

## 61 AND COUNTING

As the firm celebrated its 61st birthday this past September, I reflected once again on what makes our firm special and such a vibrant, exceptional place to practice law. It's the people, of course. Our founding partners laid down the foundation on which the firm is built: excellence in lawyering; utmost dedication to clients and commitment to community. The first and second generations of Carr McClellan lawyers, including Albert Horn (54 years with the firm) and Norm Book (40 years with the firm) have successfully passed on the torch to others of us who have devoted our legal careers to Carr McClellan and its clients, including Mike Telleen (33 years), Lage Andersen (29 years), Keith Bartel (28 years), myself (27 years), Penny Greenberg (26 years), Ed Willig (22 years), Steve Anderson (18 years), Lisa Stalteri (17 years) and others.

The years of experience of our partners and their longevity with Carr McClellan reveals much about our firm. But most of all, it reveals that our clients are assured of receiving legal advice from a team of lawyers that will be solution focused. The more one practices law, the more one realizes that exceptional lawyering is most often the product of combining knowledge of the law with judgment that only comes from experience. The experience base of Carr McClellan's lawyers directs us to focus on what matters most to our clients: legal advice and advocacy that takes into account the need to provide value. We know our clients well. Most are privately held businesses and individuals who rely on us to provide sophisticated but practical solutions to real problems, or to bring our knowledge and experience to help lead and guide them through opportunities or challenges presented to their businesses. Experience has no substitute.

We are fortunate to have added to the firm in recent years another generation of bright, dedicated, hard-working and caring people who hold great promise to continue to carry out the founding principles of the firm. As they gain the experience necessary to become exceptional lawyers, the firm's ability to serve our clients will grow and deepen. Those of us who have been with Carr McClellan for a few years are not only proud of our firm's past, but we are excited about our firm's future.

Mark Cassanego, President of Carr McClellan.

## FROM BAD TO WORSE WHEN PONZI SCHEMES AND BANKRUPTCY LAW COLLIDE

By Michael J. McQuaid, Esq.

In 1903, Carlo Ponzi emigrated from Italy to the United States. Although he stepped off the boat with less than \$3.00 to his name, within 20 years he was able to amass a multi-million dollar fortune and owned an air conditioned mansion with heated swimming pool. His was a classic rags-to-riches story, or at least it would have been except for the way he made his fortune and subsequently lost it. Ponzi's name will forever be linked to the bubble scheme, a type of fraud in which returns are paid to earlier investors entirely out of the money paid into the scheme by newer investors. Ponzi did not invent this type of scheme. However, his bubble scheme was one of the largest of the time and certainly one of the most publicized both for its initial apparent success and subsequent spectacular demise. Ponzi schemes continue to thrive today with hucksters using both traditional and modern enticements to secure investors. Obviously, the best advice is to steer clear of any such get-rich-quick offer. Most individuals who find the temptation of easy profits irresistible soon find their losses just as shocking. But some investors, those who receive some or all of their promised profits and get out before the scheme falls apart believing they have reaped a windfall, may be in for a ruder awakening. For these investors the end of a Ponzi scheme can go from bad to worse when, as often happens, the operator of the scheme declares bankruptcy.

### THE LIFE AND TIMES OF CARLO PONZI

After arriving in the United States, Ponzi was employed in various positions until 1907 when he moved to Montreal. While there, he worked as an assistant teller at a bank that was engaged in a bubble scheme of its own, paying investors in real estate deals with the savings of other depositors. This episode ended with the bank owner fleeing to Mexico and Ponzi being jailed for forgery. After being released from Canadian prison, Ponzi returned to the United States and became involved in a plan to smuggle immigrants across the Canada-U.S. border. Ponzi was arrested and served two years in an Atlanta prison. Once released from that prison term, he married and in 1918 started an export catalogue business. The business eventually failed, but it was an inquiry from a Spanish company that gave Ponzi the idea for the scheme that would bear his name.

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# TO REGISTER OR NOT TO REGISTER TAX IS THE QUESTION

By Michael Telleen, Esq. and Brendan Lund, Esq.

*Catherine, a California resident, forms a Nevada LLC, which holds Nevada real property. Catherine is the sole manager of the Nevada LLC.*

*Bernard, a California resident, is one of several members in a member-managed Washington LLC. The Washington LLC invests only in stocks and bonds and owns no real property.*

Both scenarios illustrate typical business or investment situations. Both also raise questions about California registration and taxation obligations: (1) Does a foreign (i.e. non-California) limited liability company (“LLC”) need to register with the California Secretary of State as a company transacting business in California, and (2) Is it subject to taxation by the State of California, when only managerial functions are carried on in California.

