PROTECTING ASSETS WITH LEGAL ENTITIES

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DISCLAIMER

THE INFORMATION CONTAINED IN THIS PRESENTATION IS ONLY INTENDED TO PROVIDE YOU WITH A GENERAL UNDERSTANDING OF LABOR AND EMPLOYMENT LAW AND SOME OF THE CURRENT LEGAL CHALLENGES FACING EMPLOYERS IN AGRICULTURAL INDUSTRY. THE INFORMATION CONTAINED IN THIS PRESENTATION IS NOT TO BE CONSTRUED AS LEGAL ADVICE AND IS NOT MEANT TO BE A SUBSTITUTE FOR LEGAL ADVICE. YOU SHOULD CONSULT WITH QUALIFIED LEGAL COUNSEL FOR ADVICE FOR ANY PARTICULAR SITUATION.

REAL LIFE EXAMPLE

- A grower, a packinghouse, and an FLC are in the tomato business. The grower plants and grows (using FLC labor), and leases the ground each year. The packinghouse oversees the harvest, directing the FLC's work. The FLC provides planting and harvest labor each year.

- Class action lawsuit has been filed. The FLC has engaged in….irregularities. Everyone is facing potentially severe liability due to joint employment. The grower has a large operation on ground it owns that needs to be protected.

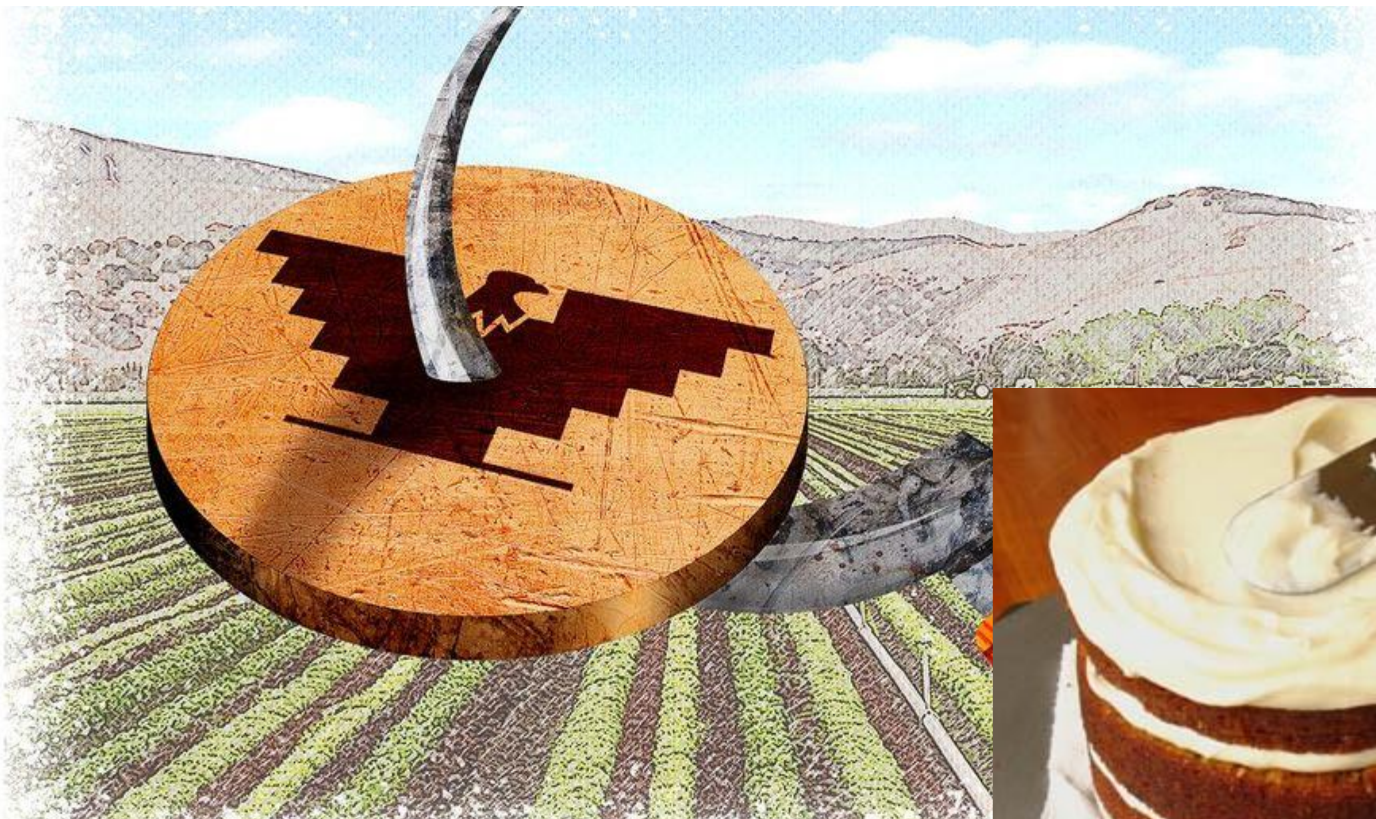
- The good news:
  - The grower formed a separate corporation to lease the tomato ground. This corporation has no assets.
  - On paper, the packinghouse is merely a shipper.
  - Grower pays the FLC, and is reimbursed for the labor under it's deal with the packinghouse.

