

OUR FIRM

In a "connected world" where instant messaging, texting, and other forms of immediate wireless connectivity around the globe have banished the "lazy days of summer" to the trash heap, we wave good-bye to summer and welcome the fall. As our lawyers have come and gone on their vacations, I have been struck by both how conscientious they are in keeping "connected" to the office and our clients, and by how those lawyers who are not on vacation have jumped in to assist their colleagues and our clients to get their deals done, their court hearings or depositions covered or their estate matters completed. It is very gratifying to see how well our attorneys and our staff work together and with our clients as a team. It is, I think, what makes being a Carr, McClellan client different than a client of many other law firms. It is also what makes working at Carr, McClellan different than working at many other firms.

Although many of you know Carr, McClellan through your interaction with perhaps only one or two lawyers in the firm, we want you to know that all of us stand ready to serve your needs. Our estate planning clients can look to our business lawyers or our real estate lawyers to help with a full range of transactional work. Our business and real estate clients can look to our estate planning team to both assist in planning their estates and administering estate and trust matters when those needs arise. And, of course, all of our clients can look to our litigation group for advice, counsel and advocacy when disputes or controversies arise in their business or personal lives. A Carr, McClellan client is a client of the whole firm, and we all stand ready to pull together to meet your legal needs whatever they may be. If the matter is within our fields of expertise and knowledge, we will get you to the right person within the firm; if it is not, we are happy to refer you to the right expert to meet your needs.

In the last issue of *Perspectives* I mentioned our commitment to increasing our emphasis on mentoring our younger lawyers so that they will carry on the tradition of Carr, McClellan's commitment to its clients and contribution to the community. Those efforts are well on their way. Hopefully, each of you will be able to work with one or more of these bright, capable and committed attorneys as they are integrated into the Carr, McClellan team. We pledge that our full team will be able and willing to meet your legal needs whenever and wherever they arise.

Mark Cassanego
President, Carr McClellan

CARR McCLELLAN GROWTH CONTINUES

As demand for legal services from Carr McClellan continues to expand with more work for existing clients and new clients as well, the number of attorneys at the firm continues to grow in order to keep pace.

Mary Lin joins our Estate Planning Group. With a B.A. in International Business from University of Alberta and her J.D. from Harvard, Mary brings a broad background in legal services with over five years experience working as in-house counsel and with private law firms. She has developed a broad background in employment law, including issues surrounding executive compensation, employee benefits & compensation, tax-qualified retirement plans, for private and publicly held businesses, including high-technology and bio-technology companies. Mary is also proficient in Mandarin.

Joining our Corporate Group, **Joy Hansma** returns to California after two years practicing law in New York City where she concentrated on Mergers & Acquisitions, Private Equity, and Global and Public Finance. Joy earned her B.A. from University of California, Berkeley, including one year studying abroad at the University of Sheffield, in Sheffield, England; and earned her J.D. magna cum laude from University of California, Hastings College of the Law.

Working in our Real Estate Group since March 2007, **Katherine (Katy) Kim Abrahams** has over four years experience in the many aspects of complex development projects, including land use, regulatory approvals, and issues regarding endangered species, wetlands and water quality. She earned her J.D. from Stanford University, and M.M. in Piano Performance from Yale University, New Haven, CT.

Jeremy Burns joined our Litigation group in April 2007 specializing in civil litigation and dispute resolution. His experience ranges from litigating intellectual property disputes to defending a non-profit religious corporation. A native of New York City, Jeremy attended Brown University where he obtained his Undergraduate in Environmental Studies. Prior to attending law school, Jeremy worked for KPMG, LLP, developing software for Fortune 500 companies. He then relocated to California, where he attended the University of California (Boalt Hall) for his J.D.

Carr McClellan is dedicated to maintaining the highest level of legal advice, counsel and services to all its clients and will continue to provide the best and brightest legal talent by searching for and retaining the most qualified attorneys.

FALL 2008



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BROAD “NO-HIRE” CLAUSES ARE UNENFORCEABLE

By Lori A. Lutzker, Esq.

Agreements between employers often include “no-hire” or “no-poach” provisions. The typical situation is where one company hires another to provide consulting or similar services. The agreement usually provides that the client will not hire any employee of the consulting firm for a certain period and, more often than not, if they do they will pay a set sum as damages (the legal term is “liquidated damages”).

It has long been an open question whether an agreement such as this is enforceable given California's strong public policy in favor of competition and employee mobility. California's Business and Professions Code section 16600 codifies the statute. Section 16600 reads, “Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.”