To the State of California, a “foreign” LLC is any LLC not formed under California limited liability company law. Though they sound similar, the legal standards for registering a foreign LLC in California and reporting tax for a foreign LLC in California are different. For registration, the standard is “transacting business,” while the standard for tax reporting is “doing business.” A foreign LLC that is required to register with the California Secretary of State is automatically subject to California taxes. However, even if a foreign LLC is not required to register in California, it may still be “doing business” in California, subjecting it to California taxes. The subtle distinction between “transacting” and “doing” business has caused much confusion for foreign LLCs.

### Is The Foreign LLC Subject To Registration In California?

The California Corporations Code requires that before transacting intrastate business in California, a foreign limited liability company must register with the Secretary of State. The Code defines transacting intrastate business as entering into repeated and successive transactions of business in California, other than in interstate or foreign commerce.

The statute does not list activities which constitute transacting intrastate business, but it does list some activities which alone do not. Actions not constituting “transacting business” include, holding meetings of managers or members or carrying on any other activities concerning the company’s internal affairs, and “maintaining bank accounts.”

Thus, business transactions are generally required in order to subject a foreign LLC to California registration requirements. As a rule, a foreign LLC that engages in repeated business transactions in California is required to register in California. If Catherine or Bernard, from our

“A foreign LLC transacting business in California, which fails to register with the Secretary of State, will be subject to penalties.”

scenarios above, conduct their foreign LLC’s business in California, their LLC may be “transacting intrastate business” in California, and thus subject to registration.

A foreign LLC transacting business in California, which fails to register with the Secretary of State, will be subject to penalties including the inability to file suit in California courts until registered. A penalty of \$20 per day for each day that unauthorized business is transacted, up to a maximum of \$10,000, is imposed on an unregistered foreign LLC. In addition, the foreign LLC will be liable for the fees and taxes that it should have paid.

### Is The Foreign LLC Subject To Taxation In California?

Managerial functions conducted in California for a foreign LLC will subject that entity to California’s annual tax and LLC gross receipts fee. Two 2006 California Board of Equalization rulings made it more difficult for foreign LLCs with California-based managers to escape taxation. **Appeal of International Health Institute, LLC (“International Health”)** and **Appeal of Mockingbird Partners LLC (“Mockingbird Partners”)**. These rulings address the continuous debate as to the types of activities that subject a foreign LLC to tax.

California’s Revenue and Taxation Code defines “doing business” as actively engaging in any transaction for the purpose of financial gain. State regulations have been put in place that elaborate on this definition of “doing business” to include such activities as the purchase and sale of securities. These types of transactions are often equated with passive, investment activities.

The “doing business” test for tax purposes has typically encompassed a broader spectrum of activities than the “transacting business” test for registration purposes. The California Supreme Court established the general parameters for what would be considered “doing business” in the 1943 case **Golden State Theatre & Realty Corp. v. Johnson**. The court determined “doing business” does not require a regular course of business, nor does it require the actual carrying on of a trade or business. It further reasoned that the California Legislature, by drafting the language of the statute in the singular tense, made it clear that a single transaction could result in taxation under California laws. All that was required was active participation in a transaction for pecuniary gain or profit.

Until recently, there has been little direction from the Franchise Tax Board (“FTB”) or State Board of Equalization (“SBE”) that delineated which actions would subject a foreign LLC to California taxation. The FTB applied the rules for a foreign corporation to determine whether a foreign LLC was doing business in this state. In a 1965 case, **Appeal of Cagan Homes, Inc.**, a corporation that had its home office in California for carrying on managerial functions, but conducted the bulk of its business in another state, was found to be doing business in California, even when the managerial functions were minor. Since this case, the FTB has tried to extend this rationale to foreign LLCs.

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## DON'T LET A FINDER BECOME AN UNLICENSED BROKER DEALER

By Mark Cassanego, Esq.

