be settled at the actual cash value at the time of loss, but not more than the amount required to repair or replace the damaged property. This is commonly known as an “actual cash value” policy.

After the Northridge earthquake, CalFair determined the actual cash value of Cheeks' loss based on the cost of repairing and replacing the damaged portions of his house, and then reduced this amount for depreciation. That's when Cheeks sued, claiming that he was to be paid the fair market value of his loss, not replacement cost less depreciation.

The Court agreed and relied on an insurance code related to fire insurance – not earthquake insurance – for its decision.

“EVER WONDERED
IF YOUR INSURANCE
COMPANY
WILL STAND BY
YOU AFTER AN
EARTHQUAKE?”

Specifically, Insurance Code section 2071 provides that, with respect to fire insurance, the insured is to be compensated for loss “to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality...”

The Cheeks court noted that the California Supreme Court in Jefferson held that the actual cash value language used in Section 2071 was synonymous with fair market value. In Jefferson, the Supreme Court concluded that the Legislature did not intend the term actual cash value to mean replacement costs less depreciation. Since the language in the Cheeks policy was the same as that in Insurance Code section 2071, the Cheeks court concluded that the Supreme Court's opinion in Jefferson regarding fire insurance should apply to Cheeks' earthquake insurance as well.

If something like this ever happens to you, be sure to consult with your attorney. Just like earthquakes, the outcome cannot be predicted. But, with Cheeks now on the books, your odds of winning have increased.

Lori A. Lutzker is a member of Carr, McClellan's Litigation Department.

■

BRINGING YOUR PHILANTHROPIC DREAMS TO LIFE

By Penelope C. Greenberg, Esq.

You are ready to make some serious philanthropic contributions and you are considering your alternatives. This article is the first of two articles discussing some of the alternatives available to you and will focus on private foundations. The second article, in the next issue of *Perspectives*, will focus on simpler alternatives such as donor advised funds and chartered family foundations (support organizations).

You do not have to be a Ford, Rockefeller or Packard to make a philanthropic mark in your community. Scores of grant-making foundations exist today – over 3,000 in California alone – and each is as unique as the founders themselves. With assets of \$29 billion, foundations statewide gave out over \$1.2 billion in total grants in 1995. The years since show no signs of slowing as new foundations continue to be formed.

WHY FORM A PRIVATE FOUNDATION?

Funding assets to a foundation can give those involved a genuine sense of contributing to the betterment of some aspect of the world in which we live. People form private foundations for various reasons:

- To honor a family member or other individual by creating a charitable organization bearing that person's name;
- To address a social need of particular interest to the donor that existing charities may not be adequately covering;
- To perpetuate the donor's family name;
- To control how the donated funds are used;
- To give the donor a focus for his or her energies;
- To avoid having to spend time and effort in public fundraising.

These considerations make private foundations appealing. The downside is that the tax rules applicable to private foundations are stricter than those for public charities. This is a relic of the days when some private foundations were created to further their founders' personal advantage, rather than operated for charitable purposes.

STEPS TO FORM A FOUNDATION

The first step in forming a private foundation is to decide what specific purpose the foundation will serve and determine that the purpose will be approved by the IRS. If the desire to create a private foundation stems from the founder's interest in a particular field, the question of charitable purpose is usually obvious. Otherwise, the purposes may address interests or concerns of the individual or family for whom the foundation will be named or areas in which the founder has some expertise or experience.

You will want the foundation's purpose to fall within the purposes allowed by the IRS for two important reasons: to permit contributions made to the foundation to be tax deductible to the gift giver and to enable the foundation to receive tax exempt status as a Section 501(c)3 organization.

The allowable purposes of private foundations are described in detail in IRS regulations, but basically include relief of the poor and underprivileged; advancement of religion, education or science; erection of public buildings, monuments or works; lessening the burdens of government; and promotion of social welfare. The Internal Revenue Service Code itself states that a charitable organization's purpose must be "religious, charitable, scientific, testing for public safety, literary or educational" or "to foster national or international amateur sports competition" or address the "prevention of cruelty to children or animals."