- The grower dissolved the tomato corporation. The packinghouse was dismissed as a shipper, not a joint employer (Martinez v. Combs). The FLC filed for bankruptcy (up and running with a new license within a few months).

- Nobody noticed that the equipment had the grower's main operation name all over it. Grower and packinghouse protected, FLC still in business.

WITH A BONUS

We used the same arrangement to deflect the ALRB and the UFW by convincing the ALRB that the grower (agricultural employer) was defunct.




THE GERMANS PLANNED
A SPECTACULAR MATCH -
THE PRISONERS PLANNED
A SPECTACULAR ESCAPE.
ESCAPE TO
VICTORY

BUSINESS STRUCTURE

- LLC's and Corporations can be used to protect personal assets from liabilities.
  - There are tax advantages and disadvantages.
    - Single owner LLCs are federally taxed like sole proprietorships, and multiple owner LLCs are federally taxed like partnerships
    - California does impose additional "franchise taxes" in addition to income tax.

- Corporations
  - S-Corp can offer some tax advantages
  - C-Corp can be double taxation due to the corporation being taxed on income, and shareholders being taxed on distributions
  - Corporations are more complicated to maintain than LLCs

- In wage cases, individual owners of corporations and LLCs can have exposure to liability, but in other types of cases (discrimination/wrongful termination/harassment) can avoid exposure.

  - The barrier does have practical advantages, even in wage cases.

CORPORATIONS AND LLCs

- When making your decision between an LLC and an S Corp, it's effective to focus on three particular areas of key importance to business owners:

  - Personal liability to the owners from business-associated liabilities are limited and the necessary formalities that come along with the maintenance of limited liability are limited as well.
  - Taxes which could potentially be associated with your business are limited.
  - Any special circumstance considered important to principals or applies to a factual circumstance.

- It's key to first establish the number of owners or shareholders of the new entity you're forming-owners are called shareholders in an S Corp and members in an LLC. Determining the number of owners before establishing the business is very important; it is a straightforward process with one owner.

S CORPORATION OVERVIEW

- **Limit Liability by Paying Respect to Corporate Formalities**
  - Do not be misled by low-cost online services which promote "self-help" and only achieve the basic task of obtaining Articles of Incorporation from the Secretary of State without any follow-up documentation afterward- these follow through formalities are required according to California law.
- **Tax Considerations**
  - Generally, an S corporation is not subject to federal income tax. The corporation divides its losses and income across the shareholders in proportion to how much ownership interest the shareholder has. ***The shareholders are required to report the losses and income on their own personal income tax returns; this is why the entity is referred to as a "flow-through."***
  - Keep California taxation in mind.

S CORP REQUIREMENTS

- All shareholders must be a:
  - U.S. citizen
  - Legal U.S. resident
  - Qualified type of trust
  - Qualified estate
- Corporations cannot be shareholders within an S corporation.
- 100 shareholder limit.
- Shareholders who are related are treated as an individual shareholder following rules on family attribution.
- The evidence of owning an S corporation are stock certificates issued to individual owners at the formation of the corporation.