The raising of capital for start-up or early stage ventures can take many forms; ranging from seed money contributed from family and friends to venture capital funds from angel investors or VC firms. If the founders of a new or early stage venture are unable to acquire the funds necessary to carry out their business plan through their own contacts, they often turn to intermediaries who introduce funding sources and sometimes participate in the negotiations regarding the issuance of the securities in connection with the offering. What is sometimes overlooked in these transactions is that unless the intermediary acts merely as a "finder," federal and state law require that the intermediary be licensed as a broker dealer. If the intermediary is not licensed as a broker dealer and engages in a transaction in which one is required, both the intermediary and the company issuing the securities can face fines and other consequences resulting from the failure to comply with federal and state securities laws.

The Securities Act of 1934 governs how the securities markets and its brokers and dealers operate throughout the country. Most securities brokers and dealers must register with the SEC and join a "self-regulatory organization, such as the National Association of Securities Dealers ("NASD"). A "broker" is defined broadly as "any person engaged in the business of effecting transactions in securities for the account of others...." The SEC generally takes the position that if an intermediary participates in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction, that person is a "broker," particularly if his or her compensation is transaction based. On the other hand, if the intermediary "merely" introduces the parties to the securities transaction and does not participate in any meaningful way to "effect" the securities transaction, then the person is not a broker and is not required to hold a broker dealer license.

California securities laws are similar to the federal laws insofar as they also require registration and licensing for broker dealers who effect, induce or solicit securities transactions in California. Although a number of exemptions exist for special kinds of transactions, intermediaries who raise

*"It is important both for the intermediary and the company to avoid having the services of the intermediary fall within the definition of a broker dealer."*

capital for growing companies generally do not qualify for them. California law does, however, contain an exemption for "merger and acquisition specialists." If an intermediary "effects transactions in this state only in connection with mergers, consolidations or purchases of corporate assets," and does not take possession of any client funds or securities, then the intermediary is exempt from the California broker dealer licensing requirement.

Because most intermediaries who assist privately held companies find capital are not registered broker dealers, it is important both for the intermediary and the company to avoid having the services of the intermediary fall within the definition of a broker dealer. Accordingly, the services of such intermediaries must come within the definition of a "finder" so that legal compliance can be assured. Legal compliance is not only important for the obvious reasons of avoiding fines, penalties and worse, but from the intermediary's point of view, necessary to ensure, in California at least, that his or her fee agreement is enforceable.

To protect themselves from a violation of the laws pertaining to broker dealers, the company and the intermediary should enter into a written agreement that proscribes the intermediary from (1) advising the company regarding the pros and cons of concluding a securities transaction with any of the persons introduced by the "finder," (2) being compensated on a contingent fee basis, (3) participating in the negotiations between the company and the investors, (4) facilitating the closing of the transaction through any direct involvement and (5) holding any funds that are part of the transaction. To assure compliance with the law, the foregoing proscriptions should not only be written but adhered to in practice. Despite any parameters contained in the agreement, if the intermediary engages in activities that constitute those of a broker dealer, it is that fact that will dictate the determination of legal compliance, not the written agreement.

*Mark Cassanego is a member of the Corporate & Business Group.*

The letter from Spain included postal coupons to purchase reply postage. Ponzi reasoned that he could purchase the coupons in the depressed economies of post-world war Europe and, due to variations in foreign exchange rates, cash them in at enormous profits. He first approached friends to invest in his plan and then with an initial capital of \$150 formed the Securities Exchange Company to solicit investments from the public. He convinced investors that enormous profits could be made, promising them a 50 percent return on their investment in 45 days, or doubling their investment in 90 days. As with most Ponzi schemes it had a semblance of truth. One could buy the coupons at a low rate in countries where currencies were weak, such as Spain or Italy, and redeem them at a higher rate in the United States, where the currency was stronger. However, as with all Ponzi schemes it was not entirely true. According to some accounts, the foreign postage coupons could only be redeemed for U.S. postage, not cash. However, even if they could have been redeemed for cash, the administrative costs involved in buying, transporting and trading enormous quantities of the inexpensive coupons would have eaten up any potential profits. It simply was not possible to realize the amount of profits Ponzi told his investors he could achieve. Despite this, investors lined up to give him their money.