On June 25, 2007, an appellate court attempted to answer the question of enforceability in a case called VL Systems, Inc. v. Unisen, Inc. In that case, VLS, a computer software consulting company that provides technical consulting services, and Star Trac entered into a short-term computer consulting contract. The contract provided that Star Trac would not solicit nor hire any VLS employee for 12 months after the contract's termination. If Star Trac did, it would pay VLS 60% of either the new annual compensation payable to the new hire or the fees paid to the new hire for one year (as liquidated damages). The purpose of the no-hire clause was to deter the hiring of consultants by its customers since a key asset in a consulting business is the expertise of the consultants. Star Trac breached the agreement by hiring a VLS employee within the proscribed time. The VLS employee had not performed any work for Star Trac and, indeed, had not even been employed by VLS at the time the Star Trac contract was performed.

The question was whether the no-hire provision was enforceable. VLS asserted it was. VLS argued that the case had absolutely nothing to do with an employee's freedom of movement or covenants not to compete (usually seen between an employer and its employee) and that the contract did not preclude Star Trac from hiring VLS employees;

“It has long been an open question whether an agreement [with a 'no hire' provision] is enforceable given California's strong public policy in favor of competition and employee mobility.”

it simply called for the payment of a fixed sum to VLS should it choose to do so.

The Court acknowledged that reasonably limited restrictions that tend more to promote than restrain trade and business do not violate the law, but held that the challenged provision of the parties' contract was much broader than necessary to protect the consulting firm's interests and was outweighed by the policy favoring freedom of mobility for employees.

The Court explained that California has a public policy to ensure that every citizen retains the right to pursue any lawful employment and enterprise of their choice. Section 16600 invalidates employment contracts which prohibit an employee from working for a competitor when the employment has terminated, unless necessary to protect the employer's trade secrets. The corollary to this is that a competitor may solicit another's employees if they do not use unlawful means or engage in acts of unfair competition. Thus, it is not wrong for a competitor to solicit his competitor's employees or to hire away one or more of his competitor's employees who are not under contract, so long as the inducement to leave is not accompanied by unlawful action.

The Court recognized that a “no-hire” provision may seriously impact the rights of a broad range of third parties. In this case, those third parties not only included the VLS employees who actually performed work for Star Trac under the contract, but all of those who did not and even those who were not employed by VLS at the time.

The Court distinguished the “no-hire” clause from nonsolicitation or nondisclosure agreements which are enforceable. Agreements such as “Former Employee is restrained from disrupting, damaging, impairing or interfering with his former employer by raiding employer's employees” under a termination agreement or a restraint on solicitation of customers or on disclosure of confidential information are enforceable. The Court noted that these restrictions only slightly affect employees as they are not hampered from seeking employment with or being employed by new employers.

The Court found it “obvious” that upholding a “no-hire” provision would unfairly narrow the mobility of an employee who had never worked for Star Trac as a VLS employee and had independently sought out Star Trac's job opportunity. The Court left the door open to the possibility that a more narrowly drawn and limited no-hire provision would be permissible under California law, but, unfortunately, never explained the terms of such a provision.

If you are concerned about protecting your valuable employees from being poached, please consult with us to make sure that your agreements have the best chance of surviving a legal challenge.



EXEMPT ORGANIZATIONS

LIABILITY PROTECTIONS FOR VOLUNTEER BOARD MEMBERS & OFFICERS, AND FOR NONPROFIT ORGANIZATIONS

By *Quynh T. Tran, Esq. and Suzanne Bonotto, Esq.*
Nonprofit public benefit organizations provide much-needed services to our communities. These organizations rely heavily on community members to serve as volunteer members of the board of directors, officers and in other capacities. While serving as a volunteer director or officer can be a rewarding endeavor, that service can subject a volunteer director or officer to potential personal liability for his or her actions. Because claims made against directors and officers are often employment related, directors and officers of organizations with a greater number of employees are exposed to greater risk, whether or not the director or officer acted in an illegal manner. Therefore, it is important for a nonprofit organization to maintain the appropriate liability coverage to protect not only the organization's assets, but the personal assets of its directors and officers as well should anyone make a claim against the organization or its directors and officers.

General liability insurance offers protection from claims for property damage or personal injury, such as a slip-and-fall. Directors and Officers (D&O) Insurance generally offers protection to directors and officers from claims such as harassment or wrongful termination.