LLC OVERVIEW

- **Moderate Formalities as Compared to an S Corporation**
  - Articles of Organization rather than Articles of Incorporation to form a California LLC.
  - Draft an Operating Agreement.
  - File the Statement of Information with the Secretary of State in California in addition to other requirements beyond this text.
  - Owners are members, not shareholders.
- **LLC - Considerations for Taxes**
  - Profits and losses pass through the LLC and reported to the individual tax return of shareholder (same as partnership).
  - California imposes franchise taxes.

S CORP

- No tax advantages (or disadvantages) to forming an LLC. In fact, forming an LLC won't change a thing for Federal income tax purposes. Single-owner LLCs are taxed just like sole proprietorships, and multiple-owner LLCs are taxed just like partnerships.

- Forming an LLC might subject your business to additional state taxes. Certain states (California for instance) subject LLCs to "franchise taxes" in addition to a typical income tax.

- S Corps have the ability to provide some tax savings as a result of the fact that profits from an S Corp are not subject to Self-Employment Tax.
  - Before you're allowed to distribute any profits, must pay any owner-employees a "reasonable salary." This minimizes the tax benefit without significant profit.

- S Corps are significantly more complicated from a tax and legal standpoint than LLCs. So if you form an S Corp, know that you're going to be spending a great many more billable hours with your accountant/attorney.

C CORP

- C corporations are taxable entities. This means that the corporation itself is taxed on its income (as opposed to other structures which simply pass the income along to the owner(s), who are then taxed on it).

- If you don't plan to distribute all of the profits from your business, you might benefit from forming a C Corp and utilizing a strategy known as "income splitting."
  - Split the business income so that part of it is taxable to the corporation and part of it is taxable to the corporation's owner(s), thus putting them each in a lower tax bracket than they'd be in if either one was earning all of the income.
- The big disadvantage to C Corp taxation is that distributions of profits (known as "dividends") are subject to double taxation.
  - The corporation is taxed once on its income, and then the shareholders are taxed upon any dividends they receive.
- Also, like S corps, C Corps are more complicated from an accounting/tax/legal standpoint than sole proprietorships, partnerships, or LLCs.

S CORP AND LLC TAX

- S Corp profits and losses pass through the corporation and reported to the individual tax return of shareholder (same as partnership and LLC)
- Self-Employment Tax Break: Profits of the S Corp which pass through to the shareholders are not subject to self-employment tax (Social Security and Medicare which is approximately 15%).
  - Self-employment is only taxed on the portion classified as a "reasonable salary".
  - LLCs and sole-proprietorships must pay self-employment tax on all income. The ability to minimize self-employment tax is deemed to be one of the greatest benefits of a S-corporation.
- Corporate losses can be deducted from the individual tax returns of the shareholder thereby allowing them to offset other sources of income such as their W-2 income.
- Franchise tax is waived in the S Corp's first year. LLC must pay franchise tax its first year.
  - S Corp must pay the CA Franchise Tax board either a 1.5% tax on net CA income or $800, whichever is greater.

S CORP AND LLC TAX

- S Corp does not allow flexible allocation of profit and losses for shareholders. Corporate profits and losses must be split up proportionately to the percentage of shares owned by each shareholder.
  - LLC's allow for flexibility as to how they split their profits and losses – allows members to decide what each owner will receive.
- LLC members must pay self-employment tax on all income from the LLC. (15.3%)
- LLC losses can be deducted from the individual tax returns of the member thereby allowing them to offset other sources of income such as their W-2 income.
- Must pay first year minimum annual franchise tax of $800, and is due 75 days after formation and every year thereafter. Annual franchise tax is greater if total reported income is greater than $250,000. On highly profitable enterprises, the LLC franchise tax fees, which are based on gross revenues (minimum $800), may be lower than the 1.5% net income tax.
- Distribution of Profits and Losses: It is flexible since an LLC allows you to decide what share of the LLC profits and losses each owner will receive.
- In high gross revenue, low profit-margin businesses, the LLC franchise tax fees may exceed the S Corp net income tax.