People literally stood in long lines outside of Ponzi's office to hand over their cash. Initial investors did see a return on their investment, not from profits on the sale of postage coupons but from the moneys paid into the scheme by subsequent investors. This initial return was key to spreading the word and encouraging more investors, and the newspapers of the day fed the frenzy. Many soon considered Ponzi to

*“He convinced investors that enormous profits could be made, promising them a 50 percent return on their investment in 45 days.”*

be a financial wizard who was doing for the common man what the elite had done for themselves. By February of 1920 Ponzi had taken in approximately \$5,000. Demand was so strong that he expanded, eventually opening 35 branch offices to take in all the money, which had to be stored in desk drawers, filing cabinets, closets, and anywhere else there was space. At the height of this scheme, Ponzi had an estimated income of \$1 million a week and by July of 1920 had taken in somewhere between \$10 and \$15 million, the equivalent of \$100 to \$150 million in today's dollars.

As is the case with all Ponzi schemes, it finally came to an end. Doubt was cast on Ponzi when it was revealed he had been virtually destitute only a few years before. There was an initial run on the Securities Exchange Company, but Ponzi was able to assuage fears by paying out to anyone who demanded their investment. However, officials remained skeptical and embarked on an investigation of Mr. Ponzi. The *Boston Post* began its own investigation, and when its financial analysis of the scheme determined that there were not enough postage coupons in existence to cover the number of investments Ponzi had received, there was another run on his company. Again, Ponzi calmed the crowd and paid off demanding investors. But by August 1920, Ponzi's criminal history was revealed, the Securities Exchange Company was shut down, he was arrested and filed bankruptcy. Incredibly, Mr. Ponzi reported receiving \$5,000 in his jail cell from hopeful investors.

Ponzi's scheme was one for the masses. The average investment had been approximately \$325, and Ponzi's trial revealed that three quarters of the Boston police force had been investors. The police and other investors lost millions of dollars.

Many resources are available online that offer guidance for those trying to determine what is a legitimate investment opportunity and what is a scam. The National Fraud Information Center at [www.fraud.org](http://www.fraud.org) offers descriptions of Internet scams. Anyone the least bit suspicious of an investment opportunity should check the scams listed there before investing. The Pennsylvania Securities Commission's Web site at [www.psc.state.pa.us/investor](http://www.psc.state.pa.us/investor) outlines the motivations behind and ways to avoid Ponzi schemes:

**Why People Are Pulled into and Stay in Ponzi Schemes:**

- **Greed.** Rather than invest for the future, victims are urged to cash in on a quick, speculative scheme. "Greed was the bottom line," said a victim of a Maryland scheme. "Fundamentally, I'm very conservative, straight as an arrow. This went against everything I believed in. But nobody put a gun to my head." Instead, the promoter dangled an 18 to 20 percent return.
- **Sure-fire scheme.** Investors are lulled by the nonsensical notion that their investment is risk free.
- **Herd instinct.** Frequently, Ponzi promoters rely solely on word of mouth to lure new investors. The promoters often concentrate on specific cities, types of investors, family members, church groups, professionals and social

acquaintances. Initial victims unwittingly aid the swindler by lining up their closest friends, relatives and professional associates as new victims.

- **Appearance of success.** Some initial investors are paid off handsomely, and often at interest rates higher than those promised. This is the "proof" that skeptical investors insist on seeing before they jump in with both feet.
- **Fear.** Even as a Ponzi scheme starts to collapse, investors are slow to admit that they've been swindled. Frequently, there's a fear that public exposure will create a run on the promoter and make matters worse. Also, there's a fear of looking foolish for being blinded by greed. And, as the scheme relies on a sense of community, there's a fear that the first investor who breaks ranks will be blackballed in his professional or social circles.
- **Tooth Fairy syndrome.** Investors frequently cling to the faintest hopes that everything will work out for the best. Even after Charles Ponzi was exposed, investors pressed funds on him under the belief that everything would work out.

**Avoiding Ponzi Schemes:**

1. Beware of promises of high, guaranteed profits. This is perhaps the easiest way to spot a Ponzi scheme. Any legitimate investment involves a degree of risk that makes it

Ponzi was convicted and served three and one-half years in federal prison. Upon his release he was convicted and sentenced by Massachusetts authorities to an additional seven to nine years. Released on a \$14,000 bond, Ponzi fled to Florida where, not surprisingly, he became involved in the great land swindle there, selling property that was underwater. Back to court he went. Again, he jumped bail and hopped a freighter for Italy. Unfortunately for Mr. Ponzi, he was caught in New Orleans, served out his sentence in Massachusetts and was deported to Italy.

Benito Mussolini offered him a position with Italy's new airline, and Ponzi served as its branch manager in Rio de Janeiro. After discovering that airline officials were using the company to smuggle currency, he demanded a cut. They refused, and Ponzi tipped off the Brazilian authorities. The airline then went out of business.