Directors and officers of nonprofit organizations often assume that they are protected from lawsuits because they serve as volunteers. This assumption is incorrect. California statutes and federal legislation-often thought to offer protection to nonprofit volunteers-in reality offer very little in the way of a shield, particularly if the nonprofit does not maintain D&O Insurance.

Liability Protection for the Individual Volunteer Director or Officer

Protection Under California Law

California Corporations Code sections 5047.5 and 5239 protect uncompensated directors and officers against personal liability for their service to nonprofit corporations, subject to certain exceptions. Section 5047.5 protects a volunteer director or officer by limiting the types of claims that may be brought by a third party against the director or officer. In contrast, Section 5239 provides protection by limiting the personal liability of a volunteer director or officer for monetary damages when a claim is made against the volunteer director or officer.

Pursuant to Section 5047.5, no claim for monetary damages may be brought against a volunteer director or officer on account of any negligent act or omission that occurs:

- within the scope of that person's duties as a director acting as a board member or as an officer acting in an official capacity;
- in good faith;
- in a manner that the person believes to be in the best interest of the nonprofit; and
- in the exercise of his or her policymaking judgment.

Protection under Section 5047.5 does not,

“Nonprofit directors and officers often feel they are protected from lawsuits because of their services to a nonprofit. Yet this is not the case.”

however, extend to all claims against a volunteer director or officer. The following are some examples of actions against volunteer directors and officers that are not barred by Section 5047.5:

- actions alleging the director or officer is guilty of self-dealing;
- actions brought by the Attorney General; and
- actions alleging liabilities arising from intentional, wanton or reckless acts, gross negligence, fraud, oppression or malice on the part of the director or officer.

In addition, for a volunteer director or officer to claim protection under Section 5047.5, the following requirements must be satisfied:

- the claim against the director or officer is one that may also be made directly against the nonprofit;
- a general liability insurance policy is in force both at the time of the injury and at the time the claim against the nonprofit is made, so that the policy is applicable to the claim;
- the general insurance policy meets the required minimum amount of coverage; and
- the general insurance policy covers the damages caused by the director or officer.

The minimum required amount of coverage under a general liability insurance policy is determined based on the size of the nonprofit's annual budget. If the nonprofit's annual budget is less than fifty thousand dollars (\$50,000), the minimum required amount of coverage is five hundred thousand dollars (\$500,000). If the nonprofit's annual budget is equal to or greater than fifty thousand dollars (\$50,000), the minimum required amount of coverage is one million dollars (\$1,000,000).

Pursuant to California Corporations Code section 5239, in the event a claim is made against a volunteer director or officer, the director or officer shall not be personally liable for monetary damages caused by the director's or officer's negligent act or omission in the performance of his or her duties if all of the following conditions are met:

- the act or omission was within the scope of the officer's or director's duties;
 - the director's or officer's act or omission was performed in good faith; and
 - the act or omission was not reckless, wanton, intentional or grossly negligent; and
 - the damages caused by the act or omission are covered pursuant to a general liability insurance policy or a director's and officer's liability policy.
- If the damages are not covered by a liability insurance policy, the volunteer director or officer will not be personally liable if all reasonable efforts were made in good faith to obtain liability insurance. For 501(c)(3) nonprofit corporations that have an annual budget of less than twenty-five thousand dollars (\$25,000), the condition of making “all reasonable efforts in good faith to obtain available liability insurance” is satisfied if the nonprofit makes an inquiry on an annual basis to purchase liability insurance with a coverage amount of at least five hundred thousand dollars (\$500,000), but the insurance policy is not available at a cost of less than five (5) percent of the organization's annual budget for the previous year.

It is important to note that before a volunteer director or officer can claim protection under these code sections, the nonprofit corporation must maintain liability insurance that is applicable to the claim. The liability insurance coverage purchased by most nonprofits, however, is for general liability coverage only. Often times, a general liability insurance policy

does not cover claims against directors or officers. Therefore, unless the nonprofit corporation purchases D&O Insurance coverage, there may be no protection available under these code sections.

Furthermore, Sections 5047.5 and 5239 only limit the liability of volunteer directors and officers. These sections do not in any way limit the liability of a nonprofit corporation for any negligent acts or omissions by its directors or officers. In addition, these sections do not protect any director or officer that is a salaried employee of the nonprofit corporation.