If the name of the foundation is important, it should be reserved as soon as possible. The name cannot be one that is already in use by an existing California corporation or one that is so close to an existing name as to cause confusion. It is a good idea to select two or three possible names. Any available name may be reserved with the Secretary of State's office for 60 days at a time for a nominal fee.

The second step is to determine how the foundation will be governed, such as how many directors the corporation will have and who they will be. The directors control the organization and are ultimately responsible for its actions. An odd number of directors is advisable so as to prevent tie votes. Three or five are preferable; more than seven is usually not very workable.

It is advisable (and the IRS will be happier) if the board includes people of diverse talents and perspectives. The board should be comprised of people with related experience and interests; members with financial, legal and other professional backgrounds; and those who are in touch with the community that will be the recipient of the foundation's assistance.

When appointing a board of directors, care must be taken not to violate the so-called "49% rule." Under California law, no more than 49% of the board may be composed of individuals who work for and are compensated (other than for being a director) by the foundation or who are **related** to individuals who work for or are compensated by the foundation.

FILING INCORPORATION AND TAX DOCUMENTS

Creating the articles of incorporation itself is very easy. There are standard articles of incorporation and bylaws for nonprofit public benefit corporations. Some tailoring of the bylaws to fit the preferences of the foundation is possible and sometimes done; the form of the articles, however, is fairly inflexible. The incorporator designates the original board of directors and sometimes the original corporate officers (usually president, chief financial officer and secretary). Officers frequently are directors, but need not be. The secretary and CFO may be the same person; however, the president cannot also be CFO or secretary.

The articles of incorporation are filed with the California Secretary of State's office and returned in a week or two. The official filing date, stamped on the returned articles, establishes the date on which the foundation's legal existence begins.

The longer, more complicated step in bringing the private foundation to life is filing for and obtaining tax-exempt status from the IRS and the California Franchise Tax Board. This requires completing federal and state exemption applications and miscellaneous related forms. The good news is that the California application asks for much the same information as the federal form, so preparing the former is largely a matter of repackaging the latter.

The applications require, among other things, a description of each activity of the foundation and when, where, and by whom each activity will be conducted; a list of the foundation's sources of financial support; and the estimated revenues and expenses for the first three years of the foundation's existence. The applications also ask about relationships with other organizations and individuals, members of the board of directors, intended beneficiaries of the foundation's assistance or services, and any planned political or legislative activities.

The state and federal fees and estimated taxes required to create a private foundation currently total approximately \$1,200.

EFFECTIVE DATE

If the federal application is filed within 15 months after the month of incorporation, the tax-exempt status will date back to the date the corporation began. Otherwise, the effective date is the date of filing the application, absent good cause for the late filing.

No specific deadline exists for filing the state application; it is usually filed at the same time as the federal application. Typically, the Franchise Tax Board waits until the IRS approves the federal application and then grants the state exemption. Processing time for the IRS application varies. Four months is very fast; eleven months is not unheard of. Generally, the IRS sends the applicant several supplemental questionnaires as part of the review.

SPECIAL TAX PROVISIONS

Once operational, a private foundation is subject to six special tax provisions that do not apply to public charities. The first is an annual excise tax of 2% of net investment income (1% if the foundation's record of qualifying distributions is good enough to meet the standards set for the 1% tax). This excise tax is designed to fund the IRS' cost of overseeing private foundations.

The other five are penalty taxes, which may be avoided by not engaging in the disapproved activities. The taxes are on:

- Acts of self-dealing (for instance, the sale of property, loan of money, or provision of goods or services between the foundation and its directors, managers or substantial contributors)
- Failure to distribute annually at least 5% of the foundation's net investment assets
- Excessive interests in other corporations held by the foundation
- Any investment by the foundation that may jeopardize its tax exempt purpose
- Expenditures for attempts to influence legislation or a public election; grants to individuals for travel, study or similar purposes; grants to organizations that are not public charities (unless steps are taken to see that the grant is spent for intended purposes); or grants for a noncharitable purpose.

Donors to private foundations are faced with annual donation limits. Generally speaking, maximum donation limits for a private foundation are 30% or 20% of the donor's *(continued on page 8)*