Ponzi died in 1949 in the charity ward of a Rio de Janeiro hospital. At his death he had \$75, which was just enough to cover his burial expenses.

### TYPES OF PONZI SCHEMES

While Mr. Ponzi died more than a half century ago, the Ponzi scheme lives on through numerous incarnations. As creative as they are nefarious, the schemes offer investments that always appear at first blush to be logical and entice investors by promising high rates of return with no risk. However, further analysis would reveal that the proposed investment could not make the returns promised. They all depend upon a steady stream of new investors. It is the new money that pays the old investors and keeps it going. The Ponzi scheme crashes when new investors cannot be found to keep the cash flowing in to pay the old investors and the operator declares bankruptcy or skips town.

*“Even if  
you are one  
of the lucky  
ones who  
gets your  
investment  
back, you  
are still  
at risk.”*

Bogus designer jeans, silver recycling, deeds of trust, used reconditioned tractors, oil and gas production, investment opportunities, equipment leasing, bus shelters, and the all-time favorite, foreign currency exchange, have all been used by Ponzi scheme operators. Investors seem to be especially fascinated by the idea of making money through the exchange of foreign currencies. Many variations of this particular scheme have cropped up, including a Northern California case from the late 1990s where the promoter promised to invest funds in foreign countries in highly leveraged transactions called “roll programs.” The only thing that got rolled were the investors to the tune of over \$2 million.

In another example, a company agreed to buy palm seeds from investors and cultivate the seeds into seedlings. The investors would pay a cash advance to cover the cultivation costs. The company then agreed to buy back the seedlings at a fixed time and guaranteed price, giving the investors a substantial return. For example, one investor purchased \$56,000 in seeds and paid the company \$40,000 for the anticipated cultivation costs. For the \$96,000 investment the investor was promised that the company would buy the seedlings cultivated from the seeds for \$225,000 fourteen months later. It sounded pretty good, more than double your investment in approximately one year. However, since the cultivation costs greatly exceeded the price and had no relation to market value of the seedlings, there was no way that the company could make a legitimate profit. Soon the company came crashing down and filed for bankruptcy.

Another company told investors that it could purchase frequent flyer miles, use them to acquire air line tickets, and then sell the tickets to the public see FROM BAD TO WORSE, page 7

impossible to promise profits, much less astronomical returns.

2. Avoid promoters who won't provide clear and detailed explanations of their investment vehicles. Don't listen to promoters who tell you that it is impossible to explain their deal in layman's terms. After all, would it make sense to buy a car if you didn't know how to drive?

3. Check out the promoter's background. In a Texas case, investors lost more than \$20 million to a promoter who had been expelled from the National Association of Securities Dealers. The promoter had been sentenced to federal prison on a bad-check charge and wasn't licensed by the state as a stockbroker.

4. Get information on the offering from the Pennsylvania Securities Commission (1-800-600-0007). [California resident's should check with the California Department of Corporations, www.corp.ca.gov.] As most Ponzi schemes involve investment contracts, they should be registered as securities offerings with the Commission. Your local Better Business Bureau also may have information about the investment program or the promoter.

5. Ask for detailed information in writing. Ask for information on the company, its officers and its financial track record. If a product is involved in the deal, ask for documentation of its cost, fair-market value, and existing and potential markets. If a promoter is reluctant to provide information, consider it a red flag of a potential Ponzi scheme.

6. Verify the promoter's claims. In one scam, promotional materials indicated that a commodities pool operation was licensed by state and federal governments, that losses were limited to 50 percent of an investor's funds, and that the pool traded more than \$100 million in commodity futures contracts in each of the past five years. None of the claims was true.

7. Seeing is believing. Be skeptical of deals that can't be checked out in person. Be particularly leery of claims that all banking transactions and bookkeeping are handled in remote cities or countries.

8. Resist pressure to reinvest without seeing your "profits." Ponzi schemes often are kept alive by promoters who convince initial investors to roll over their profits for even better returns. While it often makes sense to stick with a legitimate investment over time, be suspicious of promoters who are reluctant to let you cash in your gains.

9. Look for un-businesslike conduct or disruption of services. An investor in one scam received a handwritten receipt bearing the words, "Received With Thanks." Reluctant to have their schemes exposed, few Ponzi operators enlist much office help, if any. They may answer the phones and mail themselves. This hastens the collapse of the scheme, as one person finds it more and more difficult to keep up with all of the required interest payments and investor contacts.