PIERCING THE VEIL

- California law typically does *not* require a plaintiff to come forward with evidence of fraud. A California plaintiff only needs to show that honoring the corporate form would "promote injustice" or "bring about inequitable results."
- California utilizes a non-exclusive, multi-factor test. Courts have examined twenty factors including:
  - commingling of funds and other assets;
  - the holding out by an individual that he is personally liable for the debts of the corporation
  - failure to maintain adequate corporate records;
  - identical equitable ownership in the two entities;
  - identification of the directors and officers of the two entities in the responsible supervision and management;
  - sole ownership of all of the stock in a corporation by one individual or the members of a family;
  - the use of the same office or business location;
  - the employment of the same employees and/or attorney; and
  - failure to maintain arm's length relationships among related entities.
- In labor and employment, common or centralized management or administration can link separate entities as a single employer.

TRUSTS

- Trusts are fiduciary arrangements which allow third parties to manage assets on behalf of beneficiaries.
  - The person who manages the assets is referred to as the trustee.
  - The person who forms the trust is known as the settlor of the trust.

- Trusts split the beneficial interest of assets from their legal ownership.
  - Beneficiaries of trusts hold equitable interest in the assets held within the trust, but do not hold legal title.
  - The legal title of the assets held within the trust belongs to the trustee.
  - The trustee acts as a fiduciary for the beneficiary or beneficiaries.
  - The trustee's sole obligation is to administer the assets held within the trust for the benefit of the beneficiaries under the terms of the trust.
  - The trust typically directs the trustee to disregard the interest of any other parties with regards to the management of the trust.

TRUSTS

- Revocable trust
  - This trust can be modified, changed, or terminated at any moment. This can be done without the permission of the beneficiary, as long as the trustor is of full mental capacity to do so on their own.
  - Typically used for estate planning – "Living trust" or "family trust." Transfers ownership on death.
  - No asset protection.

- Irrevocable trust
  - Once the trust is made, the creator no longer has any rights to the trust. They are unable to change or terminate it at any time throughout their life.
  - Also common in estate planning.
  - Settlor gives up ownership and control.
  - Provides asset protection – creditors of the settlor cannot reach in to the trust. Creditors "step into the shoes" of the debtor and can only reach trust assets to the degree the debtor can.
  - There are exemptions, including child support….and taxes.

TRUSTS AND ASSET PROTECTION

- The qualified personal residence trusts or QPRTs are a form of irrevocable trust which is frequently used in estate planning and asset protection.
  - QPRTs work by moving the settlor’s personal residence out of their estate. They do so by assigning the residence a low gift tax value. Once the residence has been placed in the trust, both the property itself and any future appreciations are excluded from the settlor’s estate.
  - The settlor retains the right to live in the residence rent-free for a predetermined number of years. The remainder of the interest in the residence is allocated to the beneficiaries of the trust, such as their children. So, the beneficiaries live in the property for, say, 20 years. From there forward they rent the property from their children.
  - Technically, the interest which the settlor retains in the residence would not be protected from the claims of creditors, but claims are virtually unheard of because the limited interest of the settlor is not sellable via foreclosure.
  - QPRTs have proven to be a viable option to protect a home in California from lawsuits.

TRUSTS AND ASSET PROTECTION

- Spendthrift trusts are designed to prevent trust beneficiaries from squandering their funds. They do so by limiting or altogether removing the ability of beneficiaries to transfer or assign their interest in the trust. These restrictions apply to both the income and the principal of the trust. Nearly all modern trusts incorporate a spendthrift clause.
  - Because beneficiaries do not retain control over their interest in the trust, their creditors are unable to attack the assets held within the trust. However, this protection applies solely to assets held within the trust. Once the property has been distributed to the beneficiary, it is subject to the claims of creditors. The exception to this rule is the extent to which the distribution will be used for the support of the beneficiary.
- In a discretionary trust, the trustee has discretion with regards to the timing and amount of distributions of assets held within the trust. They also have discretion with regards to the identity of the beneficiary. Discretionary trusts must not contain controlling provisions which mandate distributions of trust assets. They may, however, include provisions which set standards for how trustees make distributions. Beneficiaries have no property rights with regards to the assets held within a discretionary trust. As a result, it is a challenge for a beneficiary's creditors to pursue the assets of a discretionary trust.