Protection Under Federal Law

The Volunteer Protection Act of 1997 (VPA) is federal legislation that provides liability protection to volunteers, subject to certain exceptions, and has many of the same requirements as those set forth under California law. In particular, under the VPA a volunteer shall not be liable for harm caused by any act or omission of the volunteer on behalf of the organization or entity if:

- the volunteer was acting within the scope of his or her responsibilities;
- if appropriate or required, the volunteer was properly licensed, certified or authorized by the appropriate authorities for his or her activities or practice in the State in which the harm occurred;
- the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed; and
- the harm was not caused by the volunteer's operation of a motor vehicle, vessel, aircraft, etc.

In addition, the VPA does not in any way limit the liability of a nonprofit corporation for any negligent acts or omissions by its directors or officers.

Under the VPA, individual states are permitted to require an organization to have an insurance policy in place that covers the specific type of claim. As previously noted, this is a requirement under California law.

Interpreting the state and federal laws together, it is evident that uncompensated directors and officers of California nonprofit organizations are only protected from personal liability if the organization has an insurance policy in place that applies to the specific claim against those directors and officers.

Does it make sense for all non-profit organizations to obtain D&O Insurance? It depends. While all organizations should obtain typical property and general liability coverage, most experts do not necessarily recommend that all nonprofits obtain D&O coverage. That decision should be made in consultation with legal counsel and other advisors. There are many factors that should be taken into consideration. These include the risk tolerance of the board and the fact that some individuals will not join a board unless there is D&O Insurance in place. The exposure of the organization's asset base, including the worth and type of those assets, should be weighed. The question of how easy and worthwhile it would be for someone to try to seize those assets should be taken into account, and since most D&O claims often arise from employment issues, the number of employees and key personnel should also be considered. Having said all of this, we usually recommend to our nonprofit clients that they maintain D&O Insurance, and we usually strongly recommend that our clients who are volunteers confirm that D&O Insurance is in place before serving as an officer or director of a nonprofit organization.

One of the most importance reasons to have

“Does it make sense for all nonprofit organizations to obtain liability insurance?”

The answer is, it depends.”

D&O Insurance is that it covers and pays for the most expensive part of any lawsuit: determining the facts and mounting a defense at the outset of the lawsuit.

Without D&O Insurance, the cost and expense of legal defense is borne by the nonprofit and/or the volunteer him/herself. Of course, D&O Insurance only covers the cost of legal defense if ultimately the court determines there is no legal liability. Additionally, D&O Insurance policies do not cover IRS fines and penalties for violations of federal tax laws, such as when directors decide to give themselves excessive salaries or benefits, and almost always contain other exclusions.

Disclosing Information When Applying for Coverage

When applying for insurance coverage it is crucial to disclose all activities and arrangements with employees or third parties, especially if the activities are somewhat unusual. There may be additional supplementary coverage (in the form of endorsements) that would fully protect the organization from any special risks it may face.

It is also important to disclose any current situations that could lead to a lawsuit or other claim. There is no benefit in concealing such a situation, as insurance carriers will invariably discover the organization was aware of the possibility. Generally pending matters are not a cause for denial of coverage or higher premiums; they are just excluded from coverage.

Focusing on the Details in D&O Insurance Policies

Most insurance companies write their own specialized D&O Insurance policy, resulting in a wide variety of policies available on the market. (Commonly, liability insurance has standardized language that is amended by specific endorsements.) Frequently, D&O Insurance policies are initially designed with for-profit organizations in mind, which can complicate matters. It is important to review the policy to determine whether the needs of the specific nonprofit are addressed. A few of the most desirable coverage provisions for nonprofits and their volunteers include:

The Definition of “Insured.” The policy should provide a definition of “Insured” that includes directors and officers, as well as the organization itself. D&O Insurance policies that define “Insured” more broadly will include past directors and officers, as well as employees.

Other Definitions. Although laborious, the organization should review all definitions contained in the D&O Insurance policy. For example, “What is a ‘loss,’ when does it occur, and when is it paid?” Often the language can be quite difficult to understand, but lack of understanding can be disastrous to the nonprofit that must use its own funds to pay legal fees in the event of a dispute. The nonprofit should seek professional advice if understanding and defining the terms of the policy is difficult.

Advancement of Defense Costs. A better D&O Insurance policy is one that requires the insurer to advance the costs of a legal defense. In contrast, a policy that includes reimbursement language often requires the nonprofit to pay all costs and attorneys' fees during the dispute, submit paper work at the conclusion of the dispute, and wait for reimbursement by the insurer. Since mounting a legal defense is usually both expensive and lengthy, policies which provide only for reimbursement and not advancement of expenses can severely hamper a nonprofit's ability to defend a claim. D&O coverage should provide for advancement of the costs of legal defense-even if a claim is without merit. Additionally, D&O Insurance should include entity coverage, which will cover a judgment against the nonprofit. see LIABILITY PROTECTIONS FEE, page 8



NEW LEGISLATION GRANTS LEAVES TO FAMILIES OF MILITARY SERVICE MEMBERS

By Valerie Menager, Esq.