# INCLUDE THE RIGHT PROVISIONS TO REDUCE THE RISK OF LITIGATION

By George Wailes, Esq.

Few businesses would purchase a warehouse without a written agreement. Few contractors would build a condominium project without a written agreement. Few banks would make a loan without a written agreement. However, businesses frequently inadvertently enter into oral agreements concerning these very subjects, and there has been extensive litigation through trial concerning oral agreements for these matters.

For example, in the first case, a business purchasing a warehouse orally agreed to extend the date of the close of escrow and allowed modification of the tenant releases before purchasing the warehouse. In the second, a contractor entered into a written partnership agreement with a developer and decided a written construction agreement was no longer necessary. In the third, a bank orally agreed to release a guarantor of a loan from further liability. Each of these oral agreements ultimately led to litigation and trial over their terms.

Most business lawsuits involve a dispute concerning an agreement of some type, too often an oral agreement or, if there is a written agreement, over an issue not covered by the written agreement. In those cases, the evidence is frequently one person's word against another's. When the outcome rests solely on the credibility of one witness against another, it is often difficult to resolve the dispute short of trial.

The best proof of an agreement is a document. Ideally, the document is signed by all of the persons who are part of the agreement. At a minimum, the document needs to be signed by the person or business against whom you want to enforce the contract. In California, some agreements are required to be in writing, such as agreements to purchase real estate and agreements that by their terms are longer than one year.

In all cases, a written document assists in proving that an agreement was reached, even if it is not signed by the person disputing the agreement. For example, a letter confirming the terms of an oral agreement can be persuasive evidence that the agreement described in the letter was reached. A step down the ladder of credible evidence is a memorandum to file or a note written during a telephone conversation or after a meeting detailing the date and participants to the conversation and the terms of the agreement reached.

Why is documentation so important? Because all of us, including jurors and judges, tend to believe the written word more than the spoken word.

*“Jurors and judges tend to believe the written word more than the spoken word.”*

For example, if a witness testifies that she sent a letter to a person detailing the terms of their agreement and the letter is found in the person's file, it will be extremely difficult for that person to deny that an agreement was made or challenge the terms of the agreement.

### IMPORTANT CONTRACT PROVISIONS

Not only should contracts be written, but they should be written well to minimize the risk of future litigation. Consider including in every agreement provisions concerning attorneys' fees, mediation, venue, liquidated damages, confidentiality, and indemnification.

#### Attorneys' Fees

An attorneys' fee provision is highly desirable. Absent an attorneys' fee provision, each side pays their own attorneys' fees no matter who prevails in the dispute. Attorneys' fee provisions assist in persuading the breaching party that an extensive battle over the agreement will result in not only an obligation to pay the contract damages but also the attorneys' fees for the non-breaching party. An attorneys' fee provision often assists the parties in deciding to attempt an early resolution to the lawsuit through mediation or another alternative dispute resolution processes rather than running the risk of paying the other side's attorneys' fees through trial.

#### Mediation

Similarly, a mediation provision may assist the parties in resolving the dispute without extensive litigation and on terms they agree to rather than a judge or jury imposes on them. As mediation has matured in the last decade, mediators have become more effective and more cases are being resolved through mediation. This allows the parties to attempt settlement before they begin litigation when the parties frequently become locked into their positions.

#### Venue

Venue provisions are especially important for anyone who does business with entities located out of state or in other parts of California. This provision can require any mediation or lawsuit to be conducted in the county in which your business is located. Without this provision, you may be forced to prosecute or defend a lawsuit in states across the country, including retaining attorneys in those locations. Generally, it is more expensive and certainly less convenient to litigate in another state.

#### Confidentiality

Many businesses will find a confidentiality and non-disclosure agreement critical to maintaining their trade secrets. The desirability of this provision is obvious to those businesses that want to protect their confidential information. However, it is often left out of agreements.

#### Indemnification

Indemnification is essential in any situation where another business's actions may result in a lawsuit against the other party by others. For example, if a company engages independent contractors as sales representatives, it could be sued for see THE RIGHT PROVISIONS, page 8

and make substantial profits. Investors were promised returns of 50% within 60 to 90 working days. Needless to say, the investors were swindled and the company filed for bankruptcy.