TRUSTS AND ASSET PROTECTION

- Domestic Asset Protection Trusts (DAPT)
  - Most people seeking asset protection are seeking to protect their own assets, rather than the assets of beneficiaries. To accomplish this, one needs a self-settled trust. Self-settled means the settlor or grantor who created the trust is also a trust beneficiary.
- Self-settled spendthrift trusts are not permitted in California. As a result, many California residents choose to establish trusts in jurisdictions where this practice is allowed. As of this writing, there are currently sixteen states in the United States which permit domestic asset protection trusts or DAPTs.
- In order for a trust to be considered a domestic asset protection trust, it must be irrevocable and contain a spendthrift clause. It must also have a trustee who is a resident of the state where the trust is established. Additionally, some administration of the trust must take place in the jurisdiction where the trust is settled. The settlor of a domestic asset protection trust may not act as the trustee.
- Though their track records are shaky, domestic asset protection trusts are preferable to the various California asset protection trust options in protecting the assets of the settlor.
- They are inferior to offshore trusts for two reasons. First, domestic asset protection trusts are subject to the judgments of US courts. This includes judgments regarding the California Fraudulent Transfer Act, which nullifies the protection afforded by the trust. Second, California judges typically enforce the California asset protection laws and disregard those in the foreign trust jurisdiction. Third of all, domestic asset protection trusts are generally not protected from the claims of exemption creditors.

TRUSTS AND ASSET PROTECTION

- Offshore trusts provide the most exhaustive protection available to California residents seeking to protect their assets. Like domestic asset protection trusts, self-settled offshore trusts are available in many jurisdictions. They also contain spendthrift clauses.
  - The advantage of an offshore trust is that, in many jurisdictions, foreign judgments are not recognized by local courts.
  - Creditors who want to attack the assets held in an offshore trust must travel to the foreign jurisdiction. They must then spend the time and money necessary to have their case re-adjudicated through the local court system.
  - Can be more trouble than it is worth and creditors will drop their claims.
  - Additionally, offshore jurisdictions often have much shorter statutes of limitations on claims of fraudulent transfer. Once the clock runs out on the statute of limitations, assets held in an offshore trust are virtually untouchable.
  - Offshore jurisdictions usually do not identify exemption creditors. As a result, offshore trusts can prove particularly advantageous in protecting assets in the event of divorce.
  - Remember that an California asset protection trust to protect your own assets and have them available for use at a later time does not exist under California law. So, that is why so many Californians seeking asset protection opt for the power of the offshore asset protection trust managed by an offshore law firm.

INDIVIDUAL LIABILITY IN EMPLOYMENT CASES

- **California Labor Code Section 558.1**
- California Labor Code § 558.1, effective January 1, 2016, states that an employer or "*other person acting on behalf of an employer*" who violates California's wage and hour laws "may be held liable as the employer[.]"
  - These wage and hour violations include unpaid overtime, unpaid minimum wage, denied meal/rest breaks, untimely termination pay, inadequate wage statements, and failing to reimburse employee business expenses.
- The statute defines "other person acting on behalf of an employer" rather broadly as a "**natural person who is an owner, director, officer, or *managing agent***" of the employer as defined under California Civil Code § 3294, a punitive damages statue.
- This extension of liability to individuals does not apply to cases other than wage and hour cases.

MANAGING AGENT

- "Managing agent" status is determined on a "case-by-case basis."
  - "Managing agent" includes "those corporate employees who exercise substantial independent authority and judgment in corporate decision making so that their decisions ultimately determine corporate policy."
- "Managing agent" does not cover supervisory employees with "limited decision making authority, but [who] possess the ability to hire and fire company employees."
  - According to the California Supreme Court, California's legislature intended to limit the class of employees whose exercise of discretion could result in an employer's liability by placing "managing agent[]" in the same category as "officer" and "director[.]"
- Case law analyzing Labor Code § 558.1 is sparse which provides companies and employees with little direction as to how a court may interpret an employee's role for wage and hour violations. A recent case analyzing the liability of a company director, however, is straightforward. The District Court in the Southern District of California found Section 558.1 "specifically provided" for the liability of two company directors.