Virtually all employers are subject to laws protecting the rights of employees who take leaves from work for their own military service. Recently, both California and federal legislation has been enacted to extend some of these protections to employees who are the relatives of military service members. Most of this legislation is effective immediately and, therefore, it is important employers understand their responsibilities and duties under these new laws now.

1. California Military Spouse Leave (2007)

On October 9, 2007, Governor Schwarzenegger signed into law AB 392 which is now codified in California Military & Veteran Code § 395.10 ("Military Spouse Leave"). The Military Spouse Leave law applies to all employers with 25 or more employees, and provides up to 10 days of unpaid leave for the spouse or registered domestic partner of a qualifying military member.

Let's explore the requirements of the California Military Spouse Leave law by considering the following hypothetical situation:

Mary and Martin

Your California company has just hired its 25th employee, Mary, into a full time exempt position. After working just one week, Mary informs you on Monday that her spouse, Martin, a member of the Armed Services, will be returning home on leave from Iraq in two days. Mary requests a week of paid leave to be with Martin commencing on Wednesday. Do you have to provide Mary with this leave, and if so, do you have to pay her for it?

In order for an employee to be eligible to take up to 10 days of Military Spouse leave, they must be regularly scheduled to work 20 or more hours per week for their employer. Independent contractors are not eligible for this benefit. A "qualifying military member" includes active duty members of the Armed Forces on leave from deployment serving in a combat theater or zone during a military conflict, and National Guard and Military Reserve members on leave from deployment during a military conflict.

Employees are required to request the leave from their employer no later than two business days after receiving official notice that their spouse will be on leave from deployment. Employers are not obligated to pay non-exempt employees on leave, but must pay a full week's salary to exempt employees who perform any work in a work week. No pay needs to be given to exempt employees who do not perform any work in a workweek. Employers can allow employees to use sick and or vacation/PTO during the leave, but cannot require them to do so. Employers subject to this law cannot retaliate against employees who request or take this leave. Employees have the right to reinstatement to their position upon return from the leave.

Must you grant Mary her request for leave even though she just started working for your company?

"Employees have the right to reinstatement to their position upon return from the leave."

Yes. Your company is required to grant Mary a leave of absence of up to 10 days because it has 25 employees, and Mary informed you within 2 days of receiving notice that Martin was returning from Iraq on a leave from the Armed Services. This is true even though Mary just started work with your Company, because the California Military Spouse Leave law has no length of service requirement.

Do you have to pay Mary during her one week leave? Although California's Military Spouse Leave law does not provide for any pay during the leave, employers can allow employees to use sick and/or vacation/PTO during the leave, but cannot require them to do so. In Mary's case she will not have any accrued sick or vacation leave since she just started work. However, Mary is an exempt employee, and under California labor law an exempt employee is entitled to a week's pay for any workweek during which she worked for the Company. If the Company's workweek is normally Monday through Friday, and Mary's leave runs from Wednesday through Tuesday, then you will have to pay Mary her full salary during the days that she is absent due to her leave.

2. FMLA Expanded to Cover Families of Service Members (2008).

On the heels of the enactment of California's Military Spouse Leave law, President Bush signed into law the National Defense Authorization Act for FY 2008 ("NDAA") which included the first major amendment of the Family Medical Leave Act ("FMLA"). Specifically this legislation requires employers of 50 or more employees to provide to qualified employees:

- a. up to 12 weeks of unpaid leave when a spouse (or in California, a Registered Domestic Partner), child or parent of an employee is on active duty or has been called or ordered to active duty in the Armed Forces. This leave may be used for "any qualifying exigency" arising out of the family member's active duty or their call to duty; and
- b. up to 26 weeks of FMLA leave in a 12 month period to care for an injured or ill service member who suffered the injury or illness while on active duty. In addition to family members covered under the FMLA, a service member's "nearest blood relative" or "next of kin" is also eligible for this type of leave. The total amount of FMLA leave provided in a 12 month period is limited to 26 weeks, although leave may be taken on an intermittent basis, or an employee may qualify for a reduced work schedule when medically necessary.