One Ponzi scheme operator convinced investors that money could be made growing and selling fungus cultures. Investors were sold activator kits to grow fungus that would then be bought by an affiliated cosmetics company. Unfortunately, there was no real market for fungus in cosmetics.

In yet another example, a 23-year-old busboy raised \$7.3 million from 2,800 investors. He promised to double their money within 60 to 90 days by buying rock concert tickets and scalping them for premium prices.

There have been countless variations on the Ponzi scheme. The types of underlying "investment opportunities" for these schemes are limited only by the imagination of the perpetrators.

#### PONZI SCHEMES AND BANKRUPTCY LAW

The first risk of involvement in a Ponzi scheme is that you will lose your money. However, even if you are one of the lucky ones who gets your investment back, you are still at risk. Many Ponzi scheme operators end up in bankruptcy. For some investors, this is just the beginning of their troubles.

In bankruptcy, a trustee is appointed to recover assets for the benefit of creditors. Since a primary tenet of bankruptcy law is equality of distribution, the trustee will attempt to recover money from investors who were paid and distribute it to those that were not paid so that all investors are treated equally. The bankruptcy trustee has three primary weapons at his disposal to accomplish this: usury, preference, and fraudulent transfer laws.

**Usury** - In California, it is unlawful, with certain exceptions, to loan money at interest rates above either 10% or 5% plus the federal reserve rate. Needless to say, most Ponzi schemes promise interest well above these rates. Consequently, to the extent an investor receives interest on his investment, he may be liable to pay it back. In certain circumstances, the investor may have to pay back three times the interest he received from the Ponzi operator.

**Preference** - The bankruptcy trustee can also sue investors to recover funds paid by the debtor as preferential transfers. A preferential transfer (or preference) is a payment made by the debtor to a creditor within 90 days of the bankruptcy filing while the debtor was insolvent. Consequently, in most Ponzi cases, if the payment was made in the 90 days prior to the bankruptcy filing, the payment is a preference and will need to be paid back.

**Fraudulent Transfer** - The bankruptcy trustee can also sue investors to recover funds paid to them by the Ponzi scheme operator as a fraudulent transfer. A transfer is fraudulent and recoverable by the bankruptcy trustee if it was made by the debtor with the intent to hinder, delay, or defraud creditors. The courts have ruled that existence of a Ponzi scheme is enough to establish that payments made by the Ponzi scheme operator are done with the intent to hinder, delay, or defraud creditors. Consequently, all payments made to investors under a Ponzi scheme are subject to recovery under the fraudulent transfer law. The look back period for fraudulent transfers is four years, but can sometimes be longer. Thus, if an investor received payments in connection with a Ponzi scheme within four years of the bankruptcy, the payments may be recovered by the bankruptcy trustee. There are some defenses available but they are difficult to establish within the context of Ponzi schemes, which promise unusually high rates of return.

#### BAD TO WORSE

Even for initial investors, it's rare that they receive all of their investment back. Suppose Henry, an initial investor in a Ponzi scheme, puts in \$10,000 with the promise of a 25 percent return in 30 days. A month passes and the scheme operator sends Henry a check for \$2,500 and convinces him to keep his original \$10,000 in the scheme. Another month passes, buzz around the scheme builds, other investors come in and the operators total take increases. Henry receives another \$2,500 check. Henry thinks he has struck gold. Then the operator, seeing that he has milked the scheme for all it's worth, hides the money and declares bankruptcy. Henry is technically owed \$10,000 but would probably be happy just to get his remaining \$5,000 back. Henry is in a bad situation.

The bankruptcy trustee, seeing that Henry was paid \$5,000 within the context of a Ponzi scheme, sues Henry to get the money returned to the bankruptcy estate so that it can be shared among all the creditors/investors. Unfortunately, Henry already spent the \$5,000 he was paid from the scheme on a vacation to Hawaii. Henry is now in a worse situation, one that might be compounded by court fees and interest payments.

If you invest in a Ponzi scheme you will probably lose your money to the scheme in the end, but even if you don't, any payments you may receive along the way may have to be returned to a bankruptcy estate. So, what's the best advice? Avoid these scams. Invest in opportunities that make financial sense not ones that promise guaranteed, high profits. The old adage is as accurate today as it was during Ponzi's time: If it looks too good to be true it probably is.