INDIVIDUAL LIABILITY IN HARASSMENT CASES

- Under California FEHA, but not under federal Title VII, supervisors and non-supervisory employees can be held individually responsible for engaging in sexual harassment.
- Supervisors are not personally liable for failing to prevent or stop harassment.
- Supervisors are not personally liable for retaliation.

INDEMNIFICATION

- Although Section 558.1 allows for an employee's personal liability, California employees will rarely pay for wage and hour violations.

- California law requires employers to indemnify employees for expenses, including legal expenses generated by claims against them.

- For an employee to receive indemnification, however, he must have been working within the scope of his employment and believed that in discharging his duties, his actions were lawful. Thus, if a court holds an officer, director, or managing agent liable for unpaid wages, the employer must reimburse that person for his legal expenses.

- In harassment cases, employers often argue that supervisors and others accused of severe harassment were acting outside the scope of their employment to avoid responsibility for defense fees.

WHAT DOES IT LOOK LIKE?

- Atempa v. Pedrazzani (2018) 27 Cal.App.5th 809. (unanimous decision)
  - Individuals responsible for overtime and/or minimum wage violations in fact ***can be held personally liable for civil penalties, regardless of whether they were the employer or the employer is a limited liability entity***.
  - Private plaintiffs may pursue and collect these penalties for "aggrieved employees" on behalf of the state of California through the Private Attorneys' General Act ("PAGA")

- Paolo Pedrazzani was the owner, president, director, and secretary of Pama, Inc. (a restaurant). Two former employees filed a variety of wage-hour claims against Pedrazzani and his business, including claims for civil penalties on the basis of unpaid minimum wages and unpaid overtime.

- Following a judgment in favor of the employees that Pedrazzani and Pama were jointly and severally liable for the civil penalties, Pedrazzani appealed and Pama filed for bankruptcy.
  - Civil penalties $30,000, attorneys' fees $315,014

WHAT DOES IT LOOK LIKE?

- … "the Legislature has decided that ***both*** the employer and any 'other person' who causes a violation of the overtime pay or minimum wage laws are subject to specified civil penalties." The owner was personally liable for the entire judgment.

- Because neither statute mentions corporate structure, corporate form, or suggests that the same has any bearing on liability, the Court of Appeal concuded that "***the business structure of the employer is irrelevant."***

- The Court also held that personal liability can attach ***even if a person has no formal relationship with the corporate employer*** (e.g., employee, manager, officer).
- Rather, for overtime violations, it is sufficient that that the "other person" was ***"acting on behalf of the employer";*** and for minimum wage violations, it is sufficient that the "other person" ***"pays or causes to be paid less than the prescribed minimum wage.***" Summarizing, the Court held that the statutes at issue "provide for an award of civil penalties against the person who committed the underlying statutory violations."

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INSURANCE SOLUTIONS

- Employment Practices Liability Insurance (EPLI) provides defense and liability coverage for discrimination, harassment and similar cases.

- The typical EPLI includes an exclusion for claims arising out of alleged violation of federal and state wage and hour laws. Some policies will include a modest sublimit (usually in the range of $100,000 to $250,000) for ***defense*** expense.

- Many cases involve vast amounts of ***penalites***. The typical management liability policy will usually expressly exclude a loss that is covered under the policy ***"fines, penalties, and amounts deemed uninsurable under applicable law."***

- Section 533 of the California Insurance Code expressly prohibits insuring liability for willful misconduct. Carriers will undoubtedly use this to attempt to avoid coverage.

- Stay tuned.

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INSURANCE SOLUTIONS

- Possible solutions include Directors & Officers policy Side A coverage.
  - D&O liability policies are often written to include coverage for lawsuits brought directly against the organization (side "C" coverage), which has resulted in a sharing of the policy limits among the organization and its directors, officers or members.
  - Some bankruptcy courts have in some situations seized the D&O liability policy as an asset of the bankruptcy estate, leaving the directors, officers or members without coverage.
  - One benefit of the excess/DIC side "A" coverage is that it provides separate limits that apply only for the directors and officers, not the organization.

- Detailed attention to insurance for all contingencies should be a consideration for every entity with wage and hour class action risk.

NOBODY SAID YOU CAN MAKE IT WITHOUT A FIGHT.