In addition to the family relationship requirement indicated for each of these leaves, in order for an employee to qualify for either of these unpaid leaves they must have worked for at least 1,250 hours in the 12 month period prior to requesting the leave. Under the Mary/Martin hypothetical situation described above, Mary would not be entitled to a leave under the federal FMLA to be with Martin while he is on leave because Mary would not have met the length of service requirement of working at least 1,250 hours in the prior year of employment. However, Mary's ineligibility for a leave under the FMLA would not invalidate her eligibility to leave under California's Military Spouse Leave law.

Let's consider another hypothetical situation in order to better understand the new military leave provisions of the federal FMLA:

Nathan and his Nephew

You are a Company with 50 or more employees and therefore covered by the FML. Nathan has been a full time, non-exempt employee with your company in California for a year and has used all of his accrued PTO of two weeks. Nathan informs you that he wants to take several weeks of leave to visit his Nephew who has just returned from serving with the Armed Services in Iraq. What questions should you ask in order to determine if Nathan is entitled to a leave?

Does Nathan qualify for a legally mandated leave? Since Nathan is the uncle of the person for whom he is requesting a leave, he is not entitled to take this leave under California's Military Spouse law. However, under the federal FMLA, Nathan meets the length of service test, as an uncle, but is still not entitled to take this leave unless he is taking the leave to care for "an injured or ill service member who suffered the injury or illness while on active duty." Your company is entitled to ask Nathan if (1) his Nephew is injured or ill as a result of his military service, and (2) if there is a more closely related relative who is available to care for the Nephew. Your company is also entitled to require Nathan to provide certification issued by a health care provider regarding the Nephew's medical condition to support Nathan's request for leave. If Nathan can provide certification that his Nephew was injured or is ill as a result of his service in Iraq, and informs you that his Nephew does not have a closer related family member to provide the needed care, then Nathan is eligible for unpaid leave up to 26 weeks. Nathan must be reinstated to work if he returns within the 26 week period, and is protected from retaliation for taking or requesting leave under the FMLA.

Do you need to pay Nathan during his leave?

Unlike Mary, Nathan is a non-exempt employee, and therefore is entitled only to pay for the hours he actually works. Since Nathan has already used up his accrued paid time off, he is most likely not entitled to any pay during his leave. However, similar to other types of FMLA leave, an employer must continue benefits to an employee while taking FMLA leave. This means that if your Company is paying for Nathan's health benefits or other employee related benefits, it must continue to pay for these benefits during the period Nathan is on leave, up to a maximum of 26 weeks.

The U.S. Department of Labor ("DOL") states that the 26 week leave for caring for an injured or ill service member became effective on January 28, 2008; however, the 12 week leave for a service member's participation in active duty or call to active duty is not effective until the DOL regulations are issued defining the term "qualifying exigency." Nevertheless, the DOL has stated that prior to issuing its final regulations on the NDAA, it "encourages" employers to provide leaves requested by family of service members due to exigencies.

The enactment of these new laws giving leave rights to the relatives of service members is complex and evolving. We encourage employers to consult with Carr McClellan to ensure they are in compliance with these new state and federal laws.

Valerie Menager is a member of the Employment Law Group.

"...to satisfy California Commissioner of Corporations statements, the seller of a TIC interest must not be connected in any way with management of the property."

TAX LAW ALERT

New Rules for Excluding Gain on the Sale of Principal Residences

Congress enacted new rules that apply to the sale of a principal residence and may restrict the ability to shelter gain on the sale.

Under the old rules, an individual could exclude \$250,000 (and \$500,000 for a married couple) of gain realized on the sale or exchange of a principal residence, provided the taxpayer used the residence as a principal residence for at least two of the five years ending on the sale or exchange.

The Housing Assistance Tax Act of 2008 introduces a new concept which may prorate the amount that can be excluded in certain instances.

1. The new rules only apply to the sale of a principal residence after December 31, 2008.

2. The rules introduce the new concept of "nonqualified use." This term applies to any period when the taxpayer does not use the residence as his personal residence before using it as his principal residence. Gain must be prorated when there is a nonqualified use period.

3. There cannot be a nonqualified use period before January 1, 2009.

Examples best illustrate these concepts:

A. An individual buys a principal residence on January 1, 2009, for \$400,000, moves out on January 1, 2019, and on December 1, 2021, sells the property for \$600,000. The entire \$200,000 gain is excluded from gross income because the periods after the last qualified use do not qualify as "nonqualified use." This example illustrates the old rules.