*Michael McQuaid is a member of the Creditors' Rights and Bankruptcy Group.*

#### TAX LAW ALERT

On August 23, 2006, the U.S. Court of Appeals for the D.C. Circuit held that it is unconstitutional for the federal government to tax an award of damages for emotional distress and loss of reputation. The court's decision in **Murphy v. Internal Revenue Service** is surprising. The IRS disagrees with the decision and might appeal to the U.S. Supreme Court.

It is possible that virtually all damages received for personal injuries - including nonphysical injuries such as emotional distress, injury to one's reputation, discrimination, wrongful termination, and sexual harassment - will no longer be considered gross income. However, damages received for loss of earnings or punitive damages will still be considered taxable gross income.

Anyone who received and reported as income an award of damages for nonphysical injuries should file an amended income tax return and claim a refund for the year in which the damage award was received. The statute of limitations for filing a refund claim is generally three years from the due date of the return.

*For more information about the **Murphy** decision and its implications, please contact Lage Andersen or Brendan Lund at 650-342-9600.*

The SBE serves as the appellate body for the FTB, and its *International Health* and *Mockingbird Partners* rulings provide more definitive guidelines for foreign LLCs managed by California residents. In *International Health*, the Board determined that a single-member LLC organized in Nevada, but managed by a California resident was subject to California taxation. The Board relied on a number of facts to conclude that the foreign LLC was “doing business” in California:

- The sole member and manager was a California resident who never left California to conduct the foreign LLC's business;
- The LLC used a California business address for tax filings;
- The LLC employed a California tax professional to prepare its tax returns;
- The LLC also owned interests in other LLCs and partnerships, and those entities were engaged in the business of investing in California real estate for rental and resale.

Each of these facts, the Board concluded, was evidence that the LLC had sufficient contacts with California to result in taxation of the LLC.

The *Mockingbird Partners* ruling involved a member-managed foreign LLC which owned Montana real property. One member was a resident of California. The other member was responsible for general administration and finances and was not a resident of California. A Montana-based property management company oversaw the day-to-day management of the Montana real property.

Despite the lack of contacts with California, the Board ruled that the LLC was subject to California taxation. It reasoned that in a member-managed LLC, every member of the LLC is an agent of the LLC. Because one member was a California resident, and the Operating Agreement delegated some duties to a California resident non-member, the LLC was “doing business” in California. The Board also reiterated that the relevant inquiry for satisfying the “doing business” test is whether the activity or transaction was motivated by financial or pecuniary gain.

In either new ruling, would the Board have ruled differently if the foreign LLC: (a) used an out-of-state business address; (b) maintained bank accounts out-of-state; (c) employed a foreign tax preparer; or (d) made no investments in other California business ventures? Would the analysis have changed if the California resident manager produced copious records reflecting all business activity and decision-making was conducted out-of-state? Ultimately, additional Board rulings may be required to answer these questions.

So what does all this mean for Catherine and Bernard? Even if Catherine does not have to register her LLC with the California Secretary of State, if she manages the LLC's property from California, her LLC will likely be subject to California LLC taxes. For Bernard, the question of California LLC taxes will be determined based on whether he or

any other member of the Washington LLC manages the LLC from California. Given that his LLC only invests in stocks and bonds, with most managerial functions capable of being handled remotely, it might be difficult for him to avoid managing the LLC from California and as a result difficult for the LLC to avoid California taxes. California cases now suggest that any management done by a member in California means the foreign LLC must pay California LLC taxes and fees.

California LLC fees are in a state of flux. On August 31, 2006, the California Assembly passed legislation, which would prohibit the FTB from using out-of-state income as the basis for collecting the LLC fee. The law is currently on the Governor's desk. Stay tuned for further developments.

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#### THE RIGHT PROVISIONS, *from page 6*

misrepresentations made by those sales representatives on the company's behalf. An indemnification agreement should require the contracting party to hold harmless, defend, and reimburse the other party for all expenses arising out of a dispute caused by that party's actions.

Needless to say, consulting with an experienced attorney about the agreement will help you anticipate issues and cover them in the agreement. Many disputes involve agreements not drafted or reviewed by counsel. It is an expensive lesson to go to trial over an issue that would have been included in the agreement by an experienced attorney for a fraction of the cost of the litigation.

Every agreement, no matter how small, should be documented with signatures of all the parties. To reduce the potential for future litigation, agreements should also contain the basic provisions concerning attorneys fees, mediation, venue, confidentiality, and indemnification.

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