B. An individual buys property on January 1, 2009 for \$400,000 and uses it as rental property for two years. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the tax payer moves out and the taxpayer sells the property for \$700,000 on January 1, 2014. Of the \$300,000 gain, 40% of the gain (2 years divided by 5 years), or \$120,000, is allocated to nonqualified use and is not eligible for the exclusion. The remaining gain of \$180,000 may be fully excluded because it is less than the \$250,000 exclusion limit. This example illustrates the nonqualified use concept under the new rules.

Please contact Lage Andersen or Brendan Lund at (650) 342-9600 for more information about selling a personal residence.



THE CALIFORNIA LLC FEE RULED UNCONSTITUTIONAL - SO FILE CLAIMS FOR REFUND NOW

California's taxation of limited liability companies is in a state of flux. If you are a member of a limited liability company ("LLC") or are contemplating forming an LLC, it is important to understand the recent and possibly permanent changes to California's method of taxing LLCs. An LLC formed to carry on an active business, hold investment real property, or facilitate complex family estate planning would all be impacted by these changes.

On January 31, 2008, the California Court of Appeal upheld a trial court's ruling that California's unapportioned LLC fee was unconstitutional. (*Northwest Energetic Services, LLC v. California Franchise Tax Board*, January 31, 2008.)

On August 11, 2008, the California Court of Appeal also held that the limited liability fee was an unconstitutional tax. (*Ventas Finance I LLC v. California Franchise Tax Board*, August 11, 2008.) The court limited the refund to the difference between the levy actually paid and the amount that could have been assessed.

The trial court and appellate court analyzed California's existing LLC fee structure. Under current law, all LLCs doing business in California are subject to the state's LLC fee. Even if there is no California income, the LLC is still obligated to pay the fee on the LLC's "total income," that is, its worldwide income. The fees are permanently set as follows:

- \$900 if the total income is at least \$250,000 but less than \$500,000;
- \$2,500 if the total income is at least \$500,000 but less than \$1,000,000;
- \$6,000 if the total income is at least \$1,000,000 but less than \$5,000,000; and,
- \$11,790 if the total income is \$5,000,000 or more.

Both the trial court and the appellate court determined that this LLC fee structure violated fundamental tax principles. A prime tenet of state and federal taxation requires that a tax imposed by a state must

"Both the trial court and the appellate court determined that this LLC structure violated fundamental tax principles."

(1) have "substantial nexus with the taxing state;" (2) be "fairly apportioned" between income earned inside the taxing state and outside the taxing state; (3) "not discriminate against interstate commerce;" and (4) be "fairly related to the service provided by the state." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). Applying these tests to the LLC fee, California courts concluded that the fee is invalid because it is not fairly apportioned. That is, the LLC fee taxes too much LLC income rather than only the income earned or related to California. Consequently, both courts held that the LLC fee was unconstitutional.

The recent appellate court ruling was anticipated. The California Legislature passed AB 198, which revised the terms of the LLC fee. Governor Schwarzenegger signed AB 198 into law on October 11, 2007, prior to the appellate court ruling. This new law preemptively reduced the state's obligation to refund LLC fees in the event it was declared unconstitutional. The Legislature made an "11th hour" play to protect California's coffers. AB 198 changes the LLC fee calculation in two significant ways: (1) The amount of the fee is determined using only California income for tax years beginning on or after January 1, 2007; and (2) If the LLC fee was declared unconstitutional, a taxpayer filing a claim for refund for year prior to 2007 would only be entitled to a refund related to the income earned outside of California.

The Legislature retroactively revised the fee calculation by requiring the amount of the LLC fee to be determined on only California income. AB 198 essentially provides that while the court can declare the entire LLC fee unconstitutional, the legislature will only allow refunds for the portion that LLCs were "harmed" by the unconstitutionality of the fee.

Under AB 198, LLCs operating solely in California will not be entitled to any refund of previously paid LLC fee. LLCs generating income from California and outside California will receive a refund of only the LLC fee related to income earned outside California.

The Franchise Tax Board (FTB) has not decided whether to appeal the appellate court decision to California's Supreme Court. In the meantime, the FTB is allowing taxpayers to file a "protective claim," which preserves the LLCs right to refund. If you need assistance in filing this claim or need further clarification about an LLC issue, please contact Lage Andersen or Brendan Lund at (650) 342-9600.

Employment Practices Liability Coverage.

Approximately ninety percent of all claims against boards of directors involve some type of employment dispute. The list of common employment disputes is extensive, including: wrongful termination; failure to hire; failure to promote; harassment; sexual, racial or age discrimination; and non-compliance with the Americans with Disabilities Act (ADA). Because employment disputes are predominant, insurers are becoming more keenly aware of this exposure. Some insurance companies have made subtle policy changes to restrict coverage in these areas. If the D&O Insurance policy includes a specific list of covered actions, be certain that the list is inclusive, rather than exclusive, of these types of claims and provides coverage for cases arising under both state and federal laws. Also, check whether a separate deductible applies to employment-related allegations. In the event the D&O Insurance policy does not cover employment related claims against directors and officers, a separate Employment Practices Liability Insurance policy may be obtained.

Breach of Fiduciary Duty Coverage. While employment practices disputes generate the most lawsuits against directors, another common allegation is breach of fiduciary duty. A lawsuit alleging breach of fiduciary duty could be brought against a director by a donor, a concerned citizen, or the Attorney General. This type of lawsuit alleges that the board of directors is not appropriately using and protecting the assets and resources of the nonprofit organization, or that the directors receive excessive benefits from the organization. A well written D&O Insurance policy will generally advance expenses incurred while defending against such claims; however, as previously noted, IRS fines against directors for receiving or approving "excessive" benefits are not covered. Under certain severe circumstances, a nonprofit may lose its tax exempt status as a result of such benefits.

Other Protection Vehicles

Homeowner's Insurance. An individual's homeowner's insurance policy may provide some insurance coverage for volunteer services, but the extent of that coverage depends on the specific wording of the policy. Typically, a homeowner's policy provides coverage for accidents, but these policies seldom provide protection for a director's or officer's management and governance decisions.

Bylaw Indemnification. Frequently, a nonprofit's bylaws provide for indemnification of directors. This promise, however, is only as good as the amount of the nonprofit's unrestricted assets that are available to mount a defense. In addition, nonprofits are not generally permitted to indemnify directors against certain types of actions, such as allegations of self-dealing. Thus, the nonprofit may be prohibited from using charitable dollars to defend a director against this type of claim.

If a Claim is Filed

If a claim against a director or officer is threatened or filed, it is important that the nonprofit immediately notify its insurance agent and consult its legal advisor.

By doing so, the organization may be able to obtain advice on how to resolve the situation before costly litigation commences. If litigation cannot be avoided, early notice to the insurance company may result in the insurance company advancing the costs of the legal defense. A nonprofit that proceeds with its own legal defense and later seeks reimbursement may have its claim questioned or its request for reimbursement denied.

Protection for the Organization

The statutory protections discussed above apply only to individual directors and officers. However, a lawsuit will typically name as defendants not only the individual directors and officers, but the organization as well. As previously stated, there is no California or federal law that provides any protection, no matter how minimal, for the nonprofit organization itself.

Moreover, there is no California or federal law that protects a nonprofit organization from being sued for the actions of its volunteers. In fact, the law makes it crystal clear that nonprofits are held responsible for the actions of their volunteers! Therefore, a properly crafted D&O Insurance policy is the only available protection for the organization.

Finally, no state law can offer protection to a director, officer or organization from claims for breach of federal law, such as claims for discrimination based on race, sexual orientation, age, or disability. As discussed earlier, a D&O Insurance policy may provide coverage for such allegations, absent a determination that the law was intentionally broken.

Conclusion

Contrary to popular belief, the protection of volunteer directors and officers of nonprofit organizations under California and federal law is quite limited. And there is no law that specifically protects the nonprofit organization. Although nonprofit directors and officers may claim some legal protection under California and federal law, they may only do so if the organization they serve maintains appropriate liability insurance coverage, such as a D&O Insurance policy. The protection afforded by an insurance policy, however, is only as strong as the specific provisions in the policy.

Since the vast majority of legal actions against nonprofit organizations involve some type of employment dispute, the greater the number of employees means the greater the risk that a cause of action will be brought for personal liability against a volunteer director or officer. In addition, an organization with more liquid assets has higher exposure. The amount and type of coverage should take these factors into account to ensure the organization is neither over-nor under-insured.

Nonprofit managers should ask their professional legal and business advisers to review any current and new policies for any potential gaps in coverage as well as ways to mitigate their risks in the event of a lawsuit.

Quynh Tran is a member of the Estate Planning, Trusts & Wealth Transfer Group, and the Exempt Organizations Group. Suzanne Bonotto is a member of the Intellectual Property Group.